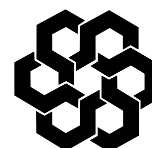

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **13 March 2008, London**

Project: ***IAS 39 Financial Instruments: Recognition and Measurement*, Exposures Qualifying for Hedge Accounting (ED)**

Subject: **Comment Letter Analysis (Agenda paper 7)**

INTRODUCTION

1. The comment period for the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement,* Exposures Qualifying for Hedge Accounting (ED) ended on 11 January 2008. The proposed amendments clarify the Board's original intentions regarding risks and portions of financial instruments that are eligible for designation as a hedged item.

2. This paper provides an overview of the main issues raised by respondents to the ED, and their responses to the questions in the ED. This paper does not address drafting suggestions from respondents. This paper also does not contain staff views or recommendations. These will be presented to the Board at a subsequent meeting.

3. The IASB received 74 comment letters. This paper does not provide a quantitative review of responses or attribute comments to individual respondents. The staff has given equal consideration to all comment letters received. An analysis of comment letters by type of constituent and geographical region is included as Appendix One.

4. This paper is divided into three parts:
   a. Background
   b. Overview of Comments Received
   c. Analysis of Responses to Questions set out in the ED

BACKGROUND

5. The International Financial Reporting Interpretations Committee (IFRIC) received requests for guidance on what IAS 39 permits to be designated as a hedged item. In particular, constituents asked the IFRIC to provide guidance on when a portion of the cash flows of a financial instrument can be designated as a hedged item. Rather than dealing with these requests individually, the IFRIC attempted to develop a principle that could be used as guidance on what IAS 39 permits to be designated as a hedged item. However, the IFRIC was unable to develop such a principle. Consequently, the IFRIC asked the Board for guidance on how to address this issue.

6. The Board acknowledged that additional guidance is required on what can be designated as a hedged item in accordance with IAS 39. Although the Board is currently undertaking research work that will ultimately lead to the replacement of IAS 39, this work is at an early stage. Consequently, the Board decided to propose the amendments to IAS 39 contained in the ED.

7. The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

8. The proposed amendments relate only to situations in which an entity designates as a hedged item a financial instrument (or some part of that financial instrument). The exposure draft does not 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.

OVERVIEW OF COMMENTS RECEIVED

9. Overall, almost all respondents who expressed a view supported the Board's *intentions* to clarify requirements for hedge accounting. However, just under half of such respondents did not support the *approach* the Board took in the ED (a rules-based approach specifying the risks and portions eligible for hedge accounting).

10. Most respondents that supported the approach chosen by the Board did so *only* as it represented a practical and interim solution. Such respondents noted that the hedge accounting requirements in IAS 39 are rules-based and, given that hedge accounting is an exception to the normal required accounting and that the application of hedge accounting is optional, some rules are inevitable.

11. In addition, several respondents suggested that the proposed amendments or parts of the proposed amendments be included in application guidance (AG) or implementation guidance (IG). These respondents claimed that such an approach would be effective in achieving the aims of the Board (for example, in clarifying that inflation risk is not always eligible for designation), and would not restrict practice unnecessarily.

12. Almost all respondents fundamentally preferred a principle-based approach, arguing that such an approach:
    a. is conceptually preferable, given that IFRSs are intended to be principle-based
    b. is more robust as markets, products and hedging strategies develop
    c. is more consistent with the Board's stated long-term objective of simplifying hedge accounting
    d. prevents to a greater extent arbitrary distinctions and structuring opportunities

13. Some respondents noted that, although the scope of the proposed amendments was limited to hedged financial items, there could be unintended consequences for the designation of non-financial items. These consequences could result in changes in current practice.

14. Many respondents also proposed that the Board address overall hedge accounting issues in a broader scope project that included consideration of non-financial hedged items.

15. Other issues that were commonly raised by respondents included paragraph AG99E (designation of the entire value of a purchased option as the hedging instrument of a hedged item that contains no optionality) and transition (with many respondents disagreeing with the proposed retrospective application).

16. All of the issues discussed in this section are discussed in greater detail below.

ANALYSIS OF RESPONSES TO THE QUESTIONS SET OUT IN THE ED

17. The ED invited responses to four questions. A summary of responses to each question is presented below.

Question 1 – Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y. Risks identified in paragraph 80Y are interest rate risk, foreign currency risk, credit risk, prepayment risk and risk associated with the contractually specified cash flows of a recognised financial instrument.

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why?

18. Respondents' views were divided. Some respondents believe that the restriction of risks increases the clarity of the Standard while other respondents disagreed with restricting eligible risks.

