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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: May 2007, London

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* - Hedging multiple risks with a single derivative hedging instrument (Agenda Paper 11(iii))**

BACKGROUND INFORMATION

1. The IFRIC has received a submission that relates to a situation in which a single derivative hedging instrument is used to hedge more than one different type of risk. The entire derivative is designated as a hedging instrument to hedge those exposures.
2. IAS 39 paragraph 76 permits a single hedging instrument to be designated as a hedge of more than one type of risk provided that the following three conditions are met:
 - (a) The risks hedged can be identified clearly;
 - (b) The effectiveness of the hedge can be demonstrated; and
 - (c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

3. The issue raised with the IFRIC relates to the application of criterion (b) above (not criteria (a) and (c)). Criteria (a) and (c) above relate to the identification of hedged risks and designation of the hedging instrument and hedged risk positions.
4. The submission notes that F.1.13 of the Guidance on Implementing IAS 39 illustrates how to apply IAS 39 paragraph 76.
5. The facts of IG F.1.13 are as follows:
 - Entity A's functional currency is the Japanese Yen.
 - It has two different foreign currency exposures: one arising from a floating rate financial liability denominated in US dollars and the other arising from a fixed rate financial asset denominated in pounds sterling.
 - To hedge against the foreign currency exposure on the principal repayments of both asset and liability, Entity A enters into a dual foreign currency forward contract under which it receives US dollars and pays pounds sterling.
 - The dual foreign currency forward contract is designated as a hedging instrument in a cash flow hedge.
6. IG F.1.13 states:

"(a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.

(b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract."
7. The submission states the approach to demonstrating hedge effectiveness set out in IG F.1.13 requires the entity to assess hedge effectiveness of each risk position separately. To do so, the entity inevitably has to divide

the single fair value derivative hedging instrument into one or more components for assessing and measuring hedge effectiveness. The ‘Yen’ leg is imputed to create two synthetic derivatives: (i) a receive-US dollars and pay-Japanese yen forward contract and (ii) a receive-Japanese yen and pay-pounds sterling forward contract. The ‘Yen’ legs do not exist in the contractual terms of the dual foreign currency forward contract.

ISSUE RAISED BY THE SUBMISSION

8. The submission asks whether the approach set out in IG F.1.13 can be extended to other circumstances in which a notional leg other than the functional currency of the entity is created as a base to split a single fair value hedging instrument into multiple components for assessing and measuring hedge effectiveness.
9. The submission says that IAS 39 does not specify whether the approach described in IG F.1.13 can be extended to other circumstances.
10. The submission cites two common examples in which an entity uses a derivative hedging instrument to hedge multiple different risks, which are set out in Appendix 1 to this paper. In those examples, notional legs (an imputed fixed rate leg in Example 1 and an imputed floating rate leg in Example 2) are created as bases to split the single fair value derivative hedging instrument into two synthetic derivatives for assessing and measuring hedge effectiveness.

SCOPE OF THIS PAPER

11. This paper does not address the recognition and measurement of hedging instruments and hedged items.
12. When a derivative in its entirety is designated as a hedging instrument, there is no doubt that all changes in the fair value of the derivative must be considered.
13. This paper focuses on the assessment of hedge effectiveness, particularly, whether a hedging instrument can be split for the purpose of assessing hedge effectiveness.

14. This paper does not address situations in which an entity uses a single derivative hedging instrument to hedge multiple risk positions which are allowed to be aggregated and hedged as a group under IAS 39 paragraph 83¹.
15. If an entity uses a single derivative hedging instrument to hedge multiple risks in more than one item and aggregates the multiple items and hedges them as a group in accordance with IAS 39 paragraph 83, it should aggregate the changes in the fair value of multiple hedged items and compare the aggregate amount with the changes in the fair value of the derivative hedging instrument for assessing and measuring hedge effectiveness. In that situation, the entity does not need to split the fair value of the derivative hedging instrument.
16. However, when the entity is not allowed to group those multiple items for hedge accounting purposes, hedge effectiveness of each hedged risk position has to be assessed separately. In that situation, a question arises as to whether an entity is allowed to impute a notional leg to split the fair value of the derivative hedging instrument into multiple components to allocate them to corresponding hedged risk positions for assessing and measuring hedge effectiveness.
17. Similarly, the same question arises when an entity uses a single derivative hedging instrument to hedge more than one exposure in an item, and the exposures are accounted for under different types of hedge accounting.
18. This paper specifically focuses on situations in which an entity uses a single derivative hedging instrument to hedge multiple risk positions which are not allowed to be aggregated and hedged as a group under IAS 39 paragraph 83.
19. As mentioned earlier, the entity in that situation is required to assess hedge effectiveness of each risk position separately. To do so, the entity inevitably has to split the fair value of the single derivative hedging

¹ IAS 39 paragraph 83 states: ‘Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.’

