

Exposure draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Exposures Qualifying for Hedge Accounting
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

xx January 2008

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 7 January 2008

Dear Sir/Madam,

Re: Exposure draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* Exposures Qualifying for Hedge Accounting

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*, Exposures Qualifying for Hedge Accounting (the Exposure Draft). This letter is submitted in EFRAG's capacity as a contributor to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendment when it is issued.

The exposure draft proposes to amend IAS 39 to specify what risks qualify for designation as hedged risks when an entity hedges its exposure to a financial instrument, and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item. The exposure draft also clarifies that in designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole, such as for example time value of a hypothetical written option in a non-derivative financial asset.

EFRAG supports the purpose of the proposed amendment, which is to clarify what would be considered an appropriate designation of risks and portions of financial instruments for hedge accounting purposes under IAS 39 to prevent situations where hedge ineffectiveness exists but is not recognised. However we question whether to achieve this clarity it is necessary to make a general amendment to IAS 39 restricting risks and

portions eligible for hedge accounting; we suggest the IASB considers instead including in IAS 39 application guidance that addresses the above issue directly. Further details on this point as well as other comments to the questions set out in the Exposure Draft are included in the Appendix to this letter.

If you would like further clarification of the points raised in this letter, either Svetlana Boysen or I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

APPENDIX

This appendix sets out EFRAG's response to the questions asked in the exposure draft.

Question 1 – Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y. Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

Draft EFRAG comments on the IASB approach to the proposed amendment to restrict risks and portions eligible for hedge accounting

1. EFRAG supports the objective of the proposed amendments, which is to clarify what can be designated as a hedged item for hedge accounting purposes under IAS 39 and minimise situations in which ineffectiveness exists but is not recognised. In particular a key objective, we understand, is to clarify when inflation can be designated as a hedged portion of a financial instrument. Although we agree with the conclusions reached in the proposed amendment about inflation, we question whether the best way to achieve clarity needed on this aspect of hedge accounting is to make a general amendment to IAS 39 (ie by restricting risks and portions eligible for hedge accounting). In this respect, we do not find convincing the advantages that the basis for conclusion mentions in paragraph BC13 as a justification for this rule based approach:
 - a. We find questionable the statement that the proposed approach would make application of the hedge accounting requirements in IAS 39 simpler;
 - b. The IASB states that placing effective restrictions on when an entity can designate as a hedged item a portion ensures that the situations in which effectiveness exists but is not recognised are minimised. We support the objective of the amendment to ensure that the situations in which ineffectiveness exists but is not recognised are minimised. However, it is our understanding that the amendment achieves this objective mainly by introducing the requirement that risk has to be associated with contractually specified cash flows. It is not clear how specifying other risks and portions would help more in achieving this objective.
 - c. The IASB further states that this approach should minimise the impact of proposed amendments on practice because it limits the situations in which it can designate a portion as a hedged item to situations that are commonly used in practice. However, by restricting risks and portions eligible for hedge accounting to those ones specifically identified in the standard the IASB runs the risk that even if the proposed lists of risks and portions identify situations that are commonly used in practice at the moment these lists may become obsolete very soon. In addition, a rule-based approach has usually a higher risk of unintended consequences. In view of this, we do not agree that one can be assured that following this rule based approach the IASB would minimise the impact on practice.

As an example of unintended consequences we note a possible (in our view unintended) interpretation of paragraph 80Z(c). This paragraph states that a

portion eligible for hedge accounting could be cash flows of a financial instrument associated with a one-sided risk of that instrument (for example, the cash flows resulting from a foreign exchange rate falling below a specified level). Even though the amendments are stated to apply only to financial instruments, this paragraph implies that when an entity hedges a one-sided risk in non-financial items, for example a hedge against a fall in price of a commodity, the entity would be hedging a portion. Since IAS 39 specifically prohibits designation of portions in non-financial items (except for foreign currency risk), one can interpret the proposed amendments as prohibiting hedges of a one sided risk in non-financial items. However, this is considered an eligible hedge for hedge accounting purposes in IAS 39 at the moment.

