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**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

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| **Board Meeting:** | **20 June 2007, London** |
| **Project:** | **Proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*** |
| **Subject:** | **Identification of exposures qualifying for hedge accounting (Agenda paper 8)** |

## Introduction

1. At its December 2006 meeting, the Board decided to propose amendments to IAS 39 to clarify when an entity may designate an exposure to a financial instrument as a hedged item. The proposed amendments specify

   (a) the risks that qualify for designation as hedged risks when an entity hedges its exposure to a financial asset or financial liability; and

   (b) when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

2. The staff circulated [to the Board] a first pre-ballot draft of the proposed amendments on 5 June 2007 requesting comments by 4 July 2007. Appendix 1 to this paper reproduces this pre-ballot draft. [Appendix omitted].

3. The staff will deal with any comments regarding the drafting of the proposed amendments after the 4 July deadline. However, at this meeting, the staff will ask Board Members whether they intend to dissent from issuing the proposed amendments.

4. The proposed amendments to IAS 39 are intended to clarify the Board's original intentions regarding what can be designated as a hedged item rather than change significantly existing practice. Consequently, the Board instructed the staff to carry out research to determine the effect that the proposed amendments would have on existing practice. This paper summarises the results of that research.

## Results of research

5. The staff sought feedback on the effect of the proposed amendments on existing practice from two sources. Firstly, the staff presented a paper explaining the proposed amendments to the Financial Instruments Working Group (FIWG) at its April 2007 meeting. In addition, the staff spoke informally to accountants at a number of the large accountancy firms. As the feedback received from the accountancy firms was on an informal basis, it may not necessarily reflect the positions taken in their comment letters.

6. Appendix 2 summarises the questions asked.

**Feedback from FIWG**

7. Members of the FIWG were broadly supportive of the proposed amendments, which they believed clarified when a financial instrument can be designated as a hedged item.

8. Some FIWG members noted that until the wording of the proposed amendments is finalised it is not possible to predict exactly the effect that the amendments will have on practice. However, based on the information provided, FIWG members considered it unlikely that the amendment would change existing practice significantly as the risks and portions specified are those most commonly designated as hedged items in practice.

9. A number of FIWG members asked whether the scope of the proposed amendments could be expanded to permit portions of non-financial items to be designated as hedged items. Currently, IAS 39 permits non-financial items to be designated as hedged items for foreign currency or in their entirety for all risks. However, the staff do not recommend expanding the scope of the proposed amendments.

**Informal feedback from accountancy firms**

10. Comments received from accountants at the large accountancy firms were for the most part consistent with the comments received from the FIWG members. That is, the proposed amendments are unlikely to result in a significant change to existing practice as the risks and portions specified are those most commonly designated as hedged items.

11. The accountancy firms suggested a number of drafting clarifications. The staff have incorporated these into the pre-ballot draft (for example, references to LIBOR have been replaced with references to a quoted inter-bank rate).

12. As noted at previous Board meetings, the proposed approach to these amendments is rules rather than principles based. Accountants from one of the firms expressed concerns regarding this rules based approach. These accountants recommend that the Board develop a principle to determine what can be designated as a hedged portion. They believe that a principles based approach has the following advantages:

    - It is consistent with the Board's stated long-term objective of simplifying hedge accounting;
    - It is more durable as it would be less likely to result in constituents asking for further amendments as markets and hedging strategies develop;
    - It avoids the arbitrary distinctions inherent in a set of rules;
    - It is consistent with the IASB's principles based approach to standard setting.

13. At its December 2006, meeting the Board considered whether to develop a principle based approach to this amendment. However, the Board rejected this. The rules based approach the Board decided to adopt has the following advantages:

- The situations in which an entity can designate a portion of the cash flows of a financial asset or financial liability are clearly defined under this proposed approach, making application of the hedge accounting requirements of IAS 39 simpler;
- It places effective restrictions on when an entity can designate a portion of the cash flows of a financial asset or liability as a hedged item. This ensures that the situations in which ineffectiveness exists but is not recognised are minimised;
- Limiting the situations in which an entity can designate a portion of the cash flows of a financial asset or financial liability as a hedged item to those situations that are commonly used in practice will minimise the impact of the proposed amendments on practice;
- Amendments of this type are relatively simple to implement, requiring only small changes to IAS 39.

14. In addition, the same accountants expressed concerns that some of the less commonly hedged risks and portions may no longer qualify for hedge accounting (for example, equity price risk, commodity price risk embedded in a financial contract and embedded derivatives that are not bifurcated).

## Staff recommendation

15. Further feedback on the proposed amendment will be obtained from comment letters on the exposure draft. The list of risks and portions qualifying for designation may need to be revised once the comment letters have been received. However, as most respondents believe that the proposed amendments will provide useful guidance on what can be designated as a hedged item without resulting in a significant change to existing practice, the staff recommend that the Board approve the exposure draft for publication.

## Question for the Board

- **Do you intend to dissent from issuing the proposed amendments?**

## Appendix 1 – Pre-ballot draft of the proposed amendments

[Appendix omitted]

## Appendix 2 – Questions asked

The staff requested answers to the following questions:

**Question 1**

Are the risks listed below those risks most commonly hedged in practice? Do you believe that any other risks should be eligible for designation as a hedged risk? If so, why?

*Risks*

- Market interest rate risk;
- Foreign currency risk;
- Credit risk;
- Prepayment risk; and
- The risks associated with the cash flows of a financial instrument that are contractually specified and are independent from the other cash flows of the same financial instrument.

**Question 2**

Are the 'other portions' listed below the portions that are most commonly designated as hedged portions in practice? Are there any other portions the Board should consider? If so, why?

*'Other portions'*

- The risk-free or LIBOR portion of an interest bearing financial instrument;
- The prepayment portion of an interest bearing financial instrument;
- The remaining portion of an interest bearing financial instrument once the interest rate or prepayment risk portion has been excluded (labelled as a 'credit portion').

**Question 3**

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