



Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Eligible hedged items: contractually specified risk components

Introduction

Background

1. The Board discussed the eligibility of risk components at two previous meetings on 2 and 17 February 2010.¹
2. At the 2 February 2010 meeting, the Board tentatively decided to permit the designation of risk components as eligible hedged items (ie permit bifurcation-by-risk).
3. At the 17 February 2010 meeting the Board looked at the criteria for the eligibility of risk components of *financial* items to be designated as hedged items that are used in IAS 39 *Financial Instruments: Recognition and Measurement*. At that meeting the Board tentatively decided to explore a new criterion (or criteria) for the purpose of determining risk components that are eligible for designation as hedged items (eligible risk components).

Purpose of this paper

4. This paper is the first step in exploring a new criterion for determining eligible *risk* components.² The analysis solely relates to risks that are *contractually*

¹ See agenda paper 4C of the 2 February 2010 meeting and agenda paper 9C of the 17 February 2010 meeting.

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specified components of an item. Such components are addressed for both financial and non-financial items.

5. Risk components that are *not* contractually specified – the next step – will be addressed at a future meeting.

The issue

Exception versus norm

6. Many risk management strategies use an approach that manages exposures by type of *risk* for different *items*. Not an approach that is by type of *item* for different (or all) *risks*. This has resulted in a misalignment of many risk management strategies and hedge accounting requirements. Hedge accounting uses the entire item as the default unit of account and then sets out rules that govern what risk components of that entire item can be used. Hence, what is the normal approach for risk management purposes is really the exception in hedge accounting requirements.

This issue and our outreach

7. Hence, the (lack of) eligibility of risk components has always been raised by constituents as an example of the disconnect between risk management and hedge accounting, and has been identified as one of the most significant issues that should be addressed. For (non-financial) corporates it is arguably the number one issue.
8. The staff has and continues to conduct extensive outreach to understand and research this issue. We believe that this outreach, which has involved considerable time and effort, is warranted to allow the Board to address this issue in an informed manner. This paper addresses part of the issue. As we

² Other types of components (components of nominal amounts and ‘one-sided’ risk components) were discussed at the 3 March 2010 meeting (agenda papers 1B and 1C).

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complete our outreach effort, we will bring forward further papers on the remainder of this issue.

Financial versus non-financial items

9. Today's hedge accounting requirements in IAS 39 differentiate the eligibility of risk components by *type of hedged item*:
- (a) **financial items** can be disaggregated into risk components based on the following criteria:³
 - (i) the risk component must be **separately identifiable** within the entire hedged item; and
 - (ii) the effects of the identifiable risk component on the changes in the cash flows or fair value of the entire financial instrument must be **reliably measurable**.
 - (b) **non-financial items** *cannot* be disaggregated into risk components except for foreign currency risk.⁴
10. A contractually specified risk component of a *financial* item fulfils the criteria of being separately identifiable and reliably measureable unless it affects other cash flows of the financial item. Therefore, these risk components are typically eligible for designation as a hedged item (unless the risk component exceeds the total cash flows of the financial item). IAS 39 sets out examples of eligible contractually specified risk components:
- (a) LIBOR based variable interest as a contractually specified benchmark interest component (provided it is less than the total interest cash flow).⁵ The hedge of the benchmark interest risk component of variable rate financial items is among the most prevalent types of hedge accounting that uses designation of risk components.

³ IAS 39.81 and AG99F.

⁴ IAS 39.82.

⁵ See IAS 39.AG99C, which explains that only if the contractually specified LIBOR component exceeds the total cash flows of the financial item the ability to designate that component is restricted.

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- (b) A contractually specified inflation component (that does not affect other cash flows of the instrument).⁶
11. In contrast, contractually specified risk components of *non-financial* items are *never* eligible risk components.⁷ This is irrespective of whether the criteria for risk components in financial items – if they were to be applied – would be fulfilled.
12. Contractually specified risk components are very common for non-financial items and cover a wide range of scenarios. Examples are:
- (a) Long term natural gas supply contracts: these are often priced using contractually specified formulas that reference different commodities and other factors (eg gas oil, fuel oil, and other components such as transportation charges).
 - (b) Many electricity supply contracts have contractually specified pricing formulas that link the price of a unit of electricity to the costs of generation. Examples are pricing formulas that include a variable fuel charge (eg linked to the price of gas or coal), a fixed capacity charge and variable pricing components linked to labour costs and inflation (eg wholesale or capital goods price indices).
 - (c) Benchmark indexed commodity supply contracts: manufacturers that require specific qualities of commodities use supply contracts that price deliveries on the basis of contractually specified formulas that refer to a benchmark commodity price element and other price elements that eg reflect differences in the quality compared to benchmark or logistics service costs. An example is a coffee supply contract for Arabica coffee from Colombia to a specific manufacturing site that prices a tonne of coffee based on the exchange traded coffee future price plus a

⁶ IAS 39.AG99F(c).

