
Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Eligibility of ‘cash instruments’ as hedging instruments—follow-up paper from 5 October meeting

Introduction

Background

1. The Board discussed the eligibility of ‘cash instruments’ as hedging instruments at the 5 October meeting (see agenda paper 5 of that meeting—Appendix A provides an extract of that paper that sets out the three alternatives discussed at that meeting).
2. At that meeting there were two requests by the Board:
 - (a) that the staff elaborate on how **Alternative B** (ie remove the restriction regarding the eligibility as a hedging instrument *only* for those cash instruments that are accounted for at fair value through profit or loss) relates to the new classification model of IFRS 9 *Financial Instruments*; and
 - (b) an indication regarding the practical application of Alternative B (if adopted).

Purpose of the paper

3. This paper solely addresses the two requests by the Board for follow-up information.

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

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

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

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

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4. Hence, this paper is only a narrow scope follow-up paper regarding the 5 October IASB meeting.

Issue 1—interaction with new classification model of IFRS 9

5. One of the key differences in classification between IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 is that the differentiation between the fair value categories of available-for-sale and held-for-trading (including derivatives) has been eliminated.
6. Instead, they were replaced with a single fair value through profit or loss category. Hence, for the classification of financial assets the definition of a derivative is no longer relevant.
7. In contrast, IAS 39 needed the derivative definition for the held-for-trading classification approