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Accounting Standards Committee of Germany

® Der Standardisierungsrat

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EFRAG
Stig Enevoldsen
13-14 Avenue des Arts
B-1210 Brussels
Belgique

Berlin, 23 October 2008

Dear Stig,

EFRAG's Assessment of IAS 39 Financial Instruments: Recognition and Measurement 'eligible hedged items'

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on EFRAG's Assessment of IAS 39 Financial Instruments: Recognition and Measurement 'eligible hedged items'. We appreciate the opportunity to comment on EFRAG's assessment.

We agree with the views set out in the assessment. As a national standard-setter we are not in a position to answer the questions regarding the costs that will arise for preparers and for users to implement the amendment.

Please find attached our comments on the above mentioned EFRAG's assessments and the comments of Daimler AG.

If you have any further questions, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr

President

Vorstandsausschuss:
Heinz-Joachim Neubürger (Vorsitzender), Dr. Helmut Perlet (Stellvertreter), Prof. Dr. Rolf Nonnenmacher (Schatzmeister), Dr. Kurt Bock, Dr. Werner Brandt
Generalsekretär: Prof. Dr. Manfred Bolin

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS OF THE AMENDMENT TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT 'ELIGIBLE HEDGED ITEMS'

Comments should be sent to commentletter@efrag.org or uploaded via our website by 27 October 2008

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the amendment to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedged Items". In order to do that, EFRAG has been carrying out a technical assessment of the amendment against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A summary of the amendment is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

German Accounting Standards Board (GASB)

(b) Are you/Is your organisation or company a:

☐ Preparer ☐ User X Other (please specify)

Standard-setter

(c) Please provide a short description of your activity/ the general activity of your organisation or company:

(d) Country where you/your organisation or company is located:

Germany

(e) Contact details including e-mail address:

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2 EFRAG's initial assessment of the amendment is that it meets the technical criteria for endorsement. In other words, it is not contrary to the true and fair principle and it meets the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

X Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the amendment? If there are, what are those issues and why do you believe they are relevant to the evaluation?

There are no other issues.

3 EFRAG is also assessing the costs that will arise for preparers and for users on implementation of the amendment in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment are set out in paragraph 11 of Appendix 3. To summarise, EFRAG's initial assessment is that the amendment is:

(a) likely to involve some preparers in some additional year one, but no ongoing, costs. However, EFRAG's initial assessment is that, when considered in aggregate, the additional year one costs will not be significant.

(b) likely to involve users in no year one or ongoing incremental costs.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

As a national standard-setter, we are not in a position to answer this question.

4 EFRAG's initial assessment is that the amendment is likely to result in improvements in the quality of the information provided (see Appendix 3, paragraph 10) and that the benefits to be derived from that will exceed the costs involved (see Appendix 3, paragraph 12).

Do you agree with this assessment?

X Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

5 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the amendment.

Do you agree that there are no other factors?

X Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF THE AMENDMENT

Hedges and hedge accounting

1 Most business activity involves risk and uncertainty, and one of the roles of management is to manage that risk and uncertainty. One way in which that can be done is to enter into transactions that expose the entity to risk and/or uncertainty that fully or partially offsets one or more of the entity's other risks and uncertainties. Such transactions are known as 'hedges'; the instrument acquired or incurred to offset risk or uncertainty is known as 'the hedging instrument'; and the risk or uncertainty hedged is known as the 'hedged risk' or the 'hedged item'.

2 IAS 39 permits entities to apply special, so-called hedge accounting to the hedged item and the hedging instrument when certain criteria are met. The result is that hedging instruments and hedged items are reported in ways that differ from the accounting the normal accounting principles require. The aim of hedge accounting is to match the accounting effect of the hedged item and of the hedging instrument in profit or loss.

3 The criteria that IAS 39 requires to be met for hedge accounting to be applied are:

(a) The hedge relationship must be designated and documented at inception;

(b) The hedge must be expected to be effective. In other words, the hedging instrument needs to be effective (within prescribed parameters) in offsetting the fair value changes or cash flow variability of the hedged item;

(c) Hedge effectiveness must be capable of being reliably measured on an ongoing basis. (Hedge ineffectiveness is required to be identified and reported in profit or loss; and, if ineffectiveness exceeds a certain limit, the use of hedge accounting is precluded);

(d) When hedging future variability in cash flows, there must be a high probability of those cash flows occurring and affecting profit or loss.

4 An entity may hedge risks and uncertainties that represent only some but not all of the risks or cash flows of a particular contract or forecast transaction. In order to enable entities to avoid reporting hedge ineffectiveness in such circumstances—relating to risks that are not being hedged—IAS 39 allows entities to apply hedge accounting to something other than for example the entire contract. However, IAS 39 imposes further restrictions in such cases to ensure that hedge accounting exceptions are applied appropriately and that any actual ineffectiveness that exists in the hedge relationship is reported in profit or loss.

Amendment

5 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.

Clarification 1

6 Consider the following example. A fixed rate bond is issued by an entity which then enters into an inflation-adjusted payment versus fixed rate receipt swap. (In other words, in economic terms the fixed rate bond has been transformed into a liability with an inflation-linked interest rate.) The question that has arisen and is addressed in this part of the amendment is whether it is possible for accounting purposes to treat the fixed rate on the liability as being made up of an inflation-indexed component plus a real rate of interest and to apply hedge accounting in such a way that effectiveness is measured by comparing the offsetting effect of fair value changes of the swap against the fair value changes of the inflation-indexed component of the fixed rate liability.

7 Hedge accounting applied in this way would show no or little ineffectiveness. On the other hand, if hedge accounting is applied in such a way that the offsetting effect of fair value changes of the swap is measured against the fair value changes of the *entire* fixed rate liability, such a hedge would reveal ineffectiveness that would need to be reported in profit or loss and, depending on the extent of that ineffectiveness, might even preclude the application of hedge accounting.

8 In developing its guidance to this question, the IASB noted that it is possible to designate something other than the entire instrument as a hedged item as long as the item is a separately identifiable component of the financial instrument and the effects on fair value or cash flow changes of the entire instrument arising from the designated component are reliably measurable.

9 The IASB concluded that inflation is not a separately identifiable component of the fixed rate financial instrument and its effects on fair value or cash flow changes of the fixed rate financial instrument are not reliably measurable. Following from this conclusion, it is not possible to apply hedge accounting to the inflation portion in a hedge where a hedged item is a fixed rate financial instrument.

10 On the other hand, it is possible to apply hedge accounting to a hedge of an inflation portion if the inflation component is contractually specified and does not affect other cash flows of the financial instrument. An example where this would be the case is an inflation-indexed bond paying the interest at inflation plus 3 per cent.

Clarification 2

11 Entities might want to hedge the risk of the value of a future transaction falling below or rising above a specified price. To achieve this objective, some entities purchase option contracts. An option contract gives its holder the right, but not the obligation, to buy (for a call option) or sell (for a put option) a specific amount of a given stock, commodity, currency, index, or debt instrument, at a specified price (the strike price) during a specified period of time.

12 The value of an option contract is affected by its intrinsic value and its time value.

(a) The intrinsic value is the amount by which the current market price exceeds the strike price.

(b) The chance that the option contract will become profitable for its holder by the time the option contract expires is referred to as the time value of the option contract. The time value is positive at the time when the option contract is entered and will be zero when the option contract expires.

13 Consider the following example. An entity forecasts that in one year's time it will purchase 1,000 bushels of wheat at then current market price for use in its operations. The entity wishes to protect itself against an increase in the cost of wheat above the current market price of CU (currency units) 10 per bushel. It therefore purchases a 1-year option contract on 1,000 bushels of wheat, paying a total premium of CU 500—which is the time value of the option contract at the date the contract is entered into. Under the terms of the option contract, if the price of wheat is above CU 10 per bushel at the maturity (settlement) date, the counterparty will pay the company 1,000 times the difference. If the price of wheat is CU10 or below at the maturity date, the contract expires worthless. The company designates the purchased option contract as a hedge of the risk of the price increasing above 10CU per bushel.

14 The issue that has arisen is whether the hedged item (the risk of the increase in the purchase price of wheat above CU 10 per bushel in the above example) includes a time value similar to the time value that is part of the value of the option contract.

15 This issue is important in deciding how effectiveness of the hedge should be measured. For example, if the fair value of the hedged item is considered not to contain a time value similar to that of the hedging option contract, the time value of the option contract will be considered an ineffective part of the hedge and would need to be reported in profit or loss. If, however, the fair value of the hedged item is considered to contain a time value similar to that of the hedging option contract, the changes in the time value of the option contract will be deferred in equity as part of the effective value changes on the option contract.

16 In the amendment, the IASB reasons that the hedged item has no cash flows that are equivalent to the time value premium in an option contract that would affect profit or loss. It follows that the time value in a hedging option contract should be reported as ineffectiveness of the hedge. The amendment also clarifies that entities have the possibility of excluding the time value of an option contract from hedge accounting entirely, in which case changes in the time value would be reported in the profit or loss in accordance with the normal accounting principles.

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENT AGAINST THE ENDORSEMENT CRITERIA

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, that:

(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.

EVALUATION

Relevance and reliability

3 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.

4 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

5 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.

6 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.

7 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.

8 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 the other cash flows of the instrument must not be affected by the inflation portion.

9 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.

10 EFRAG believes that 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 will be considered identifiable and separately measurable (and therefore eligible for designation as a hedged item under the hedge accounting provisions) if it is contractually specified and does not affect other cash flows in the financial instrument.

Clarification 2

11 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.

12 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. changes in the cash flows or fair value of a hedged forecast transaction either above or below a specified price.