F.6.2 and F.6.3 of the Guidance on Implementing IAS 39 provide specific examples to illustrate when multiple items can be aggregated and hedged as a group.

instrument into multiple components to allocate them to corresponding hedged risk positions for assessing and measuring hedge effectiveness. The approach in IG F.1.13 imputes a notional leg (that is the functional currency of the entity) as a base to split a dual foreign currency forward contract into two synthetic derivatives.

20. This paper discusses under what circumstances an entity is allowed to split the fair value of a derivative hedging instrument into multiple components for assessing and measuring hedge effectiveness.

STAFF ANALYSIS

21. This paper illustrates the following two different views:
 - View 1 – An entity is not allowed to impute cash flows (that do not exist in the contractual terms of the hedging instrument) to split a derivative hedging instrument into multiple components. Those in favour of View 1 note that C.1 of the Guidance on Implementing IAS 39 does not allow an entity to create cash flows in the identification of embedded derivatives and host contracts; and
 - View 2 - An entity should be allowed to impute notional legs as bases to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness.

Arguments for View 1

IG C.1 of IAS 39

22. IG C.1 of IAS 39 does not allow an entity to create cash flows in the identification of embedded derivatives and host contracts of hybrid instruments (even though the cash flows of those embedded derivatives and host contracts created might offset each other). IG C.1 of IAS 39 specifically states that a fixed rate interest-bearing asset with principal payment indexed to changes in an equity price index should not be considered as a floating rate host contract with an embedded equity swap.

23. Consequently, some argue that an entity should not be permitted to create cash flows to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness.
24. There is no doubt that IG C.1 of IAS 39 prohibits an entity from creating cash flows in the identification of embedded derivatives and host contracts. However, some argue that IG C.1 of IAS 39 relates only to the identification of host contracts and embedded derivatives. A reason for not allowing an entity to create cash flows is to avoid a hybrid financial instrument being recognised in an infinite variety of combinations of host contracts and embedded derivatives. The accounting consequences (for example, measurement) of these combinations might be different, and hence the financial statement comparability might be impaired.
25. As mentioned earlier, changes in the fair value of the entire hedging instrument are required to be considered. In addition, this paper does not address the recognition and measurement of hedging instruments and hedged items. Instead, it only focuses on the assessment of hedge effectiveness.

Arbitrary opportunities

26. Supporters of View 1 argue that, if any notional leg not evident in the contractual terms of a hedging instrument can be imputed to split a single fair value derivative into multiple components, the derivative can be decomposed into an infinite variety of combinations of different hypothetical derivatives.
27. However, IAS 39 places stringent restrictions on when hedge accounting can be used. An entity is required to document at inception of the hedge how it will assess hedge effectiveness. In addition, the entity is required to apply the chosen method consistently over the life of the hedging relationship. Consequently, some argue that these requirements in IAS 39 will minimize arbitrary opportunities.

Arguments for View 2

28. IAS 39 paragraph 76 allows an entity to use a single hedging instrument to hedge multiple risks provided that certain conditions are met.
29. In addition, the approach set out in IG F.1.13 requires that the hedge effectiveness of each hedged risk position should be assessed separately. To do so, the entity inevitably has to split the single fair value derivative hedging instrument into multiple components to allocate them to corresponding risk positions.
30. If an entity were not allowed to impute a notional leg as a base to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness, hedge accounting in most cases would not be allowed (even when hedged risks can be clearly identified). Hence, IAS 39 paragraph 76 would be irrelevant as its conditions would rarely be met.

IG F.1.12 and F.1.13 of IAS 39

31. As mentioned earlier, IG F.1.13 specifically allows an entity to create a notional leg (that is the functional currency leg) to split a derivative for assessing and measuring hedge effectiveness. Proponents of View 2 question why the approach in IG F.1.13 cannot be extended to other circumstances such as those set out in Examples 1 and 2 of the Appendix to this paper.
32. In addition, supporters of View 2 note that F.1.12 of the Guidance on Implementing IAS 39 does not prevent an entity from designating a single combined interest rate and currency swap simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge. An entity uses such a combined swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. Therefore, they argue that, if an entity is not allowed to impute cash flows that do not contractually exist to split a derivative hedging instrument into multiple components, the circumstance set out in IG F.1.12 will never qualify for hedge accounting because the entity is not able to assess and measure hedge effectiveness.

No recognition of cash flows that do not contractually exist

33. Of course, an entity should not recognise any cash flows that do not contractually exist. In addition, when a derivative in its entirety is designated as a hedging instrument, all changes in its fair value must be considered.
34. Therefore, View 2 suggests that an entity should be allowed to impute a notional leg as a base to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness provided that the following conditions are met:
- The split does not result in the recognition of cash flows that do not exist in the terms of the hedging instrument. Fair values of all synthetic derivatives created will offset each other; and
 - All changes in the fair value of the derivative hedging instrument are considered.
35. Furthermore, supporters of View 2 argue that the imputed notional leg is merely a reference point to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness.

Method in determining the imputed notional leg must be properly documented and consistently applied

36. As mentioned above, IAS 39 requires an entity to document at inception of the hedge how it will assess hedge effectiveness. Therefore, the method in determining the imputed notional leg is also required to be documented at inception of the hedge and applied consistently over the life of the hedging relationship.

