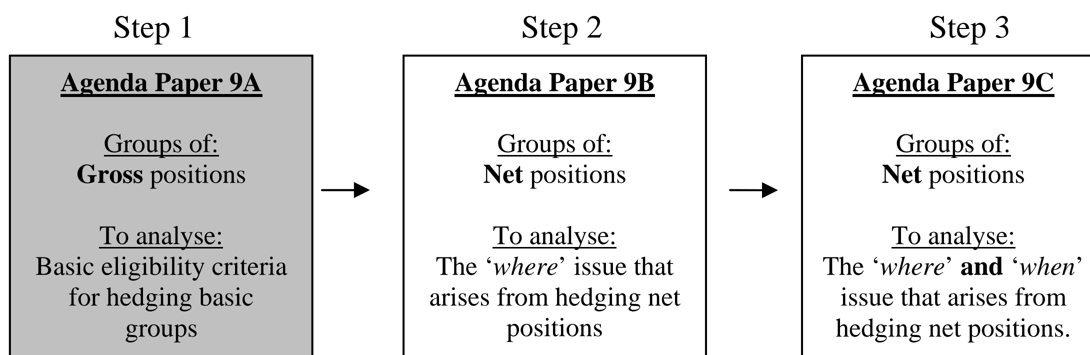
IASB Meeting Agenda reference **9A**

Staff Paper Date **Week beginning 17 May 2010**

Project	**Financial Instruments (Replacement of IAS 39) – Hedge Accounting**
Topic	**Eligible hedged items: groups of hedged items (excluding net positions)**

Introduction

Background and purpose of paper



1. This paper considers whether any specific eligibility criteria are necessary for groups that are **gross positions** of hedged items of the same nature, with different risk characteristics, that impact profit or loss **in the same reporting period**. Such criteria would be *in addition* to the eligibility criteria that apply to individual hedged items.

2. To assist the Board in making its decision this paper analyses, in paragraphs 9 to 26, two examples that do not achieve hedge accounting under the current IAS 39 model. The staff's recommendation is in paragraphs 37 to 39.

3. If it is determined that specific criteria for such groups of hedged items are not required then whatever the eligibility criteria that apply to individual hedged

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items would equally apply to the group (as a whole) of hedged items identified in paragraph 1.

4. As explained in the cover paper any decisions taken for this group hedge situation will have knock-on effects for the accounting of other group hedges. For example, if the Board decides to maintain the IAS 39 requirements for groups of hedged items (as set out in Appendix A of agenda paper 9) this would, subject to an exception, automatically disqualify a group that is a net position from being eligible as a hedged item (with the consequence that we would not need to talk about such positions any further in the general hedge accounting model).

5. This is why we are starting with a simple gross position before possibly considering the more complex situations.

Application of IAS 39 requirements to groups of items

6. Examples of groups of gross items that qualify for hedge accounting under IAS 39 include:

   (a) A group of firm commitments to buy property, plant and equipment from various suppliers in a particular month denominated in the same foreign currency, hedged for foreign exchange risk.

   (b) Stocks of a commodity hedged for the spot commodity price risk.

   (c) A group of forecast sales, denominated in the same foreign currency, expected to arise in a specified month, hedged collectively for foreign exchange risk (for example hedged with a single FX forward contract that settles in the middle of the month).

   (d) A group of UK LIBOR floating rate financial assets hedged for UK LIBOR interest rate risk.

7. In each of these cases the individual items in the group would generally qualify for hedge accounting on an individual basis for the same hedged risk.

8. Examples of groups that do not qualify include those where the change in fair value attributable to the hedged risk for each individual item in the group is not approximately proportional to the overall change in fair value of the group for the hedged risk.

Example A – stock index hedge

9. IAS 39 includes an example of a group of financial assets that would not qualify for hedge accounting as a group.

10. In the example the group is a portfolio of shares that represent the reference assets in a stock index (eg this could be a portfolio of the 100 shares that are included in the FTSE 100 index). In the example the portfolio is economically hedged as a group, for the risk of a fall in the individual share prices, with a purchased put option linked to the stock index. The IAS 39 guidance states that the portfolio of shares is not an eligible group of hedged items because the change in fair value attributable to the hedged risk (the change in individual share prices) for each individual item in the group is not expected to be proportional to the overall change in the fair value attributable to the hedged risk of the group[1].

11. In this example the entity has successfully protected itself from fair value losses arising from a fall in the individual share prices.

12. This hedge would not qualify under IAS 39 regardless of whether the hedged items are expected to impact profit or loss in the same reporting period or different reporting periods.

13. For the purpose of the staff analysis of this example (from paragraph 27 onwards), it is assumed that this group of hedged items impacts profit or loss in

[1] This example has been used in this paper solely because it is easy to understand and appropriately highlights the application of the current rules on hedging groups of items that are not net positions. The staff acknowledges that there is a broader question of whether equity instruments measured as at fair value through other comprehensive income should qualify for hedge accounting. As noted in agenda paper 12 of the April 2010 Board meeting this will be addressed as a separate issue.

the same reporting period (ie all 100 equities will be derecognised in the same reporting period).[2]

Example B – seed corn hedge

14. Another example of a hedge of a group was presented to the staff by a preparer as part of the outreach activities. Under IAS 39, this example is not eligible for hedge accounting for a number of reasons[3]. However, the reason that is relevant to this paper is the criteria for groups of hedged items.
15. In this example Entity A enters into contracts to purchase seed corn from individual independent growers.
16. The price paid for each unit of seed corn is based on two components. One component is based on the benchmark *commercial* corn price (component 1) and the other component is based on the *seed* corn yield[4] (component 2).
17. Component 2 differs for each item (seed corn purchase) such that it is not approximately proportional to the overall change for the group as a whole.
18. The objective of the contract pricing is to sufficiently incentivize and reward farmers for producing seed corn which is more costly to produce than commercial corn (the price linkage to seed corn yield helps to achieves this).
19. On some of Entity A's purchase contracts both price components are variable until closer to delivery when they are agreed and fixed. This gives rise to cash flow variability for the purchase price up until the price is fixed.

