Accounting Standards Board may 2002 fred 23

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FINANCIAL INSTRUMENTS:

HEDGE ACCOUNTING

ACCOUNTING
STANDARDS
BOARD

FINANCIAL REPORTING
EXPOSURE DRAFT

For the convenience of respondents in compiling their responses, the text of the questions in the Preface on which particular comments are invited (pages 7 and 8) can be downloaded (in Word format) from the 'Financial Instruments: Measurement' pages in the Current Projects section of the ASB Website (www.asb.org.uk).

For ease of handling, we prefer comments to be sent (in Word format) by email to:

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Comments may also be sent in hard copy form to:

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Comments should be despatched so as to be received no later than 16 September 2002. All replies will be regarded as on the public record and may be copied to the IASB and other standard-setters, unless confidentiality is requested by the commentator.

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[Draft] Financial Reporting Standard • is set out in paragraphs 1 – 22.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1, the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the [draft] FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix IV 'The development of the FRED' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions in the [draft] FRS.

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comment received before being issued in final form.

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PREFACE

Entities often enter into transactions to mitigate or 'hedge' the risks arising from assets, liabilities and other exposures that they have. To account for such transactions, the practice has grown up whereby gains and losses on the hedging instrument are deferred so that they can be included in the profit and loss account in the same period (or periods) as those on the hedged item. This practice is known as hedge accounting. Financial Reporting Exposure Draft (FRED) 23 sets out proposed restrictions on the use of hedge accounting. The proposal is that an accounting standard based on the FRED should come into effect for financial statements ending on or after a date in early 2003.

The FRED's proposals focus exclusively on the use of hedge accounting to account *for financial instruments*. Not all hedging instruments are financial instruments and not all hedged risks arise from financial instruments, so only some types of hedge accounting are covered by the FRED.

The need for an accounting standard on hedge accounting for financial instruments

Improvement in the quality of financial statements

Although there is the overarching requirement that financial statements should show a true and fair view, there are few explicit restrictions in existing UK accounting literature on the use of hedge accounting. Yet it can have a significant effect on an entity's reported financial performance and financial position and its use raises some fundamental questions for standard-setters.

The Accounting Standards Board (ASB) considered many of those questions in a Discussion Paper 'Derivatives and other Financial Instruments' (issued in July 1996)* and concluded that there should, at the very least, be some restrictions on the use of hedge accounting. The FRED proposes to do that by:

- permitting hedge accounting to be used only where the hedging relationship has been pre-designated and meets certain hedge effectiveness tests; and
- limiting the range of hedge accounting techniques that can be used by requiring the techniques adopted to conform to certain minimum standards.

The ASB believes that such restrictions will improve the quality of financial statements generally and will result in greater comparability of the information they provide.

Filling a potential gap in UK accounting literature

An FRS on hedge accounting will also fill a gap that might otherwise appear in UK accounting literature in 2003. SSAP 20 'Foreign currency translation' contains requirements about hedges of net investments in foreign operations. The ASB is proposing† that SSAP 20 should be replaced by a standard based on the revised version of IAS 21 'The Effects of Changes in Foreign Exchange Rates' that the International Accounting Standards Board (IASB) has recently issued in draft form. The draft revised IAS 21 does not address hedges

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* *The Discussion Paper also dealt with a number of issues other than hedge accounting.*

† *In FRED 24 'The Effects of Changes in Foreign Exchange Rate & Financial Reporting in Hyperinflationary Economies'.*

of net investments in foreign operations because another international accounting standard—IAS 39 'Financial Instruments: Recognition and Measurement'—deals with the subject. As a result, the proposed new UK standard in FRED 24 does not address the subject either. Therefore, when that standard is implemented, the existing UK requirements on hedges of net investments in foreign operations will be withdrawn. That will not result in a gap appearing in UK accounting literature because the FRED contains material on such hedges.

Convergence

EU Ministers have proposed that, from 1 January 2005, all listed companies in the EU should prepare their consolidated financial statements in accordance with adopted international accounting standards. A draft Regulation to this effect is at a late stage of negotiation and EU Ministers are expected to approve it shortly. The intention is that IFRSs* will form the basis of those adopted international accounting standards.

After wide discussion with interested parties, the ASB has indicated its intention to pursue a programme of work to align UK accounting standards with IFRSs wherever practicable. The ASB is proposing to do this in the main by means of a phased replacement of existing UK standards with new UK standards based on the equivalent IFRSs. The FRED's proposals if implemented would be part of this process because, as explained below, much of the material in the proposed standard is drawn from IAS 39.

* *The IASB intends to designate its future standards as International Financial Reporting Standards, or IFRSs. Standards issued prior to 2002 are identified as International Accounting Standards, or IASs. In this Preface, the term IFRS is used to refer to both IFRSs and IASs.*

The relationship between the proposals in the FRED and IAS 39

In 1998 the IASB issued an interim standard on financial instruments, IAS 39, which contains hedge accounting requirements. Those requirements are based on the principle that, in order to qualify for hedge accounting treatment, a hedging relationship has to have been pre-designated and has to have met at the outset and continued to meet certain effectiveness criteria. The proposed standard in the FRED is based on that same principle and it repeats the IAS 39 requirements that implement the principle using, wherever possible, precisely the same wording as IAS 39.

In IAS 39, those requirements are supplemented by a number of more detailed restrictions which are not repeated in the FRED. To the extent that the 'more detailed restrictions' are not implied by the requirements implementing the principle described above, their omission from the FRED will mean that it is not as restrictive as IAS 39.

IAS 39 also specifies the accounting entries that should be made if hedge accounting is adopted. The ASB is proposing to omit those provisions from its standard, primarily because it is not feasible to do so in detail in the absence of a UK accounting standard on the measurement of financial instruments.

The IAS 39 amendments project

In July 2001 the IASB announced that it would be carrying out a high priority, short-term IAS 39 amendments project. Since then the IASB has been reviewing IAS 39 and an exposure draft setting out proposals on how the standard might be amended is expected to be issued shortly.

