Project	**Accounting for Financial Instruments - Hedge Accounting**
Topic	**Eligible hedged items – Risk components**

Introduction

Purpose of this paper

1. The purpose of this paper is to discuss whether designation of risk components (bifurcation-by-risk) should be permitted for financial assets and financial liabilities. This discussion of the issues can also be used to assist the boards in determining the objective of hedge accounting.

2. The principal questions are these:

   a. Multiple risks can affect an asset's or a liability's cash flows or its fair value. If an entity wishes to hedge its exposure to only **some** of those risks, should hedge accounting be permitted to reflect that hedging strategy in financial statements, excluding the effects that other (unhedged) risks may have on the fair value or cash flows of the hedged asset, liability, firm commitment or forecast transaction?

   b. If so, should any constraints be placed on either identifying the risk being hedged or the type of asset, liability, firm commitment or non-contractual forecast transaction that is designated as the hedged item?

3. This paper does not address other aspects of a revised hedge accounting model. The following diagram illustrates what various types of risk components are addressed by this paper:

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB and 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 FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

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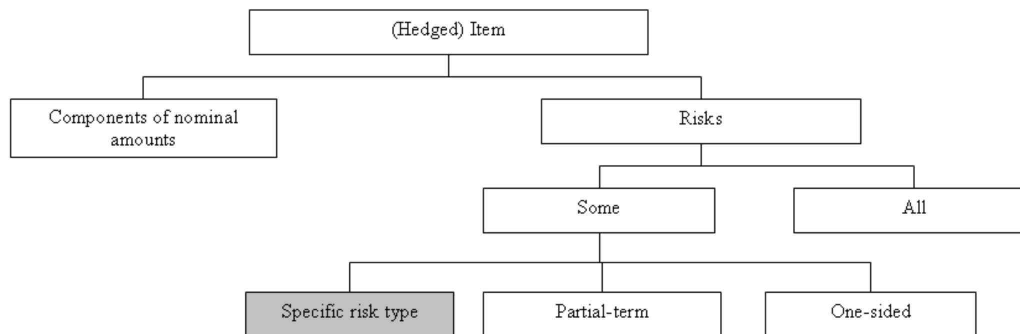

4. In the above table, the box "Risks" is the focus of the first question—whether hedge accounting and its measurement of the hedging relationship's ineffectiveness, if any, should focus on all the multiple risks that can affect the hedged item's cash flows or fair value or should focus only on the selected risks that the entity's management wants to be considered.

Risk components

5. The issue for the first question is often referred to as "Bifurcation-by-Risk" because, with respect to each hedged item addressed by an entity's risk management efforts, the issue is whether the effectiveness of the hedging relationship should be based on all of the hedged item's risks or only on those risks that the risk management has "bifurcated" from the total risk exposure. Under a bifurcation by risk approach, the designation of a hedging relationship, and thus its effectiveness, is based on only one or some of the risks that can affect the hedged item's cash flows or its fair value.

Primary interest of users of financial statements

6. As noted in Agenda Paper 19/25 of the December joint board meeting, "Feedback received from users of financial statements show that their primary interest is to be able to clearly understand an entity's risks as well as the risk management strategies being employed to manage such risks."

a. Hedge accounting itself does not address the users' primary interest in being able to clearly understand an entity's risks because hedge accounting is dependent upon the existence of a hedging instrument and, currently, the designation of hedging relationships pursuant to the entity's risk management.

b. In contrast, hedge accounting does address the users' interest in being able to clearly understand the risk management strategies being employed to manage the entity's risks because hedge accounting typically deals with only the risks of hedged items addressed by an entity's risk management efforts.

7. Paragraph 7 of Agenda Paper 19/25 of the December joint board meeting also noted that, in addition, "users are interested in the 'effectiveness' of hedging activities. Users of financial statements have repeatedly emphasised that they need to be able to identify situations in which hedging activities are not wholly effective, and to understand why. That is, to be useful the reflection of economic hedging activities within the financial statements must include recognising all ineffectiveness in profit or loss."

Current authoritative literature

8. The accounting standards of both the IASB and the FASB currently permit a bifurcation-by-risk approach, although it is significantly limited with respect to non-financial items. On June 6, 2008, the FASB released an Exposure Draft, *Accounting for Hedging Activities,* that proposed severely curtailing the bifurcation by risk approach, effectively limiting use of the bifurcation by risk approach to (a) interest rate risk related to its own debt, if hedged at inception, and (b) foreign currency exchange risk. No action has been taken with respect to that exposure draft.

9. The staff's outreach has confirmed that risk management strategies that hedge items by risk-specific components are most common in practice.