13 The objective of hedging with options is in effect to fix the value of the transaction either below or above certain price. Some consider that the hedged item therefore 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 ofthus, 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.

14 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.

15 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 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.

16 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. Thus, it is reasonable that under the hedge accounting requirements the time value of hedging option contracts is not considered as part of the effective hedge.

17 EFRAG believes that adopted 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

18 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 to identify the effe*ct* 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);

(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.

19 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

20 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.

21 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.

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

23 One place EFRAG has looked for evidence of possible inconsistencies is the IASB's existing Framework. However, EFRAG believes that, apart from the material on the qualitative characteristics, the Framework does not contain any material that provides guidance on the issues under consideration.

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 sees no reason to believe that 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 (as explained more fully in Appendix 3) 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 were not included in the endorsed version. EFRAG's initial assessment is that there is no incompatibility between the amendment and IAS 39 as adopted in the EU.

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT

1 EFRAG has also considered whether, and if so to what extent, implementing the amendment in the EU might involve preparers or users incurring incremental costs, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption.

Costs for preparers

Clarification 1

2 EFRAG's understanding is that the majority of entities in the EU are already applying IAS 39 in a way that is consistent with Clarification 1. The clarification will involve no additional costs for those entities and may even reduce costs a little by removing the uncertainty that did exist.

3 Some entities will however be required to change the way they account for certain of their hedges as a result of the clarification. In particular, where previously such an entity would have treated a hedge of an inflation component in a fixed rate financial instrument as a hedge to which hedge accounting can be applied, henceforth the entity will not be able to apply hedge accounting. In terms of record-keeping, systems and procedures, applying hedge accounting is more costly than not applying hedge accounting, so the clarification will result in a decrease in ongoing costs for preparers, although implementing the amendment will involve some change in procedures—and therefore some relatively insignificant year one costs. It is possible that such entities may pursue different hedging strategies as a result of this clarification, but uncertain behavioural implications of this kind are regarded by EFRAG as outside the scope of its assessment.

Clarification 2

4 EFRAG's understanding is that Clarification 2 will not result in a change in accounting for some entities. Therefore, for those entities no additional costs will arise for preparers and there may even be a small reduction in costs because the uncertainty that previously existed has been eliminated.

5 However, some other entities will be affected. In particular, previously they would have been considering that total changes in value of the purchased options (including the time value) as offsetting of the changes in the value of the hedged forecasted cash flows and thus fully effective. Under Clarification 2 they will be:

(a) treating those value changes as part of the hedge ineffectiveness and recognising them in profit or loss immediately, and taking them into account in determining whether the hedge is insufficiently effective to be eligible for hedge accounting; or

(b) not applying hedge accounting provisions to the time value of option contracts and report changes in the time value in profit or loss.

6 EFRAG's initial assessment is that, when judged in terms of record-keeping, systems and procedures:

(a) there may be some incremental year one costs as the change is implemented but those costs will not be significant, and

(b) there are unlikely to be any incremental ongoing costs.

Transitional arrangements

7 The Amendment requires both clarifications to be applied retrospectively for annual periods beginning on or after 1 July 2009. Retrospective application of changes to accounting standards can be complex, and therefore costly, to implement. However, in this case EFRAG's initial assessment is that, although the transitional arrangements will involve some incremental year one costs for preparers, those costs will be mitigated by the reasonably long lead time allowed by the standard (one year from the date of its publication) and, as a result, are likely not to be significant.

Costs for users

8 EFRAG has also considered whether the amendment will in some way increase the burden on users of financial statements. Its tentative view is that it will impose no additional ongoing burden on users.

9 In order to assess whether it will give rise to additional year one costs for users, EFRAG has considered the implications of the transitional arrangements particularly closely. EFRAG's analysis suggests that the overall effect of the amendment and applying it retrospectively will be 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 clarification, its financial statements are likely to report more volatility in the corresponding periods than in the current period. However, EFRAG notes that the use of hedge accounting is optional under IAS 39, so entities could stop or start hedge accounting at will at any time under existing IAS 39 irrespective of whether there are any economic changes in hedging strategies or not. For that reason EFRAG has concluded that the transitional arrangements will not introduce any new complexities for users and therefore there will be no year one incremental cost for users.

Benefits for preparers and users

10 EFRAG has concluded, for the reasons explained in Appendix 2, that the amendment will result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

Conclusion

11 Summarising the comments above, EFRAG's initial assessment is as follows.

(a) The amendment is likely to involve some preparers some additional year one costs. However, EFRAG's initial assessment is that those costs will not be significant for those entities that will be required to change their accounting. The amendment is not likely to result in additional ongoing costs for preparers.

(b) The amendment is likely to involve users in no year one or ongoing incremental costs.

(c) The amendment is likely to result in some benefits for all stakeholders.

12 EFRAG's initial assessment is that these benefits are likely to outweigh the costs involved.