19. Respondents were concerned that the list of risks proposed in the ED:
    a. does not cover all risks
    b. will soon be obsolete with the development of new risks, products, and hedging strategies
    c. restricts market innovation through limiting risks that would qualify
    d. is inconsistent with the IASB's principle-based approach to standard setting

20. Respondents that were opposed to restricting risks often proposed that all risk exposures, including inflation risk, should qualify for designation as hedged risks provided they are identifiable, measurable or contractually specified (that is, a principle-based approach should be taken). Some respondents suggested principles that might be used. These suggested principles often included the characteristics of *predictability* and *measurability.* For example, a risk eligible for hedge accounting must have a *predictable* and *reliably measurable* effect on the cash flows or fair value of the designated hedged item. The staff notes that such principles are similar to those that were discussed at the IFRIC meetings on this topic, and that the IFRIC found such principles problematic.

Are there any other risks that should be included in the list and why?

21. Many respondents identified other risks that should be included in the list. Risks identified included:
    a. equity price risk
    b. commodity price risk
    c. inflation risk
    d. extension risk - the exposure to a securities underlying principle and/or interest payment terms that may be extended at the discretion of the issuer
    e. basis risk – the risk that arises from imperfect correlations among the various interest rates earned and paid on financial instruments with otherwise similar re-pricing characteristics
    f. profit risk – a risk that is in substance interest rate risk and commonly hedged in Islamic banking transactions. However, since interest is prohibited under Islamic laws, the term interest rate risk cannot be applied by Islamic entities.
    g. liquidity risk

22. Many respondents believe that the list should include equity price risk if the denomination of the hedged equity instrument differs from the functional currency of the entity holding the asset. Respondents note that this is particularly relevant if entities hedge available for sale equity securities that are traded only in foreign currencies (as described in IG F.2.19). Some respondents stated that paragraph 80Y appears to allow an entity to hedge all risks in their entirety or foreign currency risk, but not equity price in the denomination of the instrument. Respondents find this exclusion problematic, as in practice, entities purchase and hedge equity securities denominated in foreign currencies.

23. Some respondents proposed that the scope of the proposed amendments should be extended to non-financial items (this is relevant for both risks and portions).

24. Such respondents noted that the reason IAS 39 restricts hedge accounting for a non-financial item to either foreign currency risk or for the item in its entirety is the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risk. These respondents argue that given today's highly liquid commodity markets and increasingly advanced analysis tools, this argument is no longer valid. Some believe that the difficulty in identifying and measuring portions of non-financial items is comparable to that of financial instruments.

25. Some respondents observed that hedges of non-financial items would most commonly be applied to commodity contracts to buy a non-financial item in which the price to be paid is determined by a formula that includes a quoted market variable and to leases whose payments vary directly with a quoted market interest rate.

26. For example, in a contract for the purchase of rolled metals, the price to be paid may be set as the market price of refined metal ingots (a traded commodity), plus the actual rolling costs, plus a margin. As the proposed amendments only apply to financial instruments, the traded market price of the refined metal ingots cannot be designated despite being a contractually specified subset of the total cash flows that directly affects the cash price to be paid. This is, it is argued, identical to the inflation component of an inflation linked bond which paragraph 80Y (e) explicitly permits as a hedged item.

27. Respondents believe that such and similar examples illustrate how arbitrary and illogical it is to exclude non-financial items from the scope of the proposed amendments.

28. A small number of respondents proposed that inflation risk that is not contractually specified should qualify for designation as a hedged risk. For

example, a fixed rate bond may be issued by an entity and turned into the equivalent of an inflation-linked liability by entering into an inflation swap. However, since the inflation component is not contractually specified in the hedged item it would not be eligible for designation in the proposed amendments (paragraph 80Y(e) applies only to cash flows arising from contractually specified risks that do not result in the remainder of the cash flows being a residual amount). These respondents argue that the entity should be permitted to designate inflation as a hedged risk since the proposed amendments permit the hedging of interest rate risk. Such respondents believe that the inflation rate curve can be viewed as a type of interest rate because, similar to interest rates, inflation rates over different periods are quoted and traded in the market.

29. Some respondents noted that several risks listed in paragraph 80Y are defined in IFRS 7 *Financial Instruments: Disclosures* and some risks in the proposed amendments are not defined anywhere. These respondents suggested that the Board consider whether the definitions of risks in IFRS 7 should be used, and where risks are not found in IFRS 7, they should be defined in the proposed amendments.

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 in paragraph 80Z. These portions include a partial term hedge, a percentage of cash flows, the cash flows of a financial instrument associated with a one-sided risk of that instrument, any contractually specified cash flows of a financial instrument that are independent from the other cash flows of the instrument, the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate and a portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate.

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?

30. Respondents' views regarding the proposal were divided. In accordance with responses to Question 1, some respondents did not support a rules-based approach to specifying portions.

