EFRAG
European Financial Reporting Advisory Group

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Directorate General for the Internal Market
1049 Brussels

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Dear Mr Holmquist

Adoption of the Amendment to IAS 39 "Eligible Hedged Items"

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedge Items", which was issued by the IASB in July 2008. It was issued as an Exposure Draft in September 2007 and EFRAG commented on that draft.

The Amendment clarifies two aspects of existing IAS 39. They are (a) when inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39 and (b) how hedge accounting can be applied to hedges where a hedging instrument is an option contract.

The Amendment becomes effective for annual periods beginning on or after 1 July 2009. The Amendment shall be applied retrospectively. Earlier application is permitted.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendment to IAS 39 Financial Instruments: Recognition and Measurement "Eligible Hedged Items".

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

INTRODUCTION

1 The Amendment clarifies two aspects of existing IFRS (IAS 39). They are (a) when inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39 and (b) how hedge accounting can be applied to hedges where a hedging instrument is an option contract. Henceforth we refer to these as Clarification 1 and Clarification 2 respectively.

2 EFRAG assessed whether the information resulting from the application of these two clarifications would meet the criteria for EU endorsement; in other words, whether:

(a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Amendment.

3 Having formed tentative views on these issues and prepared a draft assessment, EFRAG issued that draft assessment on 22 September 2008 and asked for comments on it by 27 October 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

EVALUATION

Relevance and reliability

4 According to the IASB's Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the Amendment would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.

5 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered whether information resulting from the application of the Amendment exhibits those qualities.

Clarification 1

6 The IASB believes that, to ensure that hedge accounting techniques are applied in a way that results in the provision of information that is relevant and reliable, it is necessary for strict criteria to be met if hedges are to be eligible for hedge accounting. In particular, hedge accounting should be available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument that affect profit or loss. Underpinning this is the requirement that the effectiveness of the hedge can be reliably measured.

7 Risks and uncertainties that companies hedge may represent only some but not all risks or cash flows of a particular contract or forecast transaction. In order that entities do not have to report hedge ineffectiveness related to risks that they are not hedging, IAS 39 allows them to apply hedge accounting to something other than for example the entire contract provided that effectiveness can be measured reliably.

8 The issue that Clarification 1 addresses is whether the inflation portion of an interest-bearing financial instrument can be considered eligible for designation as a hedged item under the hedge accounting provisions.

9 The IASB concluded that, if a hedged item is something other than an entire contract, the hedged item has to be identifiable and separately measurable to meet the requirement that hedge effectiveness must be capable of being measured reliably. The IASB further concluded that this means, in the case of the inflation portion of an interest-bearing debt instrument, that inflation must be a contractually specified portion of the cash flows of the debt instrument and that the other cash flows of the instrument must not be affected by the inflation portion.

10 For example, an entity may hold an inflation-indexed bond that pays interest at inflation plus 3 per cent. The inflation portion in this example would be considered identifiable and separately measurable—because inflation is a contractually specified cash flow and the remaining cash flows of the instrument (the 3 per cent interest) do not change when the inflation portion changes—so the entity would be permitted to designate as a hedged item changes in the cash flows of the financial asset attributable to changes in inflation. However, an entity holding a fixed rate financial asset is not permitted to designate as a hedged item an inflation portion. That is because either the inflation component is not a contractually specified cash

flow or, if inflation is a contractually specified cash flow, the remaining interest payments will vary as the inflation portion varies to match the contractually specified total fixed interest rate; in other words, in this case inflation is not an identifiable and separately measurable portion in the cash flows of the debt instrument.

11 EFRAG believes the requirements that:

(a) hedge accounting should be available for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument and

(b) a hedged portion must be identifiable and separately measurable

ensure the relevance and reliability of the reported information when using hedge accounting. Taking into account the above observations, EFRAG further concurs with the conclusion that the inflation portion in a financial instrument should be considered identifiable and separately measurable (and therefore eligible for designation as a hedged item under the hedge accounting provisions) only if it is contractually specified and does not affect other cash flows of the financial instrument.