As explained in the preceding section, the proposed standard in the FRED repeats some of IAS 39's requirements, using precisely the same wording as the existing IAS 39. The intention is that, when the ASB issues the proposed standard in its final form, it will consider the wording of the IAS 39-sourced material to reflect any revisions to that wording proposed or implemented by the IASB.

Implementation and transitional arrangements

The FRED proposes that the requirements in the draft standard should apply to all new hedges taken out on or after the effective date, which is likely to be early 2003. It will also apply to hedges already in place at that time, except that the requirement for the hedge to be pre-designated will not apply.

Amendments to other UK standards

The FRED proposes a few minor consequential amendments to other FRSs and UITF Abstracts to reflect the inclusion in the proposed standard, rather than SSAP 20, of material on hedges of net investments in foreign operations. It also proposes the withdrawal of UITF Abstract 19 'Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise' because the requirements to which the Abstract refers will be superseded by requirements in this FRED and in FRED 24.

Particular issues on which comments are invited

The ASB would welcome comments on any aspect of the FRED. Respondents' views are especially sought on the matters set out below. It would be helpful if respondents could support comments with reasons and, where applicable, preferred alternatives.

1 Do you agree that a UK standard on hedge accounting is needed at this time to improve UK accounting and to prevent a gap appearing in UK accounting literature on hedges of net investments in foreign operations?

2 The ASB has taken the view that, in order to start the process of bringing UK practice on hedge accounting into line with the practice adopted internationally, the proposed UK standard's restrictions on the use of hedge accounting should be based on the main principle that underlies the hedge accounting restrictions in IAS 39: that hedge accounting should be permitted only if the hedging relationship is pre-designated and meets certain effectiveness criteria.

(a) Do you agree that the UK standard should be based on the principles underlying IAS 39 as set out in the FRED?

(b) Does the principle need to be supplemented by any other principles?

3 The ASB has taken the view that the UK standard should contain those detailed restrictions in IAS 39 that appear to it to be necessary to implement the aforementioned principle, but should not at this stage include any other restrictions on the use of hedge accounting.

(a) Do you agree that the FRED's proposed restrictions on the use of hedge accounting (see paragraphs 4, 6 and 8 of the FRED) are all necessary to implement the aforementioned principle?

(b) Do you agree that the FRED should not contain any other restrictions on the use of hedge accounting? If not, what should those other restrictions be?

4 Do you agree with the material in the FRED on measuring hedge effectiveness (see paragraphs 9-15 of the FRED)? If you do not, what if any changes would you make to the material (bearing in mind that the material is drawn largely from IAS 39 and that one objective of the FRED is to bring about convergence of accounting practice)?

5 The ASB has taken the view that, in the main, the proposed FRS should not prescribe how hedge accounting should be done. Do you agree with this approach?

6 The ASB has nevertheless decided that the FRED should propose some minimum requirements on the hedge accounting techniques to be used. Do you agree with the FRED's proposals on:

(a) the treatment of hedges of net investments in foreign operations (see paragraph 16(a) of the FRED)?

(b) the treatment of the ineffective portion of a gain or loss on a hedge that is not a hedge of a net investment in a foreign operation (see paragraph 16(b) of the FRED)?

(c) the treatment of hedging instruments that cease to qualify for hedge accounting (see paragraphs 17 and 18 of the FRED)?

7 The ASB is proposing that the standard should come into effect for reporting periods ending on or after a date in early 2003, although it is also proposing certain transitional arrangements (see paragraph 20 of the FRED). Do you agree with this approach?

SUMMARY

a [Draft] Financial Reporting Standard • sets out principles for the use of hedge accounting techniques when accounting for financial instruments.

Hedges

b A hedging transaction or hedge is where an entity enters into a contract (the hedging instrument) that individually or with other contracts has a value or cash flow that is expected, wholly or partly, to move inversely with changes in the value of or cash flows arising from another contract or other exposure (the hedged item). The net effect will, as a result, be to mitigate some or all of the risk associated with the hedged item.

Hedge accounting

c In the absence of a hedging relationship, most realised gains and losses are recognised in the profit and loss account immediately, as are most unrealised losses. Furthermore, the exchange rate used to convert the acquisition cost of a non-financial asset bought for an amount denominated in a foreign currency would typically be the rate of exchange on the date on which the asset was acquired. However, if there is a hedging relationship, the measurement and gains and losses recognition practices that would otherwise apply are often varied so that gains and losses on the hedging instrument are recognised in the same performance statement (in other words, the profit and loss account or statement of total recognised gains and losses as appropriate) and in the same period(s) as offsetting gains and losses on the hedged item. Such accounting practices are known as hedge accounting.

Scope and breadth of the [draft] FRS

d Although hedging instruments are usually financial instruments—typically derivatives—and the hedged item often involves a financial instrument, that is not always the case. However, the [draft] FRS deals only with the accounting treatment of hedging instruments and hedged items that are financial instruments; the accounting treatment of other hedging instruments and other hedged items is outside its scope.

e The main focus of the [draft] FRS is on ensuring that hedge accounting is used only when it is appropriate to do so. In summary, it does that by specifying that, if hedge accounting is to be used, the relationship between the hedging instrument and the hedged item should have been designated as a hedge at the outset and the hedge needs to meet certain hedge effectiveness criteria.

f Hedge accounting can take different forms and, in the main, the [draft] FRS does not require or prohibit the adoption of any particular form of hedge accounting. However, it does:

- stipulate that, whatever form of hedge accounting is adopted, it should not be applied to any ineffective portion of the hedge;
- set out the prescribed form of hedge accounting to be adopted for hedges of net investments in foreign operations; and
- contain provisions dealing with the discontinuance of a hedge.