⁷ The exception for foreign currency risk, which can be designated as a risk component of a non-financial item, is not a *contractually specified* risk component (instead, it arises because of the different functional currency of the party to the contract compared to the currency in which the transaction is denominated).

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fixed price differential plus a variable logistics services charge.

Broadly similar arrangements are used for other commodities such as cocoa, sugar, or palm oil. Sometimes the supply is for a refined commodity product, in which case the pricing formula includes an additional charge for the production (or 'conversion') costs of the supplier for the refining. Such charges are similar to tolling fees and can include fixed and variable components (eg inflation indexation). Similarly, many contracts for metal sales use a pricing formula that indexes the sales price to the benchmark price or price index of that commodity as quoted on an exchange (eg for copper contracts a reference to the price of 'Copper Grade A' on the LME⁸).

- (d) Manufactured goods supply contracts: some contracts that relate to items with significant commodity inputs include price adjustment clauses that create a variable pricing component in relation to commodities. For example, a pricing component indexed to the copper price for electric motors.⁹
- (e) Transportation logistics services contracts: many contracts for transportation services include contractual adjustment clauses regarding the fuel component of the logistics service. For example, road haulage services often include a diesel fuel price adjustment clause that transfers the price risk of that fuel from the logistics services provider to its customer (eg a manufacturing company that has outsourced its transportation logistics).

⁸ London Metal Exchange.

⁹ See the example illustrated in agenda paper 4C of the 2 February 2010 IASB meeting (paragraph 49(a)).

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Staff analysis***Relevance of the issue***

13. As noted, contractually specified components of non-financial items are very common.
14. Also, as noted, it is a common risk management strategy to hedge on a 'by risk' basis.
15. By contrast to financial items, the existing requirements in IAS 39 do not allow any designation of risk components of non-financial items where they are identifiable and measureable (whether or not they are contractually specified). Instead IAS 39 prohibits any designation of risk components other than foreign currency risk.
16. Hence:
 - (a) the availability of hedge accounting is arbitrarily drawn – and this is especially obvious in the context of contractually specified components;¹⁰ and
 - (b) if hedge accounting is available, then there is no comparability between hedged financial and non-financial hedged exposures for actual hedge ineffectiveness that is recognised. For a financial exposure, hedge ineffectiveness is based on a risk component. For a non-financial item the item has to be hedged in its entirety, and so recorded ineffectiveness includes the effects of exposures that the entity has never set out to hedge. This also distorts comparisons of hedge ineffectiveness between entities that hedge non-financial exposures versus those that do not and those that hedge only a component versus those that hedge the entire item..

¹⁰ When there is more than one variable pricing component hedge accounting is usually not even available because the hedge relationship fails the initial prospective effectiveness test.

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Contractually specified risk components and the logical fallacy

17. In hedge accounting, we rarely have the opportunity to be philosophical.
18. However, we believe that the issue of contractually specified risk components offers such an opportunity, because it illustrates a fallacy. That is, it illustrates a misconception resulting from weak inductive reasoning¹¹ which obscures the logical argument.

The rationale for prohibiting designation of risk components of non-financial items

19. The rationale for banning the designation of risk components of non-financial items is set out in the Basis for Conclusions of IAS 39:

BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non-financial item other than foreign currency risk.

BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.

BC139 The Board confirmed that non-financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the market. In this context, the Board decided to clarify that a hedge ratio of other than one-to-one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

¹¹ Inductive reasoning, also known as induction or inductive logic, is a type of reasoning that involves moving from a set of specific facts to a general conclusion. Many philosophical topics such as morality and faith are explained using inductive reasoning.