Therefore, in our view it would be better if the IASB addressed directly the situations where a possibility of inappropriate application of hedge accounting exists rather than restricting risks and portions thus unnecessarily increasing the scope of the amendment. We believe that this could be achieved by adding an application guidance addressing such situations. In fact, the current proposed wording in 80Y(e) is different from the rest of paragraph 80Y: while paragraphs 80Y(a) to 80Y(d) list various types of risk, paragraph 80Y(e) explains the criteria which make a particular risk eligible for hedge accounting under IAS 39. Thus, paragraph 80Y(e) looks like application guidance already.

Other, more detailed draft comments

2. Irrespective of whether the IASB decides to proceed with the amendment as currently proposed or it will include an application guidance in line with our proposals we have a concern about the proposed wording of paragraph 80Y(e). It has become apparent from our discussions that wording in paragraph 80Y(e) is being interpreted differently by different people. As a general requirement this paragraph states that risk has to be associated with contractually specified cash flows. However, it is our understanding that for risk to be eligible for designation as hedged risk it has to be associated with the contractually specified cash flows *and*, as it follows from the example regarding inflation risk, the cash flows must be independent of any remaining cash flows in the instrument. We think that these two criteria should be stated together as a general requirement rather than one criteria being stated as a general requirement with the other being mentioned merely in the example. Therefore we suggest amending the wording in current paragraph 80Y(e) to read as follows:

"Risks associated with contractually specified cash flows that are independent of any remaining cash flows in the instrument."

For the same reason, we further suggest clarifying the sentence in the example in paragraph 80Y(e) that reads: "This is because either the inflation component is not a contractually specified cash flow or, if inflation is a contractually specified cash flow, the remaining component would be a residual." We suggest adding the following explanation at the end of that sentence "... i.e. the inflation would not be independent of the remaining cash flows in the instrument" to make a clearer link with the general requirement.

3. Paragraph 80Y states that the risks it specifies are subject to restrictions in paragraph 79 dealing with application of hedge accounting to held-to-maturity financial assets. Paragraph 79 specifically prohibits designation of held-to-maturity financial assets as a hedged item with respect to interest rate risk and prepayment risk, but allows

designation of credit risk as a hedged risk in a held-to-maturity financial asset. We believe that paragraph 79 needs to be amended to address the ‘new’ category of eligible for hedge accounting risks (“risks associated with contractually specified cash flows”).

4. We note that equity risk is missing from the list of risks eligible to be designated as hedged risks under hedge accounting provisions of IAS 39. We understand that in a situation where a hedged item is a debt instrument whose cash flows are linked to changes in equity prices, the issue whether equity risk is eligible for designation would not arise. This is because equity linked cash flows will be considered an embedded derivative not closely related to the host contract and will be separately accounted at fair value similar to a hedging instrument.

Entities may also hedge and apply hedge accounting to a stand-alone non-derivative equity instrument which is classified as available-for-sale. Possibly, in this case the first part of paragraph 80Y in which it is stated “...a financial instrument can be designated as hedge item with respect to “all” of its risks...”, will apply because either the equity risk will be the “only” risk associated with the “equity instrument” or the equity risk will be hedged together with any other risks associated with the equity position for example foreign currency risk.

However, to clarify things we think it would be helpful if in the basis for conclusions the IASB could explain its reasoning for not referring to equity risk in paragraph 80Y (if the IASB decides to proceed with its current approach).

5. We note the following inconsistency in the list of risks in paragraph 80Y: the paragraph defines interest rate risk and foreign currency risk, but it does not define credit risk and prepayment risk. As it happens, ‘interest rate risk’, ‘currency risk’ and ‘credit risk’ are already defined terms in IFRS, but ‘prepayment risk’ is not. If the IASB decides to retain paragraph 80Y largely as is, we believe it should include definitions for both credit risk and prepayment risk.

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item. Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why? Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

EFRAG draft comments

6. As explained in our response to question 1 we think it would be preferable for the IASB to add application guidance addressing the aspect of hedge accounting which is causing interpretation issues, rather than specifying risks and portions eligible for hedge accounting.

Question 3 – Effect of the proposed amendments on existing practice

The aim of the proposed amendments is to clarify the Board’s original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in

practice from arising. Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

EFRAG draft comments:

7. We understand that generally in practice the interpretation as to when inflation can be designated as a hedged risk portion has been in line with the proposed amendments. However, there is some divergence in practice as to whether it is possible to designate the time value of a hypothetical written option as part of the hedged item in a non-derivative financial asset or a non-derivative financial liability without optionality features.

Question 4 – Transition

The proposed changes would be required to be applied retrospectively. Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

EFRAG draft comments

8. Our general position is that we much prefer changes in standards to be applied retrospectively rather than prospectively, as long as retrospective application does not cause practical problems that cannot be overcome by a longer lead time. We understand that retrospective application would in this case for example imply that entities that designated inflation risk portions in fixed rate financial instruments or the time value of a hypothetical written option as part of the hedged item would have to reverse their designations retrospectively. However, as hedge accounting has contemporaneous designation requirements, it would not be possible to make 'alternative' designations going backwards.

This would be particularly relevant for situations addressed in the proposed guidance in paragraph AG99E on hypothetical derivatives. For example, entities that designated option contracts as hedging instruments in their entirety, i.e. including time value, and that considered it appropriate to designate as part of the hedged item time value of a hypothetical written option by analogy to the corresponding guidance in US GAAP¹ (thus including time value of the hypothetical written option in estimation of changes in present value of cash flows of the hedged item attributable to the hedged one-sided risk to measure hedge effectiveness), would have to reverse these designations. An alternative designation under IAS 39 would be to designate only the intrinsic value of hedging options and report changes in time value of the option in the profit or loss as allowed by paragraph 74 (a) in IAS 39 in order to meet the criteria in IAS 39 that the hedge relationship should be highly effective. If retrospective application is required, the contemporaneous designation requirements mean that the entities that followed the "US GAAP approach" would not be able to redesignate those hedge relationships in the past periods for only the change in the intrinsic value of an option while

¹ Statement 133 Implementation Issue No. G20 "Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge".

excluding the change in its time value and would have to treat the hedging derivatives as held for trading.

Question to constituents:

(a) Do you support retrospective application of the amendments proposed in the exposure draft despite of the consequences as described above?

Or

(b) Do you believe that prospective application would be more appropriate in so far that entities would be able to keep their designations until the effective date of these amendments, but would have to redesignate all previously designated hedge relationship in accordance with the new requirements going forward from the effective date of the amendments? If you do believe this is more appropriate, please explain your reasoning.

Other EFRAG draft comments

9. We support the proposed guidance in paragraph AG99E that in designating a one-sided risk as a hedged portion, an entity may not designate cash flows associated with the time value of a hypothetical written option as part of the hedged item and include the time value in estimation of changes in present value of cash flows of the hedged item attributable to the hedged one-sided risk to measure hedge effectiveness. The proposed guidance does not allow this designation on the basis that this would be considered imputing the cash flows that do not exist in the financial instrument; and we support this conclusion. However, we suggest that the IASB includes a clarification that, if there is an option embedded in the hedged item, it can be designated as a hedged item in a fair value hedge in accordance with paragraph AG94.
10. We note that the proposals in the exposure draft are limited to hedges of financial instruments. However, the proposed guidance in paragraph AG99E should in our view be made applicable to non-financial items. This is because non-financial items can be also hedged with options, for example foreign currency or commodity options. Otherwise, if an entity hedges a non-financial item with an option, some might argue that it is possible to designate the time value of a hypothetical written option in a non-financial item as part of the hedged item since the amendments are stated to apply only to financial instruments.

In this respect, we propose that the IASB also clarifies that cash flows associated with a one sided risk can be designated as a hedged item in non-financial items. IAS 39 generally prohibits designation of portions as hedged items in non-financial items (except for foreign currency risk). As mentioned in our response to question 1 above, the proposed wording in paragraph 80Z (c) may suggest that it is inappropriate to apply hedge accounting to a commodity option contract hedging a one-sided risk in a non-financial item because this would be considered hedging a portion.

Question to constituents:

Do you agree with EFRAG that the proposed guidance in AG99E is appropriate? If not, do you believe that hedge accounting provisions in IAS 39 should make it possible to designate option contracts in their entirety and designate time value of a hypothetical written option as part of the hedged item. Thus, when measuring hedge effectiveness and determining to which extent the hedge is effective, time value of a hypothetical written option would be included in estimation of changes in present value of cash flows of the hedged item attributable to the hedged one-sided risk? If so, how would you justify appropriateness of this method under IAS 39?