[DRAFT] FINANCIAL REPORTING STANDARD •

OBJECTIVE

1 The objective of this [draft] FRS is to establish principles for the use of hedge accounting techniques when accounting for financial instruments. In particular, it sets out:

(a) the criteria that should be met if hedge accounting is to be applied; and

(b) requirements that the hedge accounting technique applied should meet.

DEFINITIONS

2 The following definitions shall apply in the [draft] FRS and in particular in the Statement of Standard Accounting Practice set out in **bold type.** The term 'financial instrument' is used in the [draft] FRS with the meaning specified in FRS 13 'Derivatives and other Financial Instruments: Disclosures'.

A hedge:-

A contract (the hedging instrument) that individually, or with other contracts, has a value or cash flow that is expected, wholly or partly, to move inversely with changes in the value of or cash flows arising from another contract or other exposure (the hedged item).

Hedge accounting:-

An accounting treatment that alters the accounting that would otherwise apply so that gains and losses on the hedging instrument are recognised in the same performance statement (in other words, the profit and loss account or statement of total recognised gains and losses as appropriate) and in the same period(s) as offsetting gains and losses on the hedged item.

For example, in the absence of a hedging relationship and assuming that historical cost is being used:

(a) if a derivative acquired at no cost moves into a loss position (or the market value of a financial instrument carried at cost falls below that cost), that position would be reflected immediately in the financial statements by recognising a loss in the current period's performance statement (usually the profit and loss account);

(b) if a financial instrument is sold, the gain or loss arising on the sale would be recognised immediately in the current period's performance statement (usually the profit and loss account); and

(c) if a non-financial asset is being bought for an amount expressed in a currency other than the reporting entity's local or functional currency, that asset, when acquired, would be recognised initially in the entity's balance sheet at an amount that is equal to the purchase price converted at the rate of exchange on the date on which the asset was acquired (or, if a rate was specified in the purchase contract, at that contract rate).

However, when a hedging relationship is involved, this accounting may be varied so that gains and losses on the hedging instrument are recognised in the same performance statement and in the same period(s) as offsetting gains and losses on the hedged item. For example, in the circumstances described in (a) above, if the derivative is being held as a hedging instrument the entity might defer recognition in the performance statements of the loss on the derivative until the offsetting gain on the hedged item is recognised. In the circumstances described in (b), assuming the derivative sold was held as a hedging instrument in an ongoing hedge, the hedge accounting technique adopted might involve deferring the recognition in the performance statements of the realised gain or loss on the derivative until the offsetting losses and gains on the hedged item are recognised. In the circumstances described in (c), if the entity entered into a forward foreign exchange purchase agreement to hedge the currency exposure on the asset's purchase contract, the hedge accounting technique used might involve converting the foreign currency purchase price of the asset at the exchange rate inherent in the forward foreign exchange purchase agreement.

Hedged item:-

See the definition of a hedge.

Hedge effectiveness:-

The degree to which offsetting changes in fair value or cash flows attributable to a hedged risk are achieved by the hedging instrument.

Hedging instrument:-

See the definition of a hedge.

SCOPE

3 **The [draft] FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period, except that reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt.**

HEDGE ACCOUNTING CRITERIA

4 **A financial instrument qualifies for hedge accounting if, and only if, it is held as a hedging instrument in a hedge that meets both:**

(a) the hedging relationship criteria (including the pre-designation criterion) set out in paragraph 6; and

(b) the hedge effectiveness criteria set out in paragraph 8.

5 Under the [draft] FRS, hedge accounting is available for hedging instruments that are financial instruments but not for hedged items that are financial instruments. The [draft] FRS is, furthermore, silent on the use of hedge accounting techniques to account for hedging instruments and hedged items that are *not* financial instruments.

Hedging relationship criteria

6 **The hedging relationship criteria that need to be met are as follows:**

(a) At the inception of the hedge there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the related hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows that is attributable to the hedged risk.

(b) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item and the fair value or cash flows of the hedging instrument can be reliably measured.

(c) If a forecast transaction is being hedged, it must be highly probable and must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss.

7 Although the language used in the [draft] FRS tends to assume that there will be *a* hedging instrument that is hedging *a* hedged item, hedge accounting may also be available when other types of hedging relationship are involved. For example, in determining whether there is a hedging relationship that meets the above criteria, it is not necessary for the whole of the financial instrument that is the hedging instrument to have hedging benefits; it is acceptable for just a portion of an instrument to be a hedging instrument or for the instrument to hedge just a portion of a hedged item. Different portions of an instrument can be designated as hedges of different exposures. Furthermore, the hedging instrument need not

be a single financial instrument; for example, two or more derivatives or proportions thereof may be viewed in combination and jointly designated as a unit as the hedging instrument. Similarly, the hedged item need not be a single item; it might, for example, be the net position of two or more items. It may even be that a portfolio of financial instruments will be held to hedge the net exposure on a portfolio of other instruments and positions. Essentially, it is not the nature of the hedging 'instrument' or hedged 'item' that is important so much as whether the pre-designation and effectiveness criteria set out in the [draft] FRS are met.

Hedge effectiveness

8 **The hedge effectiveness criteria that need to be met are as follows:**

(a) The hedge was expected at the outset to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged item, consistent with the originally documented risk management strategy for that particular hedging relationship.

(b) The hedge has, since its commencement, been assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting period.

9 A hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the entity can expect changes in the fair value or cash flows of the hedged item to be almost fully offset by the changes in the fair value or cash flows of the hedging instrument, and actual results are within a range of 80 per cent to 125 per cent. For example, if the loss on the hedging instrument is 120 and the gain on the hedged item is 100, offset can be measured by 120/100, which is 120 per cent, or by 100/120, which is 83 per cent. The entity will conclude that the hedge is highly effective.

10 The method an entity adopts for assessing hedge effectiveness will depend on its risk management strategy. In some cases, an entity will adopt different methods for different types of hedges. If the principal terms of the hedging instrument and of the entire hedged item are the same, the changes in fair value and cash flows attributable to the risk being hedged offset fully, both when the hedge is entered into and thereafter until completion. For instance, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item.