Application of the three proposed objectives of hedge accounting

10. In Agenda Paper 4A/31, proposed objective of hedge accounting #1 states:

> The objective of hedge accounting should be to provide a link between an entity's risk management and its financial reporting. Hedge accounting

can convey the context of hedging instruments, which allows insights into their purpose and effect.

11. Application of Objective #1 would argue in favour of a bifurcation by risk approach. Because of its linkage to an entity's risk management and its focus on the purpose of hedging instruments, Objective #1 would support permitting hedge accounting to exclude the effect of the unhedged risks that also affect the changes in that asset's or liability's cash flows or fair value as they are not hedged within the entity's risk management strategy.

12. Proposed objective of hedge accounting #2 states:

> The objective of hedge accounting should be to (a) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items and (b) manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

13. Objective #2 is consistent with the current objectives of hedge accounting in U.S.GAAP. This objective supports either a bifurcation-by-risk approach or an approach that reflects all risks.

14. In response to concerns raised by IASB members the staff have developed proposed objective #3:

> The objective of hedge accounting is to reflect the relationship between an entity's risk management activities and the related hedged exposures by:
>
> (a) changing the timing of recognising gains or losses on hedging instruments, or the recognition or measurement of hedged items, and
>
> (b) the presentation and disclosures in relation to these items.

For the purpose of this objective, risk management activities are those activities that use financial instruments (or other contracts that are accounted for as financial instruments) as hedging instruments.

15. Application of Objective #3 seems to support a bifurcation by risk approach due to its link to an entity's risk management and the hedged exposures. Objective #3 aims to align the effects of the hedged exposure and the hedging instrument/hedged item.

16. The FASB staff believes that Objective #2 and #3 are similar in their focus on accounting for recognition and measurement differences between derivatives and hedged items.

Designation of risk components (bifurcation-by-risk)

17. The remainder of this part of the paper is structured as follows:

    (a) Arguments for permitting bifurcation-by-risk

    (b) Arguments for not permitting bifurcation-by-risk

    (c) Identification and potential limitations on designation of risk components as hedged items.

18. At the January 19, 2010 joint meeting, the boards decided that in light of the FASB's goal to publish a comprehensive exposure draft on financial instruments in March 2010 and the IASB's goal to publish an exposure draft on the remaining main phases of the project to replace IAS 39 in the first quarter of 2010, the boards will first jointly consider hedge accounting issues relating to financial hedged items. Therefore, Part A of this agenda paper focuses on the implications for financial items only.

19. However, in considering the choice of an objective (in particular, #1 and #3) the staff believes that the boards should consider the possible implications for non-financial hedged items. Hence, part B of paper 4C contains a preliminary discussion about non-financial items. Please read part B before considering the questions at the end of Part A.

PART A - FINANCIAL HEDGED ITEMS

20. Examples of risk components frequently designated include:

    (a) (benchmark) interest rate risk (e.g. EURIBOR risk in EUR-denominated debt)

    (b) foreign currency risk (USD risk in a USD denominated debt instrument where the entity has a functional currency different from USD); and

    (c) credit risk (e.g. hedging the credit spread of a B-rated bond).

21. The majority of respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* and the IASB's exposure draft *Exposures Qualifying for Hedge*

Accounting and during the outreach undertaken by the staff highlighted that the possibility of designating risk components is crucial to reflect appropriately their hedging activities in their financial statements as designation of risk components is closer to their actual hedging strategies and reduces 'accounting ineffectiveness'.

Arguments for permitting bifurcation-by-risk

22. Clearly, risk components are often not an explicit part of a fair value or a cash flow. There is rarely ever an itemised bill that shows the impact on the fair value or the cash flows from a specific risk.

23. However, many hedging strategies involve hedging of components. There are different rationales for using a component approach to hedging, including:

    (a) The entire item cannot be hedged due to a lack of appropriate hedging instruments (for the hedged timeframe).

    (b) It is cheaper to hedge the single components individually than the entire item (eg because an active market exists for the components, but not for the entire item).

    (c) The entity makes a conscious decision to hedge only certain parts of the fair value or cash flow risk (eg because one of the risk components is particularly volatile and hence justifies the hedging cost).

24. As most hedges seen in practice are 'partial hedges,' one way to appropriately reflect these risk management strategies in the financial statements is to permit designation of risk components as hedged items compared to all risks in their entirety.

