Project **Accounting for Financial Instruments - Hedge Accounting**

Topic **Eligible hedged items – Risk components**

Introduction

Purpose of this paper

1. This paper continues the Board's discussions on eligible[1] hedged items. Its purpose is to assist the Board in determining the objective of hedge accounting by illustrating how the two proposed objectives could be applied to risk components in both financial and non-financial items, including proposed constraints to eligibility.

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 non-contractual 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?

[1] This paper refers to eligibility both for mandatory or voluntary designations and hence is not aimed to pre-empt any discussion whether hedge accounting should be mandatory or voluntary.

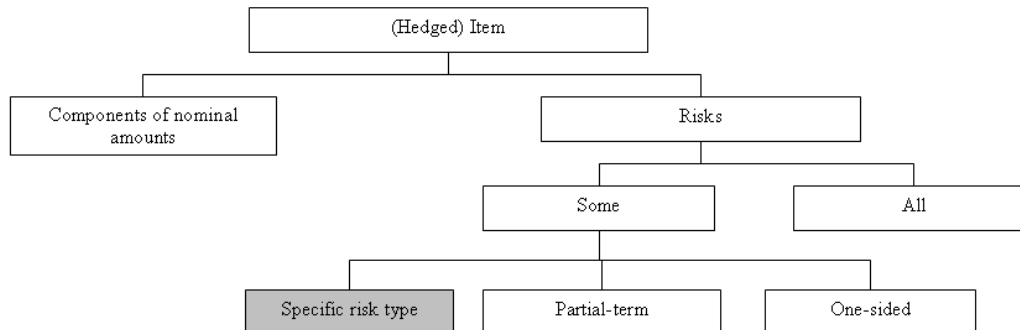
This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB and the IASB.

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.

The tentative decisions made by the FASB or the IASB at its public meetings are reported in a FASB *Action Alert* and and IASB *Update*. Official pronouncements of the FASB and the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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:



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 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, which is included as Appendix A of Agenda Paper 8A of this 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 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. As noted in Agenda Paper 8B of this Board meeting, "The staff's outreach confirmed that risk management strategies that hedge items by risk-specific components are most common in practice."

Application of the two proposed objectives of hedge accounting

10. In Agenda Paper 8A of this Board meeting, 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. Application of Objective #2 would suggest that optimally when an asset, liability, firm commitment or non-contractual forecast transaction is designated as the hedged item, hedge accounting should evaluate whether the hedging relationship is effective at mitigating the effects of all the various risks that can affect the hedged item's cash flows or fair value. However, Objective #2 should not be viewed as totally incompatible with any bifurcation by risk. Objective #2 aims to mitigate, not eliminate, the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. The application of Objective #2 would seem to be much more restrictive in permitting bifurcation by risk than Objective #1. Yet, for items designated as being hedged, Objective #2 would strongly support reporting as ineffective the extent to which the hedged items' risks are not being hedged by the hedging instrument.

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 (Objective #1): 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 non-contractual forecast transaction, or
B (Objective #2): to 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 non-contractual forecast transaction?

Potential Limitations on designation risk components as hedged items

14. The remainder of this paper is mainly relevant for Objective #1, and is written in that context.

15. The paper is structured as follows:

    (a) When does designation of risk components provide useful information?

    (b) Designating risk components of financial items.

    (c) Designating risk components of non-financial items.

16. The staff wishes to highlight whilst the paper preserves the current distinction between financial and non-financial items, this is done only for the sake of argument. As set out later in the paper the staff believes this distinction is not appropriate for Objective #1 as it is an impediment for entities to reflect their risk management in financial statements.

Background

Current IFRSs

17. Current IAS 39 *Financial Instruments: Recognition and Measurement* distinguishes between *financial items* and *non-financial items* with regard to the eligibility of risk components for designation as hedged items.

18. For *financial items* an entity can designate <u>any</u> risk component as long as effectiveness can be measured and, hence, any ineffectiveness will be recognised in profit or loss (IAS 39.81).

19. For *non-financial items* an entity can designate only foreign currency risk as a risk component (IAS 39.82). Alternatively, the entity can designate the item for all risks.

20. Appendix A of this paper provides additional information on the current guidance on risk components under IFRS.

21. The prohibition of designation of risk components for non-financial items was criticised in many of the comment letters received on the discussion paper *Reducing Complexity in Reporting Financial Instruments* and the exposure draft *Eligible Hedged Items*. Also, this was (by a substantial margin) the most common issue raised during the outreach activities undertaken by the staff.

22. Preparers noted that the current prohibition does not allow them to reflect their risk management activities in their financial statements, and that in some instances keeps them from entering into such economically sensible transactions because of the impact on their financial statements. On the other hand, many 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.

23. 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).

Comparison with US GAAP

24. The US guidance 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

(b) foreign currency risk and/or

(c) creditworthiness of the issuer.