11 On the other hand, sometimes the hedging instrument will offset the hedged risk only partially. For instance, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies and the two do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is due to the counterparty's credit risk.

12 In order for a hedge to be effective, the hedge must relate to a specific identified and designated risk, and not merely to overall entity business risks, and must ultimately affect the entity's net profit or loss.

13 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule that shows a reduction of all or part of the rate exposure, for each strip of maturity schedule, resulting from the aggregation of elements, the net position of which is hedged. When a net exposure is involved, it will be necessary either to associate that net exposure with an asset or liability giving rise to such net exposure (so that correlation can be assessed against that asset or liability) or to show that the effectiveness of the hedge can be reliably measured against an identifiable net exposure.

14 The [draft] FRS does not specify a single method for assessing hedge effectiveness. An entity's documentation of its hedging strategy will include its procedures for assessing effectiveness. Those procedures will state whether the assessment will include all of the gain or loss on a hedging instrument or whether the instrument's time value will be excluded. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements. If the critical terms of the hedging instrument and the entire hedged item are the same, an entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis.

15 In assessing the effectiveness of a hedge, an entity will generally need to consider the time value of money. The fixed rate on a hedged item need not exactly match the fixed rate on a swap that is hedging the fair value interest rate risk of the hedged item. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap that is hedging the cash flow interest rate risk of the hedged item. A swap's fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

ACCOUNTING FOR HEDGES

16 If a hedge accounting technique is adopted, that technique should meet the following requirements:

(a) If a hedge of a net investment in a foreign operation is involved:

(i) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised immediately in the statement of total recognised gains and losses and should

thereafter be treated in the same way as gains and losses on the hedged item; and

(ii) the ineffective portion should be reported immediately in the profit and loss account.

(b) If a hedge of something other than a net investment in a foreign operation is involved, any ineffective portion of the gain or loss on the hedging instrument that would have been recognised had hedge accounting not been adopted should be recognised immediately in the profit and loss account.

17 **A hedging instrument will cease to qualify for hedge accounting if, and only if, the hedge no longer meets the criteria set out in paragraph 4 or the hedging instrument expires or is sold terminated or exercised. In such circumstances, the use of hedge accounting should be discontinued prospectively and:**

(a) if hedge accounting has been discontinued because a forecast transaction that was being hedged is no longer expected to occur, the net cumulative gain or loss on the hedging instrument that has not to date been recognised in the profit and loss account should be recognised in the profit and loss account immediately.

(b) if hedge accounting has been discontinued for a reason other than the one described in (a), the net cumulative gain or loss on the hedging instrument that has not to date been recognised in the profit and loss account (or statement of total recognised gains and losses if appropriate) should be recognised in the profit and loss account (or statement of total recognised gains and losses if appropriate) so as to offset the gains and losses arising on the hedged item.

18 For the purpose of paragraph 17, the replacement or rollover of a hedging instrument into another hedging instrument is not considered to involve the hedging instrument expiring or being sold, terminated or exercised if such replacement or rollover is part of the entity's documented hedging strategy.

DATE FROM WHICH EFFECTIVE AND TRANSITIONAL ARRANGEMENTS

19 **Subject to paragraph 20, the accounting practices set out in the [draft] FRS should be regarded as standard in respect of accounting periods ending on or after [date to be inserted after exposure]. Earlier adoption is encouraged.**

20 **Paragraph 6(a) need not be applied to hedges that were being accounted for using hedge accounting techniques immediately prior to the adoption of this [draft] FRS.**

WITHDRAWAL OF UITF ABSTRACT 19 AND AMENDMENTS TO FRS 13 AND UITF ABSTRACT 21

21 **The [draft] FRS supersedes UITF Abstract 19 'Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise' [following publication in final form].**

22 **The [draft] FRS makes the following changes to other accounting standards and UITF Abstracts [following publication in final form]:**

(a) the references to "SSAP 20" in paragraphs 34(c), 37, 92 and 94 of FRS 13 are replaced with references to "FRS • 'Financial instruments: Hedge accounting'".

(b) the footnotes to paragraphs 34(c) and 92 of FRS 13 are replaced with:

"Although the FRS uses the term 'foreign net investment', FRS • 'Financial instruments: Hedge accounting' uses 'net investment in a foreign operation'."

(c) the first sentence of paragraph 15 of UITF Abstract 21, and the references to paragraphs 51 and 57 of SSAP 20 in the References section of that Abstract, are deleted.

APPENDIX I

DERIVATION TABLE

The [draft] FRS has been prepared by extracting material from IAS 39, in some cases amending it slightly, and then surrounding it with original text that gives the IAS 39 material proper context.

The following table has been prepared to assist readers of the [draft] FRS in understanding the sources used in its compilation. It explains the source of each paragraph of the [draft] FRS, indicating whether that source has been adopted (a) in its entirety (with the exception of minor stylistic changes that have no impact on the paragraph's meaning) or with minor amendments (none of which have any impact on the requirements overall), or (b) with other changes, such as the omission of an IAS 39 requirement, imposition of a requirement that is not in IAS 39 or a change to an IAS 39 requirement. Throughout, the FRED uses the term 'entity' where IAS 39 uses 'enterprise'.

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
1-5, and introductory paragraph of 6	Original text	—	—
6(a)	IAS 39.142(a)	The second sentence of IAS 39.142(a) has been amended as follows: "That documentation should include identification of the hedging instrument, the related hedged item ~~or transaction~~, …. and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or ~~the hedged transaction's~~ cash flows that is attributable to the hedged risk."	