31. The reasons respondents gave in support of a principle-based approach are similar to those identified in the Overview of Comments Received.

32. Several respondents proposed principles to identifying portions in their responses. These principles provide that a portion of a hedged item should be a *separately identifiable.* For example, a *separately identifiable* subset of the total cash flows of the hedged item or a *separately identifiable* component of the fair value of the hedged item that market participants would typically consider in determining the fair value of the instrument. The staff notes that such principles are similar to those that were discussed at the IFRIC meetings on this topic, and that the IFRIC found such principles problematic.

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?

33. Some respondents identified other situations in which an entity should be permitted to designate a portion of cash flows as a hedged item.

34. For example, some respondents identified portions of non-financial items as portions that should be eligible for designation. As noted previously these respondents believe that the scope of the proposed amendments should be extended to non-financial items and include both risks and portions of cash flows

of non-financial items. Such respondents argue that the different treatment of non-financial items and other items is not justifiable.

35. Some respondents disagreed with paragraph AG99E.

36. Paragraph AG99E states 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. For example, in designating a one-sided risk (such as the decrease in the fair value of a financial asset)
> as a hedged portion, an entity may not include any cash flows that are imputed or inferred in the designated hedged portion (for example, inferring the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset).

37. This paragraph addresses the issue of whether a purchased option can be designated in its entirety in such a way that no ineffectiveness results if the designated hedged item contains no optionality.

38. This paragraph was included in the ED to address diversity in practice, and followed a decision by the IFRIC not to issue final rejection wording because of the (then pending) proposed amendments to IAS 39.

39. Some respondents noted that under US GAAP, DIG G20 *Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge* explicitly permits such an approach. It was noted that not allowing this approach would result in greater ineffectiveness and divergence with US GAAP.

40. Several respondents believe that restriction of the above practice in effect prohibits the hypothetical derivative approach in assessing and measuring hedge effectiveness provided in IG. F.5.5. Some argue that the designated hedged item is a one-sided risk (explicitly permitted by IAS 39), and that using a hypothetical derivative (written option) to model the hedged cash flows for effectiveness assessment is a valid approach.

41. Other respondents argue that in such situations an entity is designating all of the cash flows for the variability in cash flows above or below a particular level. Therefore, it is incorrect to characterise such a designation as a hedge of the portion of the cash flows.

42. In addition, respondents raised several questions regarding the scope and clarity of paragraph AG99E – for example, the fact that such an approach is most commonly used to hedge non-financial items, but the proposed amendments do not apply to non-financial items.

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?

43. Overall, respondents do not believe that the proposed amendments would generally result in a significant change to existing practice. However, many respondents identified several situations in which entities would be affected, and noted some possible consequences of the proposed amendments. Identified entities that might be affected by the proposed amendments included those that:
    a. hedge inflation risk
    b. hedge the one-sided risk of financial instruments (and non-financial items) using an approach similar to that set out in US GAAP
    c. apply partial term hedges
    d. wish to hedge commercial liabilities at a sub-LIBOR rate (using the EU hedge accounting carve-out to IAS 39)

44. Some respondents noted that the proposed amendments will affect entities that are currently hedging inflation risk. However, the effect is expected to be limited as respondents were unaware of significant divergence in practice in this area.

45. Many respondents noted that the amendments will affect entities that hedge one-sided risks using an approach similar to that set out in US GAAP. Respondents were aware that there is significant divergence between entities applying IFRSs in this area. The impact is particularly acute as retrospective application of the proposed amendments is required; entities that hedge the time value component of options would be required to restate financial statements and reverse any designated hedging relationships that are not eligible under the proposed amendments.

46. Many respondents noted that the proposed amendments might have unintended consequences on current practice for non-financial hedged items.

47. The proposed amendments label percentages and one-sided risks as a portion. However, as explicitly stated in paragraph BC5, the proposed amendments only apply to financial instruments designated as hedged items. Respondents believe the proposed amendments narrow current hedge accounting practices by prohibiting hedges of percentages and one-sided risks of non-financial items. This could result in significant changes as hedges of one-sided risks of non-financial items are common in practice. Some respondents disagreed with the conclusion of the Board that the requirements regarding the designation of non-financial items as hedged items are clear.

48. Some respondents were concerned that the proposed amendments will prohibit partial term hedges that are explicitly permitted in paragraph 80Z(a). An entity may be fully effective in hedging interest rate risk for 5 years on a 10 year bond if the swap is designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principle payment due at maturity to the extent affected by changes in the yield

curve relating to the five years of the swap (as described in IG F.2.17). The entity will need to calculate the change in fair value of the 10 year principle cash flow due to changes in the 5 year interest rate curve, even though the principle is not settled in year 5. Such respondents were concerned that paragraph AG99E will prohibit partial term hedging in this case because these cash flows do not exist in the financial instrument as a whole.