25. For *non-financial items* similar restrictions exist as under IFRSs, ie only the risks in their entirety are permissible for designation. For cash flow hedges also foreign currency risk only can be designated.

When does designation of risk components provide useful information?

26. 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.

27. 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).

28. As most hedges seen in practice are 'partial hedges,' the only 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.

29. 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.

30. 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.

31. As for (b), the 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 (this is also relevant for (a))

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

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

33. Allowing designation of risk components, within the boundaries of the conditions identified in paragraphs 30 and 31 helps establishing the link between risk management and financial reporting and hence meets the objective of hedge accounting.

34. **The staff recommends that if the Board was 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.**

Question 2 – Criteria for designation of risk components
Does the Board agree that 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? If not, why and what does the Board wish to do instead, and why?

Designating risk components of financial items

35. As explained above, IAS 39 permits designation of risk components for financial items provided they can be separately identified and measured.

36. Examples of risk components frequently designated include:

    (a) (benchmark) interest rate risk (eg 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 (eg hedging the credit spread of a B-rated bond)

37. The staff thinks that the Board at that time believed that risk components in financial items are more easily identifiable, measurable and verifiable than in non-financial items and hence believed it is appropriate to draw the line between financial and non-financial items staff believes that the current eligibility of risk components in financial items as hedged items should be retained as long as the other criteria to achieve hedge accounting are met. Practice is well established for these types of designations. We also think this is in line with a principles-based approach to hedge accounting.

38. The majority of respondents to the aforementioned comment letters and during the outreach undertaken by the staff, in particular from the financial services industry, 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’.

39. **The staff recommends retaining the eligibility of risk components for financial items as long as these components are separately identifiable and measureable so any ineffectiveness can be determined and recognised in the period in which it occurs. Any current guidance would be updated as appropriate.** This recommendation is consistent with Objective #1 because of its linkage to an entity’s risk management and its focus on the purpose of hedging instruments. This recommendation could possibly, but

not necessarily, be viewed as inconsistent with Objective #2 without more stringent limitations, perhaps such as currently articulated in IFRS and U.S. GAAP.

Question 3 – Retention of eligibility of risk components for *financial* items
Does the Board agree to retain the eligibility of risk components as hedged items under a revised hedge accounting model for financial items? If not, why and what does the Board wish to do instead, and why?

Designating risk components of non-financial items

40. 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.

41. The staff thinks this restriction is difficult to reconcile with the objective of hedge accounting, ie to simply provide a link between risk management and financial reporting.

42. 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.

43. 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.

44. 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).[2]

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.[3]

45. 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 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.

46. For items where the risk component is *implicit* establishing whether the second condition is met proves more difficult.[4] 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?

47. 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.

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[2] 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.

[3] 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.

[4] The staff notes that this seemed to be not an obstacle for the Board at the time IAS 39 was developed to allow designation of implicit portions for financial items (eg the LIBOR component of fixed rate debt).

48. 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.

49. 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.

50. 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.

51. **Hence, the staff recommends removing the current restriction for the designation of risk components for non-financial items to be designated as hedged items in favour of a principles-based approach to designation of risk components. An entity would have to apply judgement in determining whether the risk components are separately identifiable and measureable for the purpose of determining hedge ineffectiveness – as this is the case today for risk components in financial items.** This recommendation is consistent with Objective #1 because of its linkage to an entity's risk management and its focus on the purpose of hedging instruments. This recommendation would likely be viewed as incompatible with Objective #2 without more stringent criteria than an assumption that there is a purpose for an entity's entering into hedging transactions.

Question 4 – Eligibility of risk components for *non-financial* items
Does the Board agree to remove the current restriction for the eligibility of risk components for non-financial items to be designated as hedged items in favour of a principles-based approach to designation of risk components? If not, why and what does the Board wish to do instead, and why?

Appendix A – Summary of current guidance in IAS 39

52. 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). To ensure that this criterion is met, IAS 39 specifies that such a risk component is only eligible for designation as a hedged item if the component is separately identifiable and any changes in the fair value/cash flows can be reliably determined (IAS 39.AG99F). This is not specific for the hedging of risk components, but applies to all hedging relationships designated under the current hedge accounting model.

53. For *non-financial items* an entity can designate only foreign currency risk as a risk component (IAS 39.82). Alternatively, the entity can designate the item in its entirety for all price risks. In practice, some have extended this to permit designation of every price risk *except* foreign currency risk.

54. IAS 39.82 also provides a rationale for distinguishing between financial and non-financial items: 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. IAS 39.AG100 further notes:

    'Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk.'

    The Basis for Conclusions continues to explain that the uncertainties surrounding isolation and measurement could impair the principle of effectiveness testing and that permitting such designations might result in no ineffectiveness to arise. It further notes that a hedge ratio other than one-to-one might improve expected effectiveness and the Application Guidance contains specific guidance on this aspect.