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
6(b)	IAS 39.142(d)	IAS 39.142(d) has been amended as follows: "The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item and the fair value or cash flows of the hedging instrument can be reliably measured."	
6(c)	IAS 39.142(c)	The beginning of paragraph IAS 39.142(c) has been amended as follows: "~~for cash flow hedges, a forecasted transaction that is the subject of the hedge~~ If a forecast transaction is being hedged, it must be highly probable and must …"	
7 and introductory paragraph of 8	Original text	—	—

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
8(a)	IAS 39.142(b)	IAS 39.142(b) has been amended as follows: "The hedge was ~~is~~ expected at the outset to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged item ~~risk~~, …"	
8(b)	IAS 39.142(e)	IAS 39.142(e) has been amended as follows: "The hedge ~~was~~ has, since its commencement, been assessed on an ongoing basis and …"	
9	IAS 39.146	IAS 39.147 has been amended as follows: "...and the gain on the ~~cash investment~~ hedged item is 100,..."	
10	IAS 39.147		The wording of the third sentence of IAS 39.147 has been amended as follows: "…of the entire hedged ~~asset or liability or hedged forecasted transaction~~ item …"

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
11	IAS 39.148	Entirety.	
12	IAS 39.149	(1) The beginning of the first sentence has been amended as follows:" ~~To qualify for special hedge accounting,~~ In order for a hedge to be effective …" (2) The following sentence has been deleted from the end of the paragraph: "A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government would not be eligible for hedge accounting; effectiveness cannot be measured since those risks are not measurable reliably."	

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
13	IAS 39.143	Unlike the paragraphs around this paragraph, this paragraph does not appear in IAS 39 under the heading 'Assessing Hedge Effectiveness'. However, as it addresses that subject, it has been included in the [draft] FRS.	The end of IAS 39.143 has been amended as follows: "…the net position of which is hedged, ~~providing such net exposures can be associated~~. When a net exposure is involved, it will be necessary either to associate that net exposure with an asset or liability giving rise to such net exposure ~~and~~ (so that correlation can be assessed against that asset or liability) or to show that the effectiveness of the hedge can be reliably measured against an identifiable net exposure.".
14	IAS 39.151	IAS 39.151 ends with an example that has been omitted from the [draft] FRS and the reference to "annual or interim financial report" has been replaced by a reference to "annual or interim financial statements".	IAS 39.151 has been amended as follows: "If the critical terms of the hedging instrument and ~~the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecast transaction~~ the entire hedged item are the same, an entity could conclude…"

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
15	IAS 39.152	IAS 39.152 has been amended as follows: "…The fixed rate on a hedged item need not exactly match the fixed rate on a swap ~~designated as a fair value hedge~~ that is hedging the fair value interest rate risk of the hedged item. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap ~~designated as a cash flow hedge~~ that is hedging the cash flow interest rate risk of the hedged item. …"	
Introductory text in paragraphs 16 and 16(a).	Original text		

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
16(i)	IAS 39.164		IAS 39.164 has been amended as follows: "(~~a~~i) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised ~~directly in equity through the statement of changes in equity~~ immediately in the statement of total recognised gains and losses and should thereafter be treated in the same way as gains and losses on the hedged item; and (~~b~~ii) the ineffective portion should be reported~~: (i)~~ immediately in ~~net profit or loss if the hedging instrument is a derivative; or (ii) in accordance with paragraph 19 of IAS 21, in the limited circumstances in which the hedging instrument is not a derivative~~the profit and loss account. ~~The gain or loss on the hedging instrument relating to the effective portion of the hedge should be classified in the same manner as the foreign currency translation gain or loss.~~"

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
16(b)	IAS 39.158		Although FRED 23.16(b) is based on the principles underlying IAS 39.158, the scope of the two paragraphs is different so IAS 39.158 has had to be extensively reworded.
17	IAS 39.156 & IAS 39.163 (excluding the parenthesised text—see paragraph 18 below).		FRED 23.17 and IAS 39.156 & 163 adopt the same approach to the issue being addressed here. However, the wording and structure of the requirements is very different because IAS 39 deals with fair value hedges and cash flow hedges separately.
18	The parenthesised text in IAS 39.156(a) & IAS 39.163(a)	(1) This wording was used in two places in IAS 39, once in the context of fair value hedges and once in the context of cash flow hedges. The [draft] FRS places different material around the wording, which has the effect of keeping the meaning unchanged whilst avoiding the need for repetition.	

FRED paragraph	Source	Entirety or with only minor amendments	Other changes
		(2) The wording that appears in IAS 39 has been changed as follows: "the replacement or a rollover of a hedging instrument into another hedging instrument is not considered ~~an expiration or termination~~ to involve the hedging instrument expiring or being sold, terminated or exercised if such replacement or rollover is part of the entity's documented hedging strategy."	
19-22	Original text	—	—

The paragraphs in IAS 39 on hedge accounting that are not included in the [draft] FRS are as follows:

IAS 39 paragraph number	Comment
121	Although not included, this paragraph has an equivalent in the [draft] FRS (paragraph 4).
122-126	These paragraphs limit the use of financial instruments as hedging instruments. Some of those restrictions arise out of the need for hedges to be effective, some do not. The FRED relies on its pre-designation and effectiveness criteria to ensure that hedge accounting is adopted only where appropriate.
127-135	These paragraphs limit the items that can be treated as a hedged position. Again, some of those restrictions arise out of the need for hedges to be effective and some do not, and the FRED relies on its pre-designation and effectiveness criteria to ensure that hedge accounting is adopted only where appropriate.
136-145, excluding 142 & 143	These paragraphs define and discuss the various types of hedge (fair value hedges, cash flow hedges and hedges of net investments in foreign operations). The FRED does not use such terminology.
150	This paragraph discusses the hedging of equity method investments and investments in consolidated subsidiaries. It was not included because it uses terminology not used in the [draft] FRS and it seemed easier to omit the paragraph than to amend it.
153-157, excluding 156	These paragraphs describe the accounting to be adopted for fair value hedges. The paragraphs were not included in the [draft] FRS because they assume the adoption of the IAS 39 measurement model. The ASB, furthermore, took the view that it did not wish to deal in the [draft] FRS with how various types of hedge should be accounted for.

