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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 October 2006, London**

Project: **IAS 39 *Financial Instruments: Recognition and measurement***

Subject: **Identification of a portion of an exposure eligible for hedge accounting (Agenda Paper 15)**

Purpose of this paper

1. The IFRIC has received a number of submissions asking whether the risks associated with a specific portion of a cash flow or fair value exposure might qualify for hedge accounting under IAS 39. For example, the IFRIC has been asked whether inflation risk could qualify as a hedged portion of an interest bearing asset or liability.

2. The IFRIC, after extensive debate, has been unable to find a principle which could be used to identify an eligible portion for the purposes of hedge accounting. Furthermore, there is significant diversity in practice on this issue.

3. At its meeting held in July 2006, the IFRIC asked the staff to approach the Board for guidance on how to address the issue of what can be designated as a hedged portion under IAS 39. Consequently, the purpose of this paper is to obtain the Board's view on the best way forward on this issue.

Background

4. Paragraphs 78 to 84 of IAS 39 *Financial Instruments: Recognition and Measurement* provide guidance on qualifying hedged items. In particular, paragraph 81 provides guidance in respect of designating financial items as hedged items, stating:

   If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a <u>*portion*</u> *of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).* (Emphasis added)

5. In March 2004, the Board debated adding guidance to IAS 39 on what can be designated as a hedged portion. This issue arose as part of the fatal flaw review of the amendments made to IAS 39 in respect of fair value hedge accounting for a portfolio hedge of interest rate risk. Relevant extracts from the March 2004 board paper and IASB Update are included in the appendix to this paper.

6. At its March 2004 meeting, the Board agreed that the Standard should not, at that stage, provide any other guidance on hedging portions beyond that already contained in IAS 39 and the exposure draft on macro hedging. It was agreed that the issue of portions should be the subject of a future convergence project to be given high priority. However, the Board has not subsequently discussed the issue of portions.

7. Following the direction of the IFRIC, the staff presented a paper at the July 2006 IFRIC meeting that analysed some of the guidance in IAS 39 on what can be designated as a hedged portion. The paper attempted to develop a principle which could be used to answer the questions on portions that have been put to IFRIC.

8. The paper presented to the IFRIC at the July 2006 meeting and the conclusions reached by the IFRIC are summarised in agenda paper 15A.

9. The staff recommend that the Board read agenda paper 15A before considering the questions in paragraph 10 below.

Summary of possible ways forward

10. The staff note this issue is unlikely to be dealt with as part of the Board's current work on financial instruments. Consequently, the staff believe that there are three possible ways to address this issue:

    a. The IFRIC could deal with each request for interpretation on an ad hoc basis. However, the staff note that this could result in a series of (possibly inconsistent) rulings. The staff also question whether the IFRIC would be able to reach a consensus on each issue without developing an underlying principle.

    b. The IFRIC could decline to address the issue and allow practice to develop. This approach would be consistent with the approach taken by the Board in 2004.

    c. Guidance could be developed which sets out a principle for identifying portions which can be hedged under IAS 39. This guidance could take the form of an amendment to IAS 39 (produced by the Board). Alternatively, the IFRIC could attempt to develop guidance. However, as noted above, the IFRIC has previously concluded that the current wording of IAS 39 does not provide a strong enough basis for a principle to be developed.

1) Which of the three suggested approaches above does the Board prefer?

2) If the Board believes that guidance should be developed (approach c above), should that guidance be developed by:

- **the Board as an amendment to IAS 39; or**
- **the IFRIC as an interpretation?**

3) Does the Board believe that any guidance on what can be designated as a hedged portion should be based upon the analysis in agenda paper 15A.

Appendix

Extracts from Board agenda paper 3 – March 2004

[Omitted from observer notes]

Extract from March 2004 IASB Update

The Board revisited the tentative decisions it made at the February 2004 meeting that would clarify three matters in relation to designating a portion of a financial asset or financial liability as the hedged item. In particular it discussed whether a designated portion need have some relationship to the instrument being hedged and, if so, how close that relationship should be. The Board decided it could not resolve this issue in the time available (ie before the amendments to IAS 39 are issued later this month) and that the issue would be best addressed in conjunction with the FASB, with the aim of reducing differences between IAS 39 and the equivalent US Standard (FAS 133 *Accounting for Derivative Instruments and Hedging Activities*). Accordingly, the Board

- reconfirmed the decision it made in February to clarify that an entity cannot designate, as the hedged item, a portion of the cash flows on a financial asset or financial liability that is greater than the total cash flows of the asset or liability. Hence, if a liability has an effective interest rate of less than LIBOR, the entity cannot designate, as the hedged item, a 'portion' of the cash flows on the liability equal to the principal amount of the liability plus interest at LIBOR. The Board agreed to clarify, however, an entity can designate all of the cash flows on the entire liability as the hedged item and hedge them for changes in only one risk.
- tentatively agreed that the Standard should not, at this stage, provide any other guidance on hedging portions beyond that already contained in IAS 39 and the exposure draft on macro hedging. However, this issue should be the subject of a future convergence project to be given high priority.