Arguments for not permitting bifurcation-by-risk

25. As mentioned earlier, the FASB Exposure Draft on hedging activities issued in 2008 proposed severely curtailing the bifurcation by risk approach, effectively limiting use of the bifurcation by risk approach to (a) interest rate risk related to its own debt, if hedged at inception, and (b) foreign currency exchange risk. The Basis for Conclusions stated:

    > The Board believes that an approach that permits hedging either all risks or only foreign currency risk for all hedged items or transactions better reflects

> the economics of the instruments than the bifurcation-by-risk approach currently permitted in Statement 133. Under the proposed approach, more information would be provided about both (a) risks that an entity manages or transforms and (b) risks that an entity does not manage or transform. An entity may choose to be exposed to certain risks or may not be able to identify a practical way to manage certain risks. The Board does not believe that it would be unfair, as some constituents have stated, to require entities to reflect as part of hedge accounting the economics of a hedged item associated with risks not managed or transformed by the hedging instrument. The Board believes it is just as important to reflect in the financial statements the economics of unhedged risks in order to provide users with a more complete picture of an entity's financial position and results of operations from hedge accounting activities.

26. Not permitting bifurcation-by-risk would increase the transparency in financial statements by providing information to users about not only the risks hedged but also the risks not managed or transformed by the entity. Users would be able to better assess the effect of hedging activities on an entity's financial position, performance, and cash flows. Permitting bifurcation-by-risk would reduce the transparency of this information set.

Staff recommendations

27. **The IASB staff recommends that hedge accounting permit or require entities to reflect only risks hedged in financial statements and exclude the effects that other (unhedged) risks may have on the fair value or cash flows of the hedged asset, liability firm commitment or forecast transaction (bifurcation-by-risk).** This recommendation is the closest link to an entity's risk management because it reflects what an entity does instead of what it does not do. Ineffectiveness would be determined based on the risks an entity manages instead of those it does not manage. This recommendation also focuses on the purpose of hedging instruments.

28. **The FASB staff recommends that bifurcation-by-risk not be provided and entities should reflect all risks (hedged or unhedged) arising from items that are hedged.** The staff believes that based on decisions reached to date by the FASB on the classification and measurement model for financial instruments, bifurcation-by-risk is not warranted either for cash flow or fair value hedges. The tentative FASB model for accounting for financial instruments requires all financial instruments to be measured at fair value (apart from the very narrow amortized cost option). In addition, entities must meet the 'held for collection' criteria to recognize certain fair value changes in other

comprehensive income. For financial instruments entities intend to 'hold for collection', the FASB staff believe that bifurcation-by-risk is not relevant.

Question 1 – Permitting designation of risk components as hedged items
If an entity wishes to hedge its exposure to only some of the risks that can affect a hedged item's cash flows or its fair value, should hedge accounting: A: be permitted to reflect that hedging strategy in financial statements and exclude the effects that other (unhedged) risks may have on the fair value or cash flows of the hedged asset, liability, firm commitment or forecast transaction, or B: not permit bifurcation-by-risk and instead include the effects of all risks (including unhedged risks) that affect the fair value or cash flows of the hedged asset, liability, firm commitment or forecast transaction?

Identification and potential limitations on designation of risk components as hedged items

Current IFRSs

29. Under current IAS 39 *Financial Instruments: Recognition and Measurement,* for *financial items* an entity can designate any risk component as long as effectiveness can be measured and, hence, any ineffectiveness will be recognised in profit or loss (IAS 39.81).

Comparison with U.S. GAAP

30. U.S. GAAP is significantly more restrictive in which risk components can be designated for *financial items*. A financial asset or financial liability can be either be designated for its entirety of risks or for:

    (a) benchmark interest rate risk, and/or

    (b) foreign currency risk, and/or

    (c) creditworthiness of the issuer.

Identification and potential limitations

31. In the comment letters received on the discussion paper *Reducing Complexity in Reporting Financial Instruments* and the IASB's exposure draft *Exposures Qualifying for*

Hedge Accounting, many respondents noted that the possibility to designate risk components for *financial items* is closer to their risk management and expressed the view that the IFRS approach to this is superior from an information perspective than the US GAAP approach.

32. Users expressed the view that the current approach to hedge accounting is complex and difficult to understand. Many of them rely on additional (and pro-forma) information provided by preparers in order to assess the impact of hedging activities on enterprise value. In addition, there was concern that restrictive rules result in arbitrary outcomes, which creates confusion regarding the purpose for which derivatives are used (eg characterisation as 'held for trading' for accounting purposes while they are used to hedge business risks creates conflicting messages).

33. The question arises how a hedge accounting model that permits risk components to be designated as hedged items can ensure that:

    (a) the risk components identified actually represent the components that are hedged within the entity's risk management framework and so meet the objective of hedge accounting; and

    (b) any ineffectiveness that arises is recognised in profit or loss.

