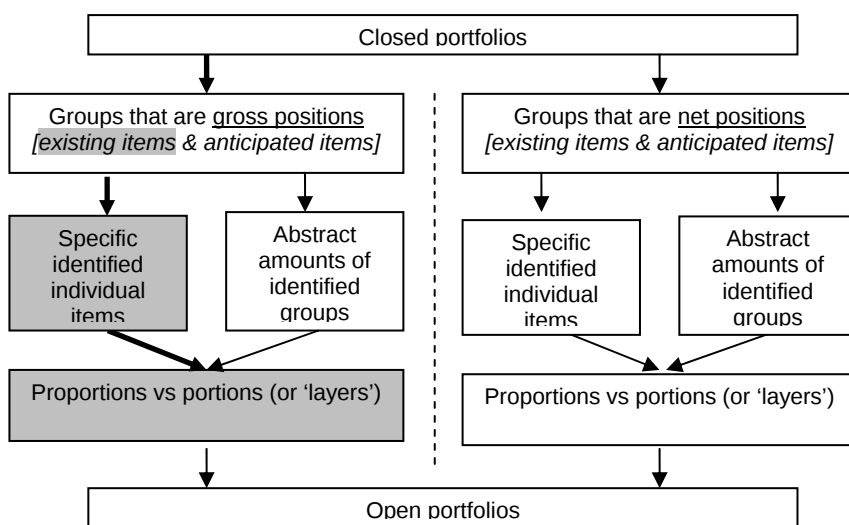


Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Identifying part of a hedged item: portions (or ‘layers’) of existing items

Introduction

Background

1. This paper forms part of the discussions about hedging closed groups of existing items in a single hedge relationship. The question in this paper relates only to *existing* items. *Anticipated* items are discussed for comparison purposes only.
2. In July 2010 the Board discussed different ways to identify hedged items when multiple items are designated together as a group (the ‘what’ issue). See agenda paper 6B from the July 2010 IASB meeting.



This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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Purpose of this paper

3. This paper analyses whether it can be appropriate to identify part of an existing item that is designated as a hedged item in a hedge relationship (eg \$80m of a single \$100m firm commitment) as a portion (or 'layer') of the entire item (eg the last \$80m of a \$100m firm commitment, or 'bottom layer' of \$80m).
4. As a starting point this paper focuses on parts of single items. If the Board agrees it is appropriate to identify part of an existing item as a portion, the staff will present a separate paper to consider how this could apply to groups of items (including hedges of part of inventory balances).
5. This paper assumes it is appropriate to identify part of an existing item that is designated in a hedge relationship as a proportion of the entire item (eg 80% of an entire \$100m firm commitment). The purpose of this paper is to analyse whether, in addition to allowing part of an existing item to be identified as a *proportion*, it is appropriate to allow part to be identified as a *portion*¹.
6. As usual, this staff paper does not interpret current IFRSs. Instead it makes a case for the new hedging model to explicitly permit part of an existing item to be identified as a portion (or 'layer'). For background, relevant extracts from IAS 39 are presented in Appendix A.
7. This paper considers both non-financial and financial items as the considerations for each are similar.

A reminder – why we need to identify the hedged item

8. Identifying the hedged item is necessary to:
 - (a) Assess effectiveness of the hedge relationship (ie effectiveness testing for qualification purposes).
 - (b) Measure ineffectiveness of the hedge relationship.

¹ A portion is a component other than a proportionate part of the entire item.

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- (c) Determine *when* to reclassify to profit or loss amounts deferred in equity under the cash flow hedge mechanics of hedge accounting.
- (d) Determine *where* in the income statement to recognise gains/losses from hedging instruments.

The Issue

9. Restricting the designation of parts of existing items, as hedged items, to (only) *proportions* of the entire item can be problematic when applying hedge accounting. These problems (which are illustrated in the following examples) could be overcome by instead identifying as the hedged item part of an existing item as a *portion* or *layer* of the entire item. This is best demonstrated using examples. These are presented in paragraphs 10 to 32. These examples have common characteristics which are explained in paragraph 33. This highlights that identifying and designating portions of existing items is helpful only in certain scenarios. As a result, identifying and designating part of an existing item as a *proportion* will still be relevant and necessary in many cases.