INPUTS FROM ‘THE PRELIMINARY DISCUSSIONS OF THE ISSUE’ IN MARCH 2007

Is there any significant diversity in practice regarding how to demonstrate hedge effectiveness?

37. Most IFRIC members noted that using a single derivative hedging instrument to hedge multiple risks is a common hedging strategy in practice. They noted that the issue related to how to demonstrate hedge effectiveness.
38. In addition, some IFRIC members noted that a possible reason for why IAS 39 does not specify a single method for assessing hedge effectiveness is to provide entities with flexibility to choose their own methods that fit their risk management strategies.

IG F.1.12 and IG F.1.13

39. [Paragraph omitted from observer note].

STAFF RECOMMENDATION

40. It is clear in IAS 39 that, when a derivative in its entirety is designated as a hedging instrument, *all* changes in its fair value must be considered.
41. In addition, it is obvious that an entity is not allowed to recognise in its financial statements any bifurcated components that do not contractually exist.
42. Moreover, IAS 39 paragraph 76 allows an entity to designate a single hedging instrument as a hedge of more than one risk provided that certain conditions are met.
43. Therefore, as long as the following conditions are met, there seems no reason why an entity should not be allowed to impute a notional leg as a base to split a single fair value derivative hedging instrument for assessing and measuring hedge effectiveness:

- The split does not result in the recognition of cash flows that do not contractually exist in the terms of the hedging instrument; and
 - All changes in the fair value of the derivative hedging instrument are considered.
44. The staff acknowledges that IAS 39 does not provide any explicit guidance on how to demonstrate hedge effectiveness in the situation addressed in this paper. However, IAS 39 intentionally does not specify a single method in assessing and measuring hedge effectiveness. Instead, IAS 39 merely requires that the chosen method must be properly documented at inception of the hedge and be consistently applied over the life of the hedging relationship.
45. The development of any guidance on how to demonstrate hedge effectiveness would result in the development of an Application Guidance (rather than an Interpretation).
46. In the past, the IFRIC declined to take issues that relate to how to assess hedge effectiveness onto its agenda.
47. For the above reasons, the staff recommends that the IFRIC should not take the issue onto its agenda. Wording for the proposed tentative agenda decision is set out in paragraph 49 of this paper.

QUESTIONS TO THE IFRIC

48. Do you agree with the staff that the issue should *not* be taken onto the agenda? If not, why?
49. Wording for the proposed tentative agenda decision is as follow:
[Paragraph omitted from observer note].

**APPENDIX 1 – EXAMPLES CITED BY THE SUBMISSION
(FOR INFORMATION PURPOSES ONLY)**

Example 1

50. The facts of Example 1 are as follows:

- Entity B has the functional currency of Euro.
- It has a floating-rate financial liability, which charges interests at LIBOR + 3%.
- It also has a floating-rate financial asset, which earns interest at inflation rate plus 4%.
- The financial asset and liability have the same interest payment dates, maturity dates and principal amounts.
- To hedge against variability in cash flows on the interest payments of both instruments, Entity B enters into an interest rate swap under which it receives LIBOR and pays inflation rate plus 2%.
- The interest rate swap is designated as a hedging instrument in a cash flow hedge (if hedge accounting is allowed).

51. A notional fixed rate leg is created as a base to split the interest rate swap into two components for assessing and measuring hedge effectiveness.

Hedged item	Hedged risk identified	Components of hedging instrument
Floating-rate liability (LIBOR + 3%)	Risk associated with changes in LIBOR	Pay fixed (notional leg) Receive LIBOR
Floating-rate asset (Inflation rate + 4%)	Risk associated with changes in inflation rates	Pay inflation rate + 2% Receive fixed (notional leg)

Example 2

52. The facts of Example 2 are as follows:

- Parent A has the functional currency of Euro.
- It has a subsidiary that has the functional currency of US dollars. Any dividends remitted to Parent A are in US dollars.
- Parent A also has a Euro-denominated fixed-rate liability.
- Parent A would like to hedge the foreign currency risk associated with any dividends received from the US operation and the fair value interest rate risk associated with the fixed-rate financial liability.

Consequently, Parent A enters into an interest rate swap under which it receives Euro fixed and pays US dollar floating.

- More than one different form of hedge accounting would be used if hedge accounting is allowed: a hedge of net investment in respect of the foreign currency risk associated with the US operation and a fair value hedge in respect of the fair value interest rate risk associated with the fixed-rate financial liability.

53. A notional floating Euro leg is created as a base to split the interest rate swap into two components for assessing and measuring hedge effectiveness.

Hedged item	Hedged risk identified	Components of hedging instrument
The US operation	Foreign currency risk arising from future cash flows from the US operation	Pay US dollar floating Receive Euro floating (notional leg)
Euro-denominated fixed rate liability	Fair value interest rate risk associated with the fixed-rate liability	Pay Euro floating (notional leg) Receive Euro fixed