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Overgeneralisation regarding lack of identifiability and measurability

20. This rationale is an example of (inductive) generalisation – moving from a set of specific facts to a general conclusion.
21. This rationale is based on (unidentified) cases in which the changes in the cash flows or fair value of a component of a non-financial hedged item are difficult to isolate and measure. However, the link between the observation (ie said unidentified cases) and the conclusion not to permit designation on a component basis is so weak that the conclusion results in an *overgeneralisation*.
22. The staff notes that the examples of contractually specified risk components in non-financial items¹² clearly demonstrate this overgeneralisation.
23. Contractually specified risk components determine a currency amount for that pricing element independently of the other pricing elements and, hence, the non-financial item as a whole. Hence, these components are clearly identifiable. In addition, these components are measurable because the currency amounts relate to the same type of cash flows that arise from outright transactions in relation to the same exposure.
24. For example, the benchmark coffee price element in the coffee supply contract for Arabica coffee from Colombia can be measured just as well as an outright purchase of Arabica coffee using an exchange traded coffee future.
25. It is determined by the nominal coffee quantity and the price of coffee quoted on the specified commodity exchange for the delivery month that the contract specifies for price fixing.
26. The resulting future cash flow is then transformed into a present value just like for an outright forward transaction for coffee.
27. That the measurement of the benchmark coffee price component is no more difficult than the measurement of a coffee future contract is evidenced by the ‘trade in’ clause in some contracts. That clause allows the buyer to deliver the

¹² See paragraph 12.

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exchange traded coffee future in lieu of paying cash for the benchmark coffee price component (ie the buyer can deliver the derivative with the specified nominal amount and delivery month and pay cash only for the fixed price differential and any variable logistics services charge).

28. Similarly, the cash flow related to the gas oil price component arising under the pricing formula of a long term natural gas supply contract can be measured just as well as an outright gas oil purchase.
29. It is determined by the nominal fuel volume and the specified reference price index for the relevant date for price fixing. The resulting future cash flow is then transformed into a present value just like for an outright forward transaction for gas oil.

Overgeneralisation regarding compromised effectiveness testing

30. The other assertion in the Basis for Conclusions¹³ – that permitting risk components (other than foreign currency risk) of non-financial items to be designated as the hedged item would compromise the principles of identifying the hedged item and effectiveness testing so that the component could be designated so that no ineffectiveness would ever arise – is also an *overgeneralisation*.
31. The example of the coffee supply contract for Arabica coffee from Colombia discussed previously demonstrates that for the benchmark coffee price element using the specified exchange traded coffee future as a hedge is fully effective – as evidenced by the ‘trade in’ settlement alternative.
32. Hence, the fact that no ineffectiveness arises is not necessarily the result of an inappropriate designation intended to compromise effectiveness testing or measurement, as the Basis for Conclusion implies. In fact, many pricing formulas that use references to benchmark commodity prices are designed like that in order to ensure there is no gap or misalignment for that pricing

¹³ See paragraph 17.

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component compared to the benchmark price. Thus, by reference to that pricing component, the exposure is economically fully hedged, which means the hedge effectiveness assessment accurately reflects the underlying economic phenomenon.

33. Conversely, designation of contractually specified risk components as the hedged item does not always result in a fully effective hedge.
34. For example, the diesel fuel price adjustment clause that is commonly included in road haulage services contracts often has a ‘ratchet’ adjustment mechanism. That means the fuel surcharge is only adjusted if the diesel fuel price change exceeds a minimum range (rather than on a fully proportionate scale). For example, the fuel surcharge is adjusted by 1¢/mile for every 6¢/gallon change of the fuel index based on a specified base index value of 1.20\$/gallon.¹⁴ Therefore, a diesel fuel price change within any given 6¢/gallon bracket is *not* offset by a change in the fuel surcharge, which creates ineffectiveness. (A common hedging instrument for diesel fuel is a heating oil derivative. In that scenario there is obviously also a basis difference regarding the type of fuel between the hedge and the fuel surcharge component of the road haulage services contract, which creates hedge ineffectiveness).

