EFRAG

European Financial Reporting Advisory Group

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

15 February 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 ED). 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 ED 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 ED 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 the proposed broadly-based amendment to IAS 39 restricting risks and portions eligible for hedge accounting to those listed in the standard.

We would much prefer if a principle could be developed to determine when a risk exposure could be designated for hedge accounting purposes under IAS 39. However, acknowledging difficulty in developing a principle in this area of hedge accounting, we suggest the IASB considers instead including in IAS 39 application guidance that focuses exclusively on the issues that have arisen and need to be addressed, because the proposed broadly–based amendment seems to have unintended consequences.

In addition, based on our consultations with constituents we note that the proposed guidance in paragraph AG99E dealing with how to measure hedge effectiveness when a designated hedged portion is the cash flows of a financial instrument associated with a one-sided risk of that instrument touches on an issue on which there are significant differences of view and of practice at the moment. Indeed, we suspect that the proposed amendment will change practice much more widely than the IASB realises. In any case, we think the different views highlight a difference in philosophy that needs to be explored more fully than it has been to date. In view of this we encourage the IASB to give this issue a further consideration.

Further details on these points as well as other comments to the questions set out in the ED are included in the Appendix to this letter.

We have commented on the ED's proposals from the perspective of IAS 39 as issued by the IASB. However, as you know IAS 39 as adopted in the EU has certain requirements carved out. We would like to draw your attention to the fact that the proposed amendment as it currently stands appears to counteract some of the effect of the "European carve out".

We also understand that the IASB is currently in dialogue with the FBE regarding possible amendments to IAS 39 which might enable Europe to eliminate the carve out. It would clearly be unfortunate if the proposed amendments in this ED were to cut across any such solution and this should be further considered by the IASB.

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?

The approach proposed

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 we understand that the ED was developed in response to submissions to the IFRIC asking to clarify the following issues relating to what can be designated as a hedged portion of a financial instrument: (a) can inflation be designated as a hedged exposure for hedge accounting purposes; (b) is it possible to designate a hedging relationship in such a way as to achieve a fully effective hedge when the hedging derivative matures before the forecast transaction; and (c) is it possible to designate the full change in fair value (both time value and intrinsic value) of a purchased option as the hedging instrument in a fully effective cash flow hedging relationship?

2. Although we agree with some of the conclusions reached in the proposed amendment (for example regarding issue (a)), we question whether the best way to achieve clarity in this area of hedge accounting is to make the broadly-based amendment to IAS 39 (i.e. by restricting risks and portions eligible for hedge accounting to those set out in a list).

3. The IASB states that the rule-based approach of listing risks and portions eligible for hedge accounting 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 sure that following the rule based approach propose does 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.

Similarly, if an entity hedges the cash flows of a commodity contract for part of the time period to maturity - for example only the first year of a five year gas delivery contract if the first year is traded in an active market - or a percentage of the cash flows of a commodity – for example, only 70 MWh of a 100 MWh electricity contract - such exposures would be considered portions of the whole contracts in accordance with proposed paragraphs 80Z (a) and 80Z (b) and thus could not be designated as hedged items because paragraph 82 in IAS 39 precludes portions being designated as hedged items in non-financial assets and liabilities.

4. We would have much preferred if a principle-based solution could be developed to address questions of what exposures qualify for hedge accounting under IAS 39. However, we understand that the IASB made an attempt to develop a principle in this area of hedge accounting but found it difficult. Therefore, acknowledging difficulties in developing a principle-based solution, at least in the short run, we believe it would be better if the IASB addressed directly the situations where a possibility of hedge accounting being applied inappropriately exists rather than including in IAS 39 a list of all the risks and portions eligible for hedge accounting and thus unnecessarily increasing the scope of the amendment and possibly still not providing enough guidance where a need for clarification exists. We believe that this could be achieved by adding application guidance addressing such situations. We accept that this would be a rule-based solution too, but it would be a narrow amendment that is unlikely to cause the problems that the broadly-based solution in the ED would.

Other, more detailed comments

5. Irrespective of whether the IASB decides to proceed with the amendment as currently proposed or to include 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 the wording 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, the last sentence in this paragraph ("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") suggests that meeting this requirement alone is not sufficient. If that is the case, we recommend that the IASB states all the relevant criteria as a general requirement rather than one criteria being stated as a general requirement with the other being mentioned merely in the example. We further note that the term "residual" as it is used in the above context is not clear (as became apparent from our consultations). Therefore, we recommend the IASB explains the principle it is trying to get at instead of just referring to "a residual".

6. 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").

7. 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 of 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).

8. 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.

9. We understand that the ED was developed in response to issues submitted to the IFRIC (we referred to this in paragraph 1 above). We note that the ED deals explicitly with issue (a) (in paragraph 80Y(e)) and with issue (c) (in paragraph AG99E). However, we question whether the ED actually achieves enough clarity on issue (b) (whether it is possible to designate a hedging relationship in such a way as to achieve a fully effective hedge when the hedging derivative matures before the forecast transaction). Although the ED refers to a "partial term hedge" in paragraph 80Z (a), that paragraph is talking about recognised financial instruments so it still might not be clear whether and how this guidance can be applied to unrecognised forecast transactions.