Clarification 2

12 As mentioned earlier, to ensure that hedge accounting techniques are applied in a way that results in the provision of information that is relevant and reliable, it is necessary that hedge accounting is available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument.

13 The issue that Clarification 2 addresses is the extent to which option contracts used as hedging instruments offset risks and uncertainties in hedged forecast transactions. This issue is important in deciding how the effectiveness of a hedge should be measured when an option contract is used to hedge a one-sided risk, i.e. the cash flows resulting from the price falling below a specified level.

14 The objective of hedging with options is in effect to fix the value of the transaction at a certain price. Some consider that the hedged item includes a possibility that, even if the price is below or above the specified level today, this may not continue to be the case. Economically the objective of the hedge will be successfully achieved if the terms of the option contracts (such as its notional amount, underlying, and maturity date, etc.) completely match the related terms of the hedged forecast transaction. In view of this, some conclude that in such circumstances it would be appropriate to treat fair value changes of the option contract, including the changes in the time value, as fully effective in offsetting the fair value changes in the hedged item.

15 The IASB concluded that the hedged forecast transaction does not contain a time value component that affects profit or loss. Therefore, if an option contract is designated as a hedging instrument in its entirety the time value of the option contract should be reported as hedge ineffectiveness in profit or loss. However, IAS 39 gives entities the possibility of separating the intrinsic value of an option contract and designating only the change in the intrinsic value of the option contract as a hedging instrument. Such a designation may result in a hedging relationship that is perfectly effective. If such an approach is adopted, the time value of an option contract will be reported in profit or loss following normal accounting requirements.

16 EFRAG notes that the existing hedge accounting requirements in IAS 39 stipulate that a forecast transaction that is the subject of a hedge must present an exposure to variations in cash flows that could ultimately affect profit or loss. The cash flows resulting from the forecast transaction described above will when recognised affect profit or loss as revenue, cost of sales, an interest expense etc. However, there are no cash flows associated with the possibility that, if the price of the hedged forecast transaction is currently below or above the specified level, this will not continue to be the case. On the other hand, when one buys an option contract, one pays a premium. Unless the option is deeply in-the-money, most of that premium will be time value. That is a cash flow that will affect profit or loss.

17 Therefore, EFRAG concurs with the IASB's conclusion that there is no offset between the cash flows relating to the time value of the option contract and the cash flows associated with the hedged item and that, as a result, under the hedge accounting requirements the time value of hedging option contracts is not considered as part of the effective hedge.

18 EFRAG believes the clarification is an appropriate application of the existing hedge accounting requirements that hedge accounting should be available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument that affect profit or loss ensuring relevance and reliability of the reported information.

Transitional arrangements

19 The Amendment requires both clarifications to be applied retrospectively for annual periods beginning on or after 1 July 2009. Usually when a change in accounting standard is applied retrospectively, issues of relevance and reliability do not arise (and the comparability and understandability of the information is maintained because users are able to identify the effect that the change in accounting has had on previously-reported numbers and to take that into account in their long-term trend information). EFRAG notes that in this case:

(a) some hedges that have previously been designated for hedge accounting treatment not in accordance with the clarifications will no longer be eligible for hedge accounting, so the effects of accounting for them using hedge accounting techniques will need to be reversed out of the financial statements;

(b) as IAS 39 requires contemporaneous designation of hedges if hedge accounting is to be applied, no alternative hedges can be substituted for the hedges referred to in (a); and

(c) going forward, entities will be able to get hedge accounting for hedges that are identical economically to those described in (a), except that the way the hedge has been designated is different.

The overall effect is that, if an entity does not change its hedging strategy in any significant way economically but changes the way it designates its hedges to comply with the clarifications, its financial statements are likely to report more volatility in the relevant preceding periods than in the current period.