IAS 39 paragraph number	Comment
159-162	These paragraphs describe the accounting to be adopted for cash flow hedges. They were not included in the [draft] FRS for the same reasons that IAS 39.153–IAS 39.157 (excluding IAS 39.156) were omitted.
165	This paragraph states that a hedge that does not qualify for hedge accounting should be accounted for like any non-hedge. The ASB decided that this was implicit in the [draft] FRS and therefore did not need to be stated.

APPENDIX II

NOTE ON LEGAL REQUIREMENTS

1 Hedge accounting is not a subject that is addressed explicitly by legal requirements. However, the adoption of hedge accounting techniques has implications for measurement and for the treatment of gains and losses, and those matters *are* dealt with by legal requirements. This note sets out the main statutory requirements involved.

Great Britain

2 The statutory requirements relating to measurement and gains and losses recognition are set out in the Companies Act 1985. In special circumstances, compliance with a provision of the Act on the matters to be included in a company's financial statements (or notes thereto) may be inconsistent with the requirement to give a true and fair view of the state of affairs and profit or loss. Sections 226(5) and 227(6) of the Act provide, for individual company financial statements and for group financial statements, that in such circumstances the directors shall depart from that provision to the extent necessary to give a true and fair view. Where this true and fair view override is used, the Act requires particulars of the departure, the reasons for it and its effect to be given in a note to the financial statements.

Companies and groups other than banks and insurance companies and groups

3 Paragraph 9 of Schedule 4 to the Act requires the amounts to be included in a company's financial statements to be determined in accordance with certain principles (although the directors of a company are permitted to depart from the principles if it appears to them that there are special reasons for such a departure).

(a) One of those principles (set out in paragraph 12 of Schedule 4) is that the amount of any item shall be determined on a prudent basis, and in particular:

(i) only profits realised at the balance sheet date shall be included in the profit and loss account; and

(ii) all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the financial statements relate or a previous financial year shall be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed on behalf of the board of directors.

(b) Another of the principles (set out in paragraph 13 of Schedule 4) is that all income and charges relating to the financial year to which the financial statements relate shall be taken into account, without regard to the date of receipt or payment.

4 Except to the extent that a company chooses to adopt the alternative accounting rules, the amounts to be included in a company's financial statements are to be determined in accordance with the historical cost accounting rules set out in paragraphs 17-28 of Schedule 4. Those rules require a cost-based measure (such as lower of cost and market value, or cost less impairment provisions) to be used. The alternative accounting rules, which are set out in paragraphs 29-34 of Schedule 4, permit certain up-to-date measures to be used, but only if any resulting gains and losses are recognised in a revaluation reserve rather than the profit and loss account.

5 Schedule 4A contains similar requirements for the consolidated financial statements of groups other than banking groups and insurance groups.

Banks and banking groups

6 Schedule 9 to the Act imposes requirements on banks and banking groups that are similar to those referred to above except that banks and banking groups using the historical cost accounting rules are permitted by paragraph 34 of Schedule 9 to mark-to-market transferable securities not held as financial fixed assets and to recognise all changes in those amounts in the profit and loss account immediately.

Insurance companies and groups

7 Schedule 9A to the Act imposes requirements on insurance companies and groups.

(a) Paragraphs 13-19 of the Schedule contain requirements that are similar to those referred to in paragraph 3 above, except that the principle described in (a) is varied to permit the inclusion of certain unrealised gains in the long-term business technical account and non-technical account parts of the profit and loss account.

(b) The historical cost accounting rules and current value accounting rules (set out in paragraphs 30-41 and 20-29 respectively of Schedule 9A) require insurance companies and groups to measure some assets at cost-based amounts, some at current value and some at either cost-based amounts or current value. In the case of most investments and certain other assets, changes in those current values are required to be recognised immediately in the profit and loss account; in other cases, the gains and losses are required to be recognised in a revaluation reserve. The measurement requirements for provisions are set out in paragraphs 42-53 of the Schedule.

Northern Ireland

8 The statutory requirements in Northern Ireland are set out in the Companies (Northern Ireland) Order 1986. Those requirements are identical to the legislation for Great Britain cited above.

Republic of Ireland

9 The statutory requirements in the Republic of Ireland that correspond to those cited above for Great Britain are shown in the following table.

Para	*Great Britain*	*Republic of Ireland*
2	Section 226(5) of the Companies Act 1985	Section 3(1) of the Companies (Amendment) Act 1986
	Section 227(6) of the Companies Act 1985	Regulation 14(3) and (4) of the European Communities (Companies: Group Accounts) Regulations 1992
3	Paragraphs 9, 12 and 13 of Schedule 4 to the Companies Act 1985	Sections 5, 5(c) and 5(d) of the Companies (Amendment) Act 1986
4	Paragraphs 17-28 and 29-34 of Schedule 4 to the Companies Act 1985	Paragraphs 5-16* and 17-22† of the Schedule to the Companies (Amendment) Act 1986

* *Note: There is no requirement corresponding to paragraph 27(2)(b) of Schedule 4.*

† *Note: There is no requirement corresponding to paragraph 34(3(a)(ii) and (3A) of Schedule 4.*

5	Schedule 4A to the Companies Act 1985	European Communities (Companies: Group Accounts) Regulations 1992
6	Paragraph 34 of Schedule 9 to the Companies Act 1985	Paragraph 34, Schedule, European Communities (Credit Institutions: Accounts) Regulations 1992
7	Paragraphs 13-19, 30-41, 20-29 and 42-53 of Schedule 9A to the Companies Act 1985	Regulation 7 and 8, European Communities (Insurance Undertakings: Accounts) Regulations 1996 and paragraphs 1-11, 14-21 and 23-31 of the Schedule to those Regulations.*

* *Note: There is no requirement corresponding to paragraphs 20, 21, 24, 35 and 40(2)(b) of Schedule 9A.*

APPENDIX III

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

1 The international requirements for hedge accounting of financial instruments are contained in IAS 39 'Financial Instruments: Recognition and Measurement'. Those requirements can be classified into restrictions on the use of hedge accounting and restrictions as to the hedge accounting techniques that can be used.