34. As for (a), because hedge accounting aims to provide a link between an entity's risk management and financial reporting, it should be evident from risk management policies and the hedge documentation how the designated risk component fits into the risk management strategy of the entity.

35. As for (b), the staff is providing the boards with two approaches for identifying and designating risk components as hedged items for financial instruments if the boards decide to retain the ability to designate risk components.

36. **Approach 1** would permit an entity to designate a risk component as a hedged risk when the risk component is separately identifiable and measurable.

37. **Approach 2** would retain the existing risks (interest rate risk based on a benchmark notion, credit risk, and foreign currency risk) that are eligible to be designated as the hedged risk in a hedge of a financial instrument. This approach is based on the notion that the specific risks currently eligible under U.S. GAAP to be designated as a hedged

risk are easily identifiable risks existing within financial instruments. Identification of hedged risks is not an issue under current U.S. GAAP. Under IFRS to qualify as a hedged risk, the hedged risk must be separately identifiable and its effects reliably measurable.

38. The staff notes that the IASB explored a similar approach of specifying an exhaustive list of eligible hedged risks in its exposure draft *Exposures Qualifying for Hedge Accounting*. Respondents to that ED widely disagreed with this approach as it is not principles-based and does not reflect an entity's risk management activities.

Staff recommendations

39. The IASB staff recommends that if the boards were to retain the possibility to designate risk components of an item as a hedged item that the identifiable risk component must both be separately identifiable and measureable for the purpose of determining hedge ineffectiveness.

40. The IASB staff thinks it is important that two criteria have to be met in order to ensure that any ineffectiveness can be determined by the entity in a representationally faithful manner:

    (a) the risk component must be **separately identifiable** within the entire item

    (b) the effects of the identifiable risk component must be **measureable** for the purpose of determining hedge ineffectiveness.

41. If both (a) and (b) are met, the IASB staff thinks any ineffectiveness can be determined in a representationally faithful manner.

42. Allowing designation of risk components, within the boundaries of the conditions identified in paragraph 40 helps establish the link between risk management and financial reporting and hence meets the proposed objective of hedge accounting.

43. Moreover, current IAS 39 requirements on eligible hedged risks are restrictive as a hedged risk must meet the conditions of being separately identifiable and reliably

measurable. These conditions have proved effective in the determination (and restriction) of eligible hedged risks in practice.

44. **The FASB staff recommends Approach 2 (retaining the current US GAAP list of eligible hedged risks – see paragraph 30) based on the reasons stated above. In addition, the FASB staff is concerned that Approach 1 would result in identifying as the hedged risk any risk that exists in the hedging instrument. In other words, identifying risks based on Approach 1 is may be a self-fulfilling prophecy. That could result the lack of comparability among entities who issue or hold the same instruments but identify and designate a different interest rate risk depending on which interest rate index is referenced in the derivative hedging instrument. Also, financial instruments can be characterized in numerous and different ways; thus creating an endless list of hedgable risks that could be separately identifiable and measurable.**

Question 2 – Identification of risk components for designation
Do the boards believe, if it was to retain the possibility to designate risk components, that the risk component must both be separately identifiable and measureable for the purpose of determining hedge ineffectiveness? Or, Do the boards believe, if it was to retain the possibility to designate risk components, that the current US GAAP list of risk components eligible for designation should be retained?

PART B - Designating risk components of non-financial items

45. As described above, IAS 39 restricts the designation of risk components to foreign currency risk for hedged non-financial items. Many respondents to various documents relating to hedge accounting criticised the Board that this restriction prevents an entity from faithfully reflecting their hedging activities and strategies in the financial statements. Some noted that if they try to achieve hedge accounting within the boundaries of the current guidance this comes at the price of ineffectiveness (sometimes outside the 80%-125% range and hence not achieving hedge accounting at all). Both Objective #1

and Objective #2 could be viewed as supporting the relaxation of the 80%–125% highly effective test.

46. The staff thinks this restriction is difficult to reconcile, especially with objective #1 and possibly objective #3.

47. As evidenced during the staff's outreach many corporates use sophisticated hedging strategies and systems. Some of these systems are similar to those used by banks. The staff believes retaining the restrictions on designating components based on the difficulty to isolate and reliably measure the effects has no valid rationale.

48. Instead of *ex ante* prohibiting designation of risk components of non-financial items as hedged items, a future standard on hedge accounting should focus on whether the designation ensures that the underlying principles are met. In particular the principle of recognising all ineffectiveness in profit or loss in the period in which it occurs.