Example 1 – Firm commitment to purchase items of PPE in a foreign currency

10. Entity A enters into a single legally binding contract with its supplier, Entity B, to purchase 10 items of machinery for €1m (in total). The contract is entered into on 1 January 20X0 and will settle with delivery and cash payment, two years later on 31 December 20X1. Entity A's functional currency is C\$.
11. Entity A has a risk management policy to hedge between 70% to 100% of € cash flows in the business. In this case it chooses to hedge 70% of the €1m exposure with a forward exchange contract (FEC) exchanging €700k for C\$950m on 31 December 20X1.

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12. Entity A chooses to hedge at the bottom end of the 70% to 100% range because it is aware that there is a risk that the supplier will not deliver all 10 items of machinery on time (ie non-performance risk).²
13. Therefore hedging 70% of the € purchase reduces the possibility of the entity hedging more than 100% of € cash flows and hence falling outside its risk management target cover range (of 70% to 100%).
14. As 31 December 20X1 approaches it becomes apparent that Entity B is on schedule to deliver only 9 of the 10 items on time. Due to the breach of contract, Entity A has the option to cancel the order in respect of the remaining 1 item. For business reasons it chooses to cancel its order for the remaining item but does not seek compensation for the breach of contract (to protect its business relationship with Entity B).
15. Designating a 70% *proportion* of the entire firm commitment equal to €700k can give rise to different accounting outcomes compared to designating a bottom layer *portion* equal to €700k. These differences are explained below.

Hedging a proportion

16. If Entity A designated a 70% proportion of the €1m purchase in the hedge relationship, the hedge would have exhibited ineffectiveness on 10% of the designated hedge (because 10% of the contract was cancelled)³.
17. The accounting effect of this depends on the hedge designation⁴:
 - (a) If the hedge was designated as a cash flow hedge, it would have resulted in 10% of deferred gains/losses from the FEC being reclassified to profit or loss immediately.

² This would be a breach of contract subject to legal ramifications. Although in practice legal proceedings are unlikely to be pursued to maintain the business relationship as Entity B is the only supplier in the market for the machinery being purchased.

³ Assuming there were no other sources of hedge ineffectiveness.

⁴ As this is a foreign currency exchange rate hedge of a firm commitment it is assumed that this could either be designated as a cash flow or fair value accounting hedge.

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- (b) If the hedge was designated as a fair value hedge, it would have resulted in 10% of the hedge adjustment posted to the balance sheet (in respect of the hedged 70% of the firm commitment) being derecognised immediately with the corresponding gain/loss recognised in profit or loss.
18. From the perspective of the risk management objective of Entity A, both accounting results distort profit or loss. In the case of a fair value hedge it arises from the mismatch between recognition of the derivative gain/loss and the recognition in profit or loss of the firm commitment. In the case of a cash flow hedge it arises from the transfer of the hedge ineffectiveness from the cash flow hedge reserve to profit or loss.

Hedging a portion

19. Despite the eventual cancellation of 10% of the contract, the entity was still in full compliance with its overall risk management strategy to hedge 70% to 100% of € cash flows (ie it was 78% hedged (700k/900k)). This was achieved as a result of its deliberate decision to hedge only €700k of the total firm commitment because of its consideration of non-performance risk (see paragraph 12).
20. To reflect this risk management strategy the entity would need to designate a €700k *portion* of the purchase order in a hedge relationship. Ineffectiveness would not arise from non-performance by Entity B as long as it delivered 7 or more of the 10 items (because this would give rise to payment of at least €700k which covers the hedge of €700k). This would give rise to a hedge of 70% to 100% (700/1000 to 700/700) of the total € cash flow which is in line with its risk management strategy (to hedge 70% to 100%). If 6 or fewer items were delivered then this would give rise to hedge ineffectiveness as the entity would be over-hedged.

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Staff view

21. The staff believe that identifying the hedged item as a bottom layer portion is more appropriate in this scenario. This is because the entity's risk management strategy is to hedge *at least* 70% of € cash flows. Furthermore it was aware of, and accommodated, the potential non-performance risk. Hence in the staff's view the entity's risk management strategy is better characterised as a hedge of a €700k bottom layer portion of the €1m exposure.