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 comments

10. As explained in our response to question 1, although we think it would be preferable for the IASB to have developed a principle underlying what exposures qualify for hedge accounting, we accept that that has proved difficult. However, we again think it would have been better in the short run for the IASB to have addressed issues which cause diverse interpretation in practice directly, rather than making a broadly-based amendment to IAS 39 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 comments:

11. 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 a finely balanced division of opinion with regard 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 (which is the subject of the amendment proposed in paragraph AG99E); as a result, many entities will be affected by this amendment. (We explain what those different views are, and therefore what the changes in practice would be, in our comments on paragraph AG99E in section "Other EFRAG comments" of this letter.)

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 comments

12. 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.

13. 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 GAAP[1] (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

[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".

periods for only the change in the intrinsic value of an option while excluding the change in its time value and would have to treat the hedging derivatives as held for trading.

14. Therefore we 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.

Other EFRAG comments

Proposed guidance in paragraph AG99E

15. We note that while allowing the cash flows of a financial instrument associated with a one-sided risk of that instrument to be designated as a hedged item the IASB nevertheless concluded that the inherent time value of a one-sided hedge does not exist in the overall hedged item and hence this element cannot be designated as part of the hedged portion. What can be designated is the intrinsic value. It means that the time value of the option will be taken to profit or loss as the mark-to-market changes over its life.

16. However, some of our constituents are of the opinion that when the hedged item is a portion of cash flows associated with a one-sided risk of an instrument it has time value associated with it and that the time value should be allowed to be designated as part of the hedged item. As a result of such a designation, the time value of the option is deferred as part of the hedging gain or loss in equity and is "recycled" as part of that hedging gain or loss in profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. Thus, there is not only a diversity in practice as to how hedge effectiveness is measured in a cash flow hedge where a hedging instrument is an option, but also a difference in understanding or 'philosophy'. Our understanding is however that the issue has not been discussed in any detail by the IASB, and we note that it is not discussed in the Basis for Conclusions either. We would encourage the IASB to give this matter further consideration, particularly as it is understanding that the practice that this proposed amendment would prohibit is much more widespread than is perhaps realised.

17. Furthermore, although the ED addresses this issue in relation to financial instruments, it is also relevant to non-financial items because non-financial items can be also hedged with options, for example foreign currency or commodity options.

Designation of portions as hedged items in non-financial assets and liabilities

18. The IASB states in the ED's Basis for Conclusions that it is not the purpose of the ED to deal with situations in which an entity designates a non-financial item as a hedged item because the Board concluded that the requirements of IAS 39 are clear in this respect.

19. However, from our discussions and consultations, it would seem that the ED has actually revealed areas with regard to application of hedge accounting to hedges of non-financial assets and liabilities which are not so clear—for example hedges of one sided risk, partial term hedges or hedges of portions of cash flows—as explained in our response to question 1 of this letter.

20. In addition, constituents inform us that there are situations in which in their view prices of an ingredient or component of non-financial items *do* have a predictable and separately measurable effect on the total price of the item; which is contrary to the reasoning in the

Basis for Conclusions to IAS 39 that states that one of the reasons why the IASB does not permit designation of portions of non-financial items is that "…changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure." They provided us with the following examples:

a. A lease contract with payments that vary directly with a quoted market interest rate (for example LIBOR). Currently, if the lease is classified as an operating lease, the interest rate portion (for example the LIBOR portion) is not eligible for hedge accounting, because such payments (although contractually specified) are a portion of a non-financial item. As a consequence, all the cash flows under the lease contract would have to be designated as a hedged item, and that would most probably lead to ineffectiveness because the hedging derivative economically hedges only the LIBOR risk. However, if the lease is classified as a finance lease, the interest rate portion can be designated as a hedged item under IAS 39 because in this case there will be a financial item recognised on the balance sheet.

b. An executory contract to buy a non-financial item in which the price to be paid is determined by a formula that includes a quoted market variable. For instance, in a contract for the purchase of rolled metals, the price to be paid may be set as the market price of the refined metal ingots (a traded commodity) plus the actual rolling costs plus a margin. In this example, the traded market price of the refined metal ingots cannot be designated as a hedged portion despite the fact that it is contractually specified subset of the total cash flows that directly affects the cash price to be paid and as such represents a separately identifiable and measurable risk of the total price of rolled metals.

21. Bearing in mind there is a lack of clarity in this area and that there are circumstances in which a portion of a non-financial item can have a predictable and separately measurable effect on the item as a whole, we encourage the IASB to provide necessary clarifications and reconsider its approach to when a portion of a non-financial asset and liability can be designated as a hedged item as soon as it is reasonably possible.