49. So when are these conditions met for non-financial items? Two types of transactions can be distinguished:

    (a) transactions where the risk component is *explicit* (eg a contract with a price adjustment clause relating to the risk to be hedged)

    Example: An entity has a master agreement with one of its suppliers over the delivery of electric engines. A significant driver of the production costs for the supplier is the copper that is required for the coils. As copper prices are very volatile, but the supplier does not have the capacities to hedge against copper price risk itself, the master agreement contains a price adjustment clause to adjust the prices based on the price of copper. The entity enters into copper forward contracts to hedge the copper price risk for its forecasted future purchases of electric engines.

    Treatment under IAS 39: The entity can only designate the full price risk or the foreign currency risk alone as the hedged item in a cash flow hedge of a forecasted transaction. This is less of an issue if the price of the overall contract is only subject to the variability arising from the copper price adjustment clause. However, if there are other adjustment clauses (eg for

other production cost, logistics cost, etc) within the master agreement ineffectiveness will arise with regard to the copper hedge and the hedge relationship might not meet the prospective hedge effectiveness test at all.

(b) transactions where the risk component is *implicit*

Example: An entity forecasts its purchases of jet fuel in two years time. The price of jet fuel is highly correlated to the price of crude oil (in simple terms, the jet fuel price is determined by adding a refining margin to the price of crude oil). To hedge against the price risk of its future jet fuel purchases the entity enters into options. For the two year hedging timeframe the only derivatives available in a liquid market are options on crude oil – not for the actual jet fuel to be purchased. It plans to roll the crude oil options into jet fuel options in due course once these contracts become available (this can be done by closing out the original option and entering into a new option, entering into a basis swap, etc).[1]

Treatment under IAS 39: The entity can only designate the full price risk of jet fuel (or the foreign currency risk alone) as the hedged item in a cash flow hedge of a forecasted transaction. The impact of changes in the jet fuel price caused by the other components will most likely create ineffectiveness and depending on the magnitude of the changes lead to actual effectiveness being outside the 80%-125% range and hence not being able to apply any hedge accounting or failing the prospective effectiveness test.[2]

50. For items where the risk component is *explicitly* specified (first example) it can be assumed that both criteria for the designation of a risk component are met. Through the contractual agreement the risk component is separately identifiable as a source of

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[1] This highlights another issue under today's rules. When the additional hedging instruments are contracted an entity has to de-designate the original hedging relationship in order to include them into the hedging relationship and designate the new bundle of derivatives as a new hedging relationship. This will cause ineffectiveness as the fair value of the crude oil option does not equal the premium paid anymore.

[2] However, for a fixed-rate debt instrument the entity can designate the component of fair value that is determined by the benchmark interest risk and hence both improve effectiveness and align risk management and financial reporting.

variability of fair value or cash flows. In many cases (eg for commodity hedges) the price adjustment is linked to market prices for the risk component using a formula approach. Hence a measure of the effect of the risk component on the fair value or cash flows is generally possible for the purpose of determining ineffectiveness.

51. For items where the risk component is *implicit* establishing whether the second condition is met proves more difficult. How can an entity identify the change in fair value or cash flows that is caused by the risk component? And how reliable can the measure of that component be?

52. However, it is impossible to specify when the criteria are met without providing a set of rules for all possible hedging strategies that exist or will exist in the future. This would also contradict a principles-based approach to hedge accounting.

53. An entity would have to apply judgement in determining whether the criteria are met. However, in the staff's view, it must be assumed there is a purpose for entering into these transactions and there is some degree of monitoring of the success of the hedge from an economic perspective. The link to the risk management policies will show this and the requirement to show any ineffectiveness will make transparent how successful the hedging strategy was.

54. For example, when for hedge accounting under IAS 39 entities determine the change in the full price of jet fuel (ie the value of the entire jet fuel purchase) the price of jet fuel for periods before jet fuel forward prices are observable is typically determined using a building block approach. That approach uses observable crude oil forward prices and assumptions about the refining margin. Hence, the entity knows the crude oil component of the jet fuel price and calculates it in applying IAS 39 but faces the non-rebuttable presumption that this crude oil component is not known even though it demonstrably is. The result is a systematic overstatement of hedge ineffectiveness resulting from changes in the refining margin, which is not hedged but presented by hedge accounting as if it were. That information is not a faithful representation of the underlying economic event.

55. In accordance especially with objective #1 and possibly objective #3, permitting designation of risk components for non-financial items:

    (a) reflects actual risk management

(b) aligns risk management and financial reporting

(c) increases decision-usefulness of financial statements by making transparent to users the hedging activities of an entity and their effectiveness.