Restrictions on the use of hedge accounting

2 IAS 39 contains a number of restrictions on the use of hedge accounting. The [draft] FRS contains some, but not all, of those restrictions.

3 Most of the restrictions in IAS 39 but not in the [draft] FRS relate to the types of hedging instruments and hedged items that qualify for hedge accounting treatment. The [draft] FRS contains no specific restrictions on this issue because it relies on the requirement for hedges to be effective if hedge accounting is to be applied.

4 Some of the other restrictions in IAS 39 but not in the [draft] FRS relate to the types of hedging relationship that qualify for hedge accounting treatment. Again, the [draft] FRS relies on its effectiveness requirements to prohibit the use of hedge accounting in inappropriate circumstances.

5 As a number of the IAS 39 restrictions not repeated in the [draft] FRS will be implicit in the effectiveness requirement, some of the differences are differences in theory but not in practice. However, some of the omitted restrictions go beyond the effectiveness requirement. This means that hedge accounting will be permitted under the [draft] FRS in circumstances in which it is not permitted under IAS 39. Compliance with the restrictions in the [draft] FRS will therefore not ensure compliance with IAS 39's restrictions, although the reverse will be true.

Restrictions as to the hedge accounting techniques that can be used

6 IAS 39 contains requirements prescribing exactly what accounting entries should be made if hedge accounting is to be adopted. It also sets out what should be done if a hedging relationship is terminated early. The [draft] FRS contains some, but not all, of these IAS 39 requirements.

7 The [draft] FRS also contains one requirement that is not consistent with IAS 39's requirements. IAS 39 requires the recycling—from the statement of total recognised gains and losses to the profit and loss account—of certain gains and losses arising on hedging instruments; the effect of the [draft] FRS and [draft] FRS • 'The Effects of Changes in Foreign Exchange Rates' is to prohibit such recycling.

APPENDIX IV

THE DEVELOPMENT OF THE FRED

The 1996 Discussion Paper

1 In 1993 the Accounting Standards Board (ASB) commenced a project on financial instruments. The objective of that project was to consider all aspects of accounting for financial instruments, including the use of various hedge accounting techniques, and to reach conclusions as to what if anything the ASB should say on the subject. In the context of hedge accounting, the ASB considered, in particular, whether hedge accounting was an appropriate accounting technique and, if it was, what criteria needed to be met if it was to be used.

2 The ASB set out its tentative conclusions on hedge accounting in a Discussion Paper 'Derivatives and other Financial Instruments', which was issued in July 1996. As that paper made clear, some ASB Board members believed that hedge accounting should not be permitted in any circumstances and others believed that it was an appropriate accounting technique in certain circumstances, although there were differing views as to what those circumstances should be. All were agreed, however, that there should, at the very least, be some restrictions on the use of hedge accounting.*

3 The comments received in response to this aspect of the paper reflected the range of possibilities described in the paper itself: although some respondents took the view that hedge accounting should be prohibited, most did not; and although the majority agreed that there should be some restrictions on the use of hedge accounting, there was little agreement on what those restrictions should be.

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* *These conclusions on hedge accounting were part of the Discussion Paper's wider discussion about the appropriate measurement basis or bases to be used for financial instruments and about the treatment of gains and losses arising on financial instruments.*

FRED 13 and FRS 13

4 The Discussion Paper also considered the disclosures that entities were providing in their financial statements about financial instruments and concluded that those disclosures needed to be significantly enhanced. The paper set out some proposed new disclosures, and those disclosures were developed further in FRED 13 'Derivatives and other Financial Instruments: Disclosures' (and the supplement to FRED 13) and issued in final form as FRS 13 'Derivatives and other Financial Instruments: Disclosures'.

5 FRS 13 requires the amount—and an analysis—of the gains and losses on hedging instruments that have not been recognised in a performance statement because hedge accounting is being applied. In FRED 13 it was proposed that this information should be analysed to show gains and losses on hedges of uncontracted future transactions separately from other gains and losses. Paragraph 30 of Appendix VI 'The Development of the FRED' of FRED 13 explained the reason behind this proposal in the following terms:

> Many commentators who support the use of hedge accounting nevertheless believe that it is not appropriate to use hedge accounting for hedges of future transactions that are not yet the subject of a firm contract. Although the Board has not yet formed a view on this matter (or on whether hedge accounting should be permitted at all), it believes it would be appropriate to require entities to disclose the effect on the performance statements of using hedge accounting for uncontracted future transactions.

6 This proposal was not generally supported by respondents because the difference between uncontracted future transactions and contracted future transactions was considered to be of little significance in many cases. The ASB accepted this argument and did not include the proposed requirement in the final standard. It also recognised that, if it was to differentiate between different types of hedge in some future standard on hedge accounting, that bright line needed to be based on a difference that had substance.

The JWG's proposals on hedge accounting

7 In December 2000, the ASB issued a Consultation Paper 'Financial Instruments and Similar Items'. The paper was developed by the Financial Instruments Joint Working Group of standard-setters (JWG), a group set up by ten standard setters (including the ASB) to develop a proposed comprehensive fair value-based standard on financial instruments.

8 The paper, which represented the majority view of the members of the JWG and did not necessarily represent the views of any of the participating standard setters themselves, proposed that hedge accounting for financial instruments should be prohibited.

9 The comment period for the paper ended last year and an initial analysis of the comments received has been discussed by standard setters. No decisions have as yet been taken as to whether, and if so how, the proposals should be taken forward, although it has been recognised that, even if they are taken forward with speed, it is unlikely that a standard based on the proposals could be implemented before 2005.