20 Some might question whether this results in a loss of relevance or reliability (or maybe understandability). However, EFRAG notes that in any case application of hedge accounting is optional and it can be stopped and started at will even if the

entity does not change its hedging strategy and the economics do not change in other ways. Bearing this in mind, EFRAG does not believe that the retrospective application of the clarifications make reported information less relevant or reliable. Moreover, EFRAG generally supports retrospective application of an Amendment or a clarification provided there is sufficient lead time to implement a new or clarified requirement. These clarifications have a lead time of one year from the date of their publication, which EFRAG thinks is sufficiently long.

Comparability

21 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

22 EFRAG notes that both clarifications are designed to eliminate causes of diversity in current practice. EFRAG's assessment is that they will achieve that objective, and therefore enhance the comparability of the information provided.

23 EFRAG has also considered whether the clarifications create any new inconsistencies.

24 EFRAG has also considered whether there are inconsistencies between the clarifications and other parts of IAS 39.

Clarification 1

25 EFRAG notes that IAS 39 allows the application of hedge accounting to a hedge of a benchmark interest rate portion of an interest-bearing financial instrument *even if it is not contractually specified*. For example, a benchmark interest rate portion such as, say, a Euribor portion of a fixed rate debt instrument can potentially qualify for application of hedge accounting. EFRAG believes that the difference between application of hedge accounting to the benchmark interest rate portion and inflation portion is justifiable and does not create any new inconsistencies. That is because there is an observable effect on the fair value of a fixed rate instrument when the market benchmark interest rate (such as Euribor) changes, while there is no clear relationship between the inflation index (which is calculated using many financial and non-financial inputs from across the whole economy) and the inflation risk in a fixed rate financial instrument. Therefore, it is reasonable that a benchmark interest rate portion is considered identifiable and separately measurable in a fixed rate financial instrument while inflation is not.

Clarification 2

26 Before the IASB issued this clarification, some considered it appropriate to measure changes in the fair value of the hedged forecast transaction using an option pricing model and to measure ineffectiveness as the difference between the actual derivative used and the change in value of the hedged item calculated using an option pricing model. Such a method is referred to as a hypothetical derivative method to measure hedge effectiveness. However, as a result of the clarification it will no longer be possible to measure changes in the value of the hedged item using an option pricing model. Some commentators find this inconsistent with the fact that IAS 39 mentions the hypothetical derivative approach as being one among many possible ways to measure effectiveness.

27 EFRAG thinks this concern is misplaced. In accordance with Clarification 2, it is inappropriate to calculate the value changes of the hedged item using an assumption that the hedged item contains time value when it does not. That implies that it is not that the hypothetical derivative method cannot be used to value the hedged item, but rather that the option pricing methodology would not be appropriate in this case because it would not replicate the cash flows of the hedged item. Thus, EFRAG does not think that there is any inconsistency between the clarification and IAS 39 allowing the use of a hypothetical derivative method to measure hedge ineffectiveness.

28 EFRAG has therefore tentatively concluded that the Amendment meets the comparability criterion.

Understandability

29 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

30 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability because information that, for example, represents something as similar when it is in fact dissimilar is not understandable. The one aspect of understandability that EFRAG believes is not covered involves the complexity of the information provided and of the methodologies underlying the information. EFRAG's initial assessment is that neither clarification adds to the complexities that already exist.

31 EFRAG has therefore concluded that the information that results from the application of the two clarifications meets the understandability characteristic.

True and Fair

32 Having concluded that the information that results from the application of the Amendment will meet the criteria of relevance, reliability, comparability and understandability and, being unaware of any other reason to be concerned about the accounting effect of the Amendment, EFRAG thinks there is no reason to believe the Amendment is inconsistent with the true and fair view requirement.

European Interest

33 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its initial assessment is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

CONCLUSION

34 EFRAG's overall conclusion is that the Amendment satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

35 EFRAG has considered whether the Amendment has any additional implications in the EU bearing in mind that certain requirements relating to hedge accounting in

IAS 39 are not included in the endorsed version. EFRAG's assessment is that there is no incompatibility between the Amendment and IAS 39 as adopted in the EU.