[2] This is obviously unlikely, but allows us to isolate the three different issues arising from hedge accounting for groups of items identified in paper 9 to consider which of those three are important.

[3] Under IAS 39 requirements Entity A cannot hedge account for only the benchmark commercial corn price component of the contract because non-financial items can only be hedged for all price risk or for FX risk (IAS 39.82). Therefore Entity A attempts to designate the full price risk of the contracts in the hedge relationship. However, as noted above, this paper addresses the designation of groups of items that are gross positions, and that is the issue the analysis focuses on.

[4] Seed corn hybrids produce fewer plants than commercial corn so growers must be compensated adequately for using their land to grow seed corn instead of commercial corn. A target seed corn yield and 'multiplier' ratio to convert commercial corn yield to seed corn yield is determined based on a geographically dispersed population of test plots. The seed corn yield component varies depending on whether the actual yield achieved by the grower is more or less than the target yield.

20. Where Entity A has found a fixed price buyer for its seed corn it does not want to be exposed to the cash flow variability on its purchase price with growers.

21. To hedge its risk exposure it enters into benchmark commercial corn derivatives to hedge price component 1 for a group of individual purchase contracts collectively. It does not attempt to hedge for the variability of component 2 as on an aggregated net basis this largely offsets amongst purchase contracts. Also, hedging instruments are generally not available to hedge component 2 of the pricing.

22. The commercial corn derivatives are to buy commercial corn at a fixed price to offset the cash flow variability arising from component 1 until it fixes the purchase price for its physical seed corn. Once it fixes the purchase price for its physical seed corn it closes out its derivative position as it is no longer exposed to changes in the benchmark commercial corn price.

23. For the purpose of the staff's analysis (from paragraph 27onwards) it is assumed that the hedged items in this group impact profit or loss in the same reporting period.

24. In order to qualify for hedge accounting under IAS 39 the change in fair value of the expected future cash flows on each individual contract in the group must be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. However, because of the variability of the second pricing component linked to the seed corn yield (which does not vary approximately proportional for each item compared to the group) it does not comply with the IAS 39 group hedging requirement.

25. Economically, the entity is able to demonstrate that the fair value of the hedging derivative largely offsets the fair value of the cash flow variability of the group. The reason the group hedge is more effective than a hedge of the individual contracts is because the adjustments to the seed corn target yield price differential (component 2) largely offset each other and are more effectively modelled as a group rather than on an individual basis.

26. In this example Entity A has commercially hedged itself (with a high degree of offset) against changes in fair value of the expected future cash flows on its purchase contracts with growers.

Staff analysis of examples A and B

Timing of profit or loss recognition of the group of hedged items

27. The alternative to designating the group of items in a single hedge relationship with the entire hedging instrument (or instruments), is to designate each individual hedged item in a hedge relationship with a proportion of a hedging instrument (ie many individual hedge relationships).

28. However, in the two examples individual hedge relationships are unlikely to be effective. For instance, in example A an individual stock price in the group may increase whilst the overall stock index price may decrease.

29. The reason the group hedge is effective is because some of the risks in the group offset and provide a hedge against each other leaving the group residual risk to be hedged by the hedging instrument.

30. Another way to characterize this is to say that some of the hedged items in the group also act economically as hedging instruments. It is worth noting however that a hedging instrument would only be identified and designated in a hedge relationship if it impacts profit or loss in a different reporting period to the hedged item (otherwise there is no benefit of hedge accounting).

31. In both examples A and B, the hedged items impact profit or loss in the same reporting period. Hence the question of whether the hedged items behave as hedging instruments is not relevant here.

Staff conclusion on examples A and B

32. Given the commercial effectiveness of the hedges in the two examples detailed above the staff believes that the groups should be eligible for hedge accounting.

33. In these circumstances the staff does not see any benefit to financial reporting of restricting hedge accounting.

34. Of course, the Board may decide upon other restrictions as to eligible hedged items. For example, the eligibility criteria that apply to individual hedged items may result in such hedging activities not being eligible for hedge accounting.

35. However, the staff does not believe that specific criteria for groups that are gross positions of hedged items where the hedged items impact profit or loss **in the same reporting period** are required. Hence the staff believes that the eligibility criteria that apply to individual hedged items should equally apply to such a group of hedged items that impact profit or loss in the same reporting period.

36. As detailed in the cover paper (agenda paper 9) the staff will separately consider other types of groups in a separate paper (eg groups that are gross positions of hedged items that impact profit or loss in *different* reporting periods).

Staff recommendation and question to the Board

37. The staff recommends that the new hedge accounting model does not include specific criteria on the eligibility, for hedge accounting, of a group that is a gross position of hedged items if all items affect profit or loss in the same reporting period.

38. Instead where such a group of items is hedged collectively the staff proposes that the eligibility criteria that apply to individual items equally apply to the group of items as a whole.

39. In addition other criteria (for example, hedge effectiveness) will also have to be met.

Question – eligibility of groups of hedged items
Does the Board agree with the staff recommendation not to have specific eligibility criteria for groups that are gross positions of hedged items if all items affect profit or loss in the same reporting period? If the Board disagrees with the staff recommendation what eligibility criteria does the Board propose for such groups of hedged items and why would that improve financial reporting?