Why is the FRED being issued now?

10 Until now, the ASB has not acted on the tentative conclusion in its 1996 Discussion Paper that there should, at the very least, be some restrictions on the use of hedge accounting. There are two reasons for that. First of all, there has been little agreement at any level of the debate as to what the restrictions should be. Secondly—and more importantly—it has been difficult to consider hedge accounting in isolation from the wider—and as yet not resolved—debate about the measurement of financial instruments.

11 Two recent events have resulted in the ASB concluding that the time is right to develop an accounting standard on the use of hedge accounting. The first was the proposal, by EU Ministers, that, from 1 January 2005, all listed companies in the EU should prepare their consolidated financial statements in accordance with adopted international accounting standards. As the intention is that IFRSs will form the basis of those adopted international accounting standards, it follows that the ASB can look to IFRSs for an understanding of the future direction of UK practice on the measurement of financial instruments.

12 The IASB's requirements on hedge accounting are set out in IAS 39. Until recently, those requirements have been the subject of uncertainty because:

(a) IAS 39 is only an interim standard, and is therefore due to be replaced at some point by a definitive standard; and

(b) IAS 39 is currently the subject of an amendments project, and is therefore subject to change.

However, this uncertainty has been largely dispelled because the indications are that IAS 39 will remain in place for some time, and the scope of the IASB's proposals for a revision to IAS 39 has become clearer.

13 Against this backdrop the ASB believes it is now possible for it to develop a credible standard on hedge accounting.

14 It could be argued that, as UK hedge accounting practice is likely to converge towards the hedge accounting requirements set out in IAS 39,* a UK standard on hedge accounting is not needed. The ASB does not accept this argument, believing instead (as already explained in the Preface, under the heading 'The need for an accounting standard on hedge accounting for financial instruments') that putting such a standard in place now would result in an improvement in the quality of financial statements, would fill a potential gap in UK accounting literature, and would represent an important step in the work the ASB is carrying out to align UK accounting standards with IFRSs.

How the proposals in the FRED were developed

15 Since the publication of the JWG's paper at the end of 2000, the ASB has been re-considering various aspects of the financial instruments debate. In doing so, it has concluded that, if hedge accounting is to be permitted, it is essential that the hedging relationship is clearly defined, measurable, and effective.

(a) *Clearly defined* - The hedging relationship should be identified and designated clearly at the outset.

* *The expectation is that, with effect from 2005, listed entities will be required by EU Regulation to adopt IA39 (and all other IFRSs) in preparing their consolidated financial statements. Furthermore, it seems likely that the hedge accounting practices used in other financial statements and by other entities will converge towards, rather than diverge from, the requirements of that standard.*

(b) *Measurable* – There needs to have been a clear understanding from the outset of how the effectiveness of the hedge is to be measured. It is also necessary that the chosen hedge effectiveness measurement method is expected to produce reliable measures and has actually done so.

(c) *Effective* – There needs to have been an expectation from the outset that the hedge would be highly effective and this expectation needs to have been fulfilled in practice.

16 The ASB is not unique in reaching this conclusion; the principle also underpins the hedge accounting restrictions in IAS 39 and US Financial Accounting Standard (FAS) 133 'Accounting for Derivative Instruments and Hedging Activities'. The ASB is also not alone in recognising that the principle does not in itself represent an effective set of hedge accounting restrictions and that more detail is needed; both IAS 39 and FAS 133 implement the principle through a package of more detailed requirements.

17 In the interests of convergence, the ASB decided that it should, as far as possible, adopt precisely the same words as IAS 39. However, the ASB has taken the view that a hedge accounting restriction should be included in its hedge accounting standard only if it is necessary to implement the principle outlined above. IAS 39 contains some restrictions that go beyond that principle. Therefore, although the FRED proposes that certain of IAS 39's restrictions should be repeated in the proposed standard, it also proposes that some should be omitted.

18 The ASB believes that this approach ensures that its standard is no more complex than is necessary and that the bright lines that have to be drawn are kept to a minimum.

19 IAS 39 also contains a number of paragraphs setting out precisely which hedge accounting techniques are deemed to be acceptable. The FRED is not proposing to incorporate this material, primarily because it assumes the adoption of the IAS 39 measurement model and that assumption is not valid in a UK context at the moment.

20 However, there are two concerns that the ASB thought it should address in the proposed FRS. They are the treatment of the ineffective part of an effective hedge and the treatment of hedging relationships that are terminated early. The FRED proposes that these issues should be addressed using wording from IAS 39 wherever possible.

21 Furthermore, as explained in the Preface, the ASB has concluded that its hedge accounting standard needs to address hedges of net investments in foreign operations at the same level of detail as the subject is currently addressed in SSAP 20 'Foreign currency translation'. Again, wording from IAS 39 has been used to do this.

22 Amongst other things, IAS 39 prohibits the use of basis adjustments and it requires that hedging instrument gains and losses initially recognised in the statement of total recognised gains and losses should in due course be recycled to the profit and loss account.

(a) A basis adjustment is when a change in the amount at which the hedging instrument is carried on the balance sheet is recognised, but that change is not recognised immediately in a performance statement. For example, assume an entity operating in a pounds sterling economy enters into a euro-denominated contract to buy a machine, and that it also enters into a forward foreign exchange contract to hedge the currency exposure on that purchase order. Under hedge accounting, the entity might not recognise any gains and losses on the forward contract until the machine is acquired, and then may use the gains and losses to adjust the amount at which the machine is carried in the balance sheet (ie to adjust the basis of the carrying amount of the machine). The FRED does not prohibit the use of 'basis adjustments'.

(b) The FRED does not require—or even permit—gains and losses on cash flow hedges to be recycled from the statement of total recognised gains and losses to the profit and loss account as the hedge matures. The ASB does not consider recycling to be an appropriate accounting practice and is undertaking a project with the IASB on reporting financial performance, one result of which may be that this practice will be prohibited internationally.

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