Example 2 – 5 year fixed rate loan with options to prepay at fair value

22. Company X issues £100m of debt at par (assume no transaction costs), with a 5 year term, at 7% (includes 2% margin over the 5 year swap rate). The debt includes an issuer option to repay any of the principal amount and unpaid interest, at fair value, before contractual maturity⁵. The entity has no other issued debt outstanding. This example assumes that no embedded derivative is separately accounted for.
23. Company X's risk management policy is to limit fixed rate exposure to less than 50% of total issued debt. Its risk management policy allows it to manage this risk with the use of derivatives (ie it is not restricted in the type of debt (eg fixed or floating) it issues as long as the overall exposure after taking into account interest rate swaps is within the risk management limits).
24. Based on forecasts, Company X determines that there is a reasonable possibility that it could repay up to £30m of the debt before maturity in 5 years' time.
25. Based on its risk management policy the entity decides to hedge £50m of the issued fixed rate debt by entering into a five-year interest rate swap with notional of £50m, to receive fixed interest (5%) and pay floating interest (3m UK LIBOR). If the company does repay up to £30m of the debt early, it plans

⁵ The fact that the prepayment option has a strike price of fair value means that the option's fair value does not change when the hedged interest rates change. As explained in the staff recommendation in paragraph 41, this paper does not consider hedged items with prepayment options whose fair value changes due to changes in the hedged risk.

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to retain the interest rate swap hedging £50m of notional as this will continue to be within the entity's risk management limits (eg £50m/£70m = 71% floating, leaving 29% fixed which is within the 50% limit imposed by the risk management strategy).

26. Designating a 50% *proportion* of the debt equal to £50m can give rise to different accounting outcomes compared to designating a bottom layer *portion* equal to £50m. The different outcomes arise due to early repayment of the debt balance. These differences are explained below.
27. For the following analysis assume that:
 - (a) £30m of debt is repaid during year 3; and
 - (b) the hedge is designated in a fair value hedge of interest rate risk.

Designating a 50% proportion of the debt as the hedged item

28. If the entity had designated a 50% proportion of the debt then the early repayment of £30m of debt would have two accounting effects:
 - (a) When £30m of the debt is repaid at fair value, 30% of the total £100m carrying value of the debt, including any fair value hedge adjustment would be derecognised, and the difference between the amount derecognised and the redemption amount paid would be recognised in profit or loss.
 - (b) In order for an effective hedge relationship to continue for £50m of debt after the early repayment, £15m of previously unhedged debt must be designated going forward with £15m notional of the existing (off-market) interest rate swap⁶. There are two consequences of this:
 - (i) Documented designation of the £15m of debt previously not designated must be in place from the day of early repayment.

⁶ £15m of hedged debt has been repaid (30% of £50m) and so £15m of previously unhedged debt is designated in its place.

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- (ii) The designation of £15m of previously unhedged debt with an off-market interest swap as the hedging instrument gives rise to ‘noise’ in profit or loss.

Designating a £50m bottom layer portion of the debt as the hedged item

- 29. If instead of designating a *proportion* of the entire debt, the entity designated a bottom layer portion equal to £50m, the issues noted above in paragraph 28 would not arise as the hedge relationship would continue for the original £50m debt designated in the hedge.⁷

Staff view

- 30. In this circumstance the staff believes that identifying the hedged item as a bottom layer portion of the entire debt (documented at inception of the hedge) better reflects the risk management strategy of the entity. This is because:
 - (a) the entity’s risk management policy is to limit fixed rate debt to less than 50% of total debt;
 - (b) the entity correctly anticipated early repayment of the *unhedged fixed rate portion of the debt* (which was evidenced by its retention of the entire swap as a continued hedging instrument)⁸.

⁷ Note that derecognising the portion of the debt not designated in the hedge (ie without the hedge adjustment attached) will result in a higher gain or loss (from changes in interest rates) on derecognition compared to if a proportion of the entire debt was derecognised.

⁸ Note that if the entity’s risk management strategy had (in part) been to hedge the fair value risk associated with the debt anticipated to be repaid early (such that it would close out £30m notional of the swap upon early repayment of £30m of debt), it would have been appropriate for the hedge to be designated as a ‘*top layer portion*’ of £50m of debt. The effect of this would be that the full hedge adjustment in respect of the £30m of the hedged portion of debt would be derecognised on early repayment. This would result in nil gain/loss arising from changes in interest rates on derecognition of £30m of debt. Only if the entity’s risk management policy was to hedge a *proportion* of 50% of debt (such that it would have closed out £15m of its swap on early repayment) would it have been appropriate to designate a 50% proportion instead of any portion.