Reference to hedge ratio adjustment

35. In order to mitigate the problems created by the prohibition to designate risk components of non-financial items as hedged items the Basis for Conclusions suggests that a hedge ratio of other than one-to-one may maximise expected effectiveness.¹⁵
36. This referral to adjusting the hedge ratio as a means to compensate for the ineligibility of risk components is inappropriate. This approach is a means to

¹⁴ Meaning that for every 6¢/gallon increase of the fuel index above 1.20 \$/gallon the fuel charge increases by 1¢/mile and for every decrease in the fuel index (until 1.20 \$/gallon) there is a corresponding decrease in the fuel charge.

¹⁵ See also example in IAS 39.AG100.

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facilitate hedging relationships where the change in one variable is largely *proportional* compared to the change in another variable.¹⁶ For example if a commodity of a certain grade in Location A trades at 90% of the price for the benchmark grade of the same commodity in the location with the most liquid market then designating the hedging relationship using a hedge ratio of 1.11¹⁷ units of the commodity purchased in Location A for each unit (nominal volume) of a hedge contract for the benchmark commodity gives the best effectiveness result. This is actually aligned with how the volume of hedges required would often be determined for risk management purposes in such scenarios.

37. However, the issue with risk components is an entirely different one.¹⁸
38. Using a hedge ratio adjustment in the example of the coffee supply contract for Arabica coffee from Colombia would be tantamount to assuming that the exchange traded coffee future price would change largely proportional to the variable logistics services charge. Only that assumption would give rise to an expectation of achieving a better hedge effectiveness result given the ineligibility of the benchmark coffee price element for designation as a hedged item. The assumption of a valid statistical relationship between coffee prices and logistic charges is obviously untenable. Hence, even if a better hedge ratio were achieved using an adjusted hedge ratio this would be the result of a ‘statistical lottery’ and artificially overstate hedge effectiveness (on the basis of the unit of account required – ie the hedged item in its entirety). That is obviously not useful information to anyone.
39. Moreover, the designation using an adjusted hedge ratio completely misrepresents the risk management strategy, which actually uses a hedge ratio of

¹⁶ See also IAS 39.AG100, which refers to a valid statistical relationship that allows using the slope of the regression line for determining the best hedge ratio.

¹⁷ 1 divided by 0.9.

¹⁸ However, if a hedge contract with a different coffee quality than Arabica were used that traded at a stable percentage discount or premium then if designation on a risk components basis were allowed adjusting the hedge ratio would be appropriate (if it reflects how the risk is actually managed).

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one-to-one, which means the hedge is fully effective¹⁹ on the basis it is managed (ie the benchmark coffee price element). Again, the result is financial information that is not useful.

Staff conclusion

40. The staff analysis illustrates that the categorical prohibition of any designation of risk components (other than foreign currency risk) of non-financial items is the result of an inappropriate overgeneralisation.
41. Moreover, the staff analysis reveals the knock-on problem that this creates by providing detrimental incentives for (or even encouraging) entities to use inappropriate hedge ratios purely to obtain an accounting result.
42. At the same time the staff analysis demonstrates that there are many *contractually specified* risk components of non-financial items that can be identified and reliably measured – without a foregone conclusion of perfect hedge effectiveness.
43. The conclusions therefore are that:
 - (a) risk components that are contractually specified should be eligible for designation as hedged items, and
 - (b) there is *no rational reason* for differentiating between financial and non-financial items for this purpose (ie the decision under (a) above).

Staff recommendation

44. The staff recommends that a *contractually specified* risk component should be eligible for designation as the hedged item in a hedging relationship for hedge accounting purposes, irrespective of whether it is the component of a financial or a non-financial item.

¹⁹ See paragraph 31.

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45. As mentioned in the introduction,²⁰ this is the first step in exploring a new criterion for determining eligible *risk* components. Hence, this recommendation is ***not* a drafting suggestion** but a recommendation for the outcome for these types of risk components.
46. Depending on the future discussion on risk components that are *not* contractually specified the criterion used for determining eligible risk components might be such that it would include the risk components addressed in this paper anyway (which means no separate criterion for them would be required and hence no specific drafting to that effect).

Question to the Board

Eligibility of contractually specified risk components for designation as hedged items

Does the Board agree with the staff recommendation that a *contractually specified* risk component should be eligible for designation as the hedged item in a hedging relationship for hedge accounting purposes, irrespective of whether it is the component of a financial or a non-financial item?

If the Board does not agree, which contractually specified risk component should not be eligible for designation as hedged items and why?

²⁰ See paragraph 4.