49. Several respondents from the EU believe that the amendments will affect entities that wish to hedge commercial liabilities at a sub-LIBOR rate. Respondents believe that commercial liabilities such as core deposits of European banks should be eligible for designation as hedged items. These respondents argue that the asymmetrical treatment of commercial assets and liabilities cannot be justified from a conceptual stand-point. Such respondents believe that the timing of the proposed amendments is inappropriate in light of current discussions to address issues relating to the carve-out. These respondents noted that as the proposed amendments will be carved-out by the EU as they are consistent with sections of IAS 39 currently carved-out.

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?

50. Many respondents believe that the requirement to apply the proposed changes retrospectively is inappropriate.

51. Most of these respondents disagreed with retrospective application as they believe it is inconsistent with the hedge accounting principles of IAS 39 and especially

problematic for entities that apply an approach for purchased options similar to that set out in DIG G20.

52. Respondents believe that retrospective application is inconsistent with IAS 39 which requires formal designation and documentation at inception of the hedging relationship.

53. In addition, respondents noted that retrospective application is particularly problematic for entities that previously deferred the time value component of options in the cash flow hedging reserve. These entities will be required to unwind their hedge accounting. However, there is no ability to restate the position as if they had designated the intrinsic value only as hedge accounting can only be applied prospectively. Hedge documentation that supports this alternative designation is unlikely to be in place. Therefore, entities would only be able to defer the intrinsic value component on purchased options prospectively once new hedge documentation was put in place.

54. Some respondents identified other issues concerning retrospective application. These issues include:
    a. inconsistency with transition requirements of other amendments to hedge accounting e.g. amendments to IAS 39 for Cash flow hedge accounting of forecast intra-group transactions. (The staff notes that that amendment changed hedged accounting; the proposed amendments are meant to clarify what is permitted today.)
    b. added costs for entities to restate financial statements and perform ongoing effectiveness calculations both retrospectively and prospectively
    c. reduced comparability between entities

55. Respondents that disagreed with retrospective application requested the Board consider the following alternatives which are described in more detail below:
    a. prospective application

b. limited retrospective application
c. transition provisions similar to those proposed in paragraph 29 of IFRS 1 *First-time Adoption of International Financial Reporting Standards*

56. Many respondents proposed that amendments only apply to hedging relationships after the effective date. These respondents believe that prospective application reduces distortions and manipulation of financial statements due to restatement. This transition requirement further eliminates the need to reconsider hedging relationships that have already been designated. Moreover, entities will be permitted to choose whether or not to enter into new hedge accounting relationships under the new requirements.

57. Several respondents proposed limited retrospective application i.e. transition requirements similar to the amendment to IAS 39 for Cash flow hedge accounting of forecast intra-group transactions. Under this alternative hedging relationships are de-designated at the point at which the amendments are adopted and re-designated (if desired and if permitted) in a new hedging relationship.

58. Respondents believe that the above approach is consistent with earlier transition requirements of other amendments to hedge accounting. Such requirements will also enhance comparability by aligning entities that had designated both time and intrinsic value to restate their cash flow hedge reserve to include changes in intrinsic value only.

59. Some respondents proposed transition provisions similar to those proposed in paragraph 29 of IFRS 1. Respondents that proposed this alternative did not specify how this transition requirement would apply. However, these respondents believe that this approach respects the principle in IAS 39 which does not permit re-designation of a hedging relationship. Moreover, this transition provision is familiar to constituents and easy to implement as it does not entail complex retrospective calculations. (The staff notes that this approach appears to be similar

to prospective application, but is unclear how it would apply in the context of the proposed amendments.)

60. A small number of respondents believe that retrospective application of the proposed amendments is appropriate. Respondents that supported retrospective application believe that it:
    a. is conceptually right
    b. provides more information to users
    c. is necessary as the effect of the differential accounting treatment in current practice is significant and material
    d. corrects the error some entities made by misapplying IAS 39 and measuring effectiveness incorrectly

APPENDIX ONE – SUMMARY ANALYSIS OF RESPONSES

By constituent type

	Number
Academics	1
Accountancy bodies	21
Accounting firms	7
Analysts	2
Banks	3
Preparers (company)	13
Preparers (representative)	11
Professional associations	2
Regulators	1
Standard setters	13
	74

By geographical region

	Number
Africa	3
Asia-Pacific (excluding Australia/ New Zealand)	8
Australia/New Zealand	6
Eastern Europe	2
Multi-regional[1]	10
North America	1
South America	1
Western Europe	43
	74

[1] Multi-regional comprises of respondents representing multiple regions, such as the joint international responses from each of the Big 4 Accounting Firms, and other international organisations.