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31. Furthermore,
- (a) the accounting result achieved by designating a portion is more meaningful as the profit or loss ‘noise’ noted in 28(b)(ii) is avoided; and
 - (b) the hedge designation is less of an administrative burden because:
 - (i) as described in paragraph 29 there is no need to designate £15m of previously unhedged debt to take effect on the day of repayment (noting that in other situations there could be multiple repayments over the term of the hedge); and
 - (ii) the tracking of the profit or loss ‘noise’ referred to in 28(b)(ii) is not required.
32. In addition, identifying the hedged part as a portion is consistent with the way forecast transactions (which also exhibit some level of uncertainty or change in the timing or amount of the hedged item) are identified (see paragraphs 34 to 38 below).

Characteristics of the above scenarios

33. The examples above each have certain characteristics such that when a part of that item is hedged it is more appropriate to identify that part as a portion instead of a proportion of the total item. These characteristics include:
- (a) The risk management policy in each example was to achieve hedge coverage of an amount equal to *at least* a certain percentage (eg example 1 the objective was to hedge at least 70% but no more than 100% and example 2 was to hedge at least 50% but no more than 100% of the debt). In other words the objective was not to hedge a specific proportion of the entire item.
 - (b) In the examples, although the hedged items are contractual arrangements, the final outcome of the contract was affected by either:

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- (i) Options in the contract whose fair value were not affected by changes in the hedged risk; or
- (ii) Non-performance risk which did not form part of the hedge designation.

Comparison to IAS 39 hedge accounting model for forecast transactions

34. The hedge accounting considerations for existing transactions (eg firm commitments, etc) are different to those for anticipated transactions (eg forecast transactions, etc) generally because anticipated transactions are not certain to occur whereas contractual transactions are binding agreements. However, as shown in examples 1 and 2 above, this distinction is not always appropriate. For example, a contractual arrangement may:
- (a) be a financial contract with an early termination option in the contract allowing the contract to be terminated before maturity (as in example 2 above); or
 - (b) be cancelled due to a breach of contract (ie non-performance, see example 1 above).
35. In these situations the contractual arrangement may not settle as originally expected. Hence this will have an impact on any hedge relationship that designates a proportion of the contractual arrangement as the hedged item.
36. Under IAS 39 (and the related Guidance on Implementing), anticipated transactions designated as hedged items must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. As a result, under IAS 39, *anticipated* transactions can be identified as *portions*. For example, an anticipated transaction can be identified as the purchase or sale of the first 15,000 units of a product in a particular month.
37. Such a designation accommodates the fact that there is a level of uncertainty surrounding the hedged item and that uncertainty does not form part of the hedge relationship.

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38. The staff believe that such a rationale for forecast transactions is also appropriate for hedges of existing items with the characteristics noted in paragraph 33.

A note about under-hedging and reported ineffectiveness

39. It should be noted that allowing parts of existing items to be identified as bottom layer portions does not mean that hedge ineffectiveness from under-hedging is avoided.
40. Hedge ineffectiveness, in a fair value hedge, arises when the fair value change of the hedging instrument is different to the fair value change of the hedged item for the hedged risk. Hence it is possible that the fair value change of the hedging instrument is less than the fair value change of the hedged portion (for example due to mismatches in terms, derivative counterparty credit risk, etc).

Staff recommendation

41. For the reasons set out in paragraphs 21 and 30 to 32, the staff recommends that the Board permits part of an existing item to be identified and designated as a portion (or 'layer') of the entire item (as described in the examples above) in cases where:
- (a) the portion is identified and documented at inception of the hedge;
 - (b) the designation is in line with the entity's risk management strategy;
and
 - (c) the fair value of any early termination option in the item is not affected by the hedged risk⁹.

⁹ This is to deliberately exclude certain hedges where it may not be appropriate to use a bottom layer approach. For example, fair value interest rate hedges of fixed rate loans with prepayment options whose fair value changes as interest rates change. Such hedges will be considered separately in a subsequent staff paper.

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Question to the Board

Does the Board agree with the staff recommendation in paragraph 41?

If not, what does the Board propose instead and why?

Appendix A – Relevant extracts from IAS 39

Designation of financial items as hedged items

81. 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 portion 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).

...

Designation of non-financial items as hedged items

82. If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of 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 risks.

...

86. Hedging relationships are of three types:

(a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

(b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that

(i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and

(ii) could affect profit or loss.

(c) *hedge of a net investment in a foreign operation* as defined in IAS 21.

AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

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IG.F.2.8 Hedge accounting: risk of a transaction not occurring

Does IAS 39 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (IAS 39.86).

IG.F.3.10 Hedge accounting: identification of hedged forecast transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

IG.F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.