EFRAG

European Financial Reporting Advisory Group

EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT TO IAS 39 "ELIGIBLE HEDGED ITEMS"

INTRODUCTION

1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedged Items" (the Amendment).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

3 EFRAG already carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENT

Hedges and hedge accounting explained

4 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'.

5 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.

6 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.

7 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 some (but not all) risks or cash flows of a contract. However, IAS 39 imposes further restrictions in such cases to ensure that hedge accounting is applied appropriately and that any ineffectiveness that exists in the hedge relationship is reported in profit or loss.

The Amendment explained

8 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

9 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.

10 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 preclude the application of hedge accounting.

11 In developing its guidance on 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.

12 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.

13 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 interest at inflation plus 3 per cent.

Clarification 2

14 Entities might want to hedge the risk that the value of a future transaction will fall below or rise 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.

15 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 the option contract is entered into and will be zero when the option contract expires.

16 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 amount by which it exceeds CU 10. If the price of wheat is CU 10 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 CU 10 per bushel.

17 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.

18 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.

19 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 fair value of the hedged item should be considered not to contain a "time value". An implication of that is 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.

EFRAG'S INITIAL ANALYSIS OF COSTS AND BENEFITS OF THE AMENDMENT

20 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendment, both in year one and in subsequent years. The results of the initial assessment can be summarised as follows.

(a) EFRAG's initial assessment was that the Amendment was:

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

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

(b) EFRAG's initial assessment of the benefits that would arise from the Amendment was that the Amendment was likely to 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.

(c) EFRAG's initial assessment was that the benefits to be derived from implementing the Amendment in the EU were likely to exceed the costs involved in its implementation.

21 EFRAG published its initial assessment of the costs and benefits of implementing the Amendment in the EU and supporting analysis on 22 September 2008 and invited comment on it until 27 October 2008. In response, EFRAG received 8 comment letters. Two of those letters did not comment on EFRAG's initial assessment. The other 6 all agreed with EFRAG's initial assessment and had no additional comments, although one stated it had not carried out a detailed examination of the effects involved.

22 In addition, EFRAG consulted its User Panel in October 2008 on EFRAG's initial assessment and Panel members were content with the assessment.

EFRAG's FINAL ANALYSIS OF THE COSTS AND BENEFITS OF THE AMENDMENT

23 Based on its initial analysis, comment letters received in response to that analysis and input from EFRAG's User Panel members, EFRAG's final analysis of the costs and benefits of the Amendment is presented in the paragraphs below.

Costs for preparers

Clarification 1

24 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.

25 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 entities 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

26 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 and there may even be a small reduction in costs because the uncertainty that previously existed has been eliminated.

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

(a) treat those value changes as part of the hedge ineffectiveness and therefore recognise them in profit or loss immediately. They will also take those value changes in determining whether the hedge is insufficiently effective to be eligible for hedge accounting; or

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

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

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

(b) there will be no incremental ongoing costs.

Transitional arrangements

29 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 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, will not be significant.

Costs for users

30 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. For that reason EFRAG has concluded that the transitional arrangements will not introduce any new complexities for users and therefore that there will be no incremental year one costs for users.

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

Benefits for preparers and users

32 In EFRAG's view the Amendment will result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This will be a benefit to all stakeholders.

Overall assessment

33 EFRAG's assessment is that the benefits that will arise from implementation of the Amendment in the EU are likely to exceed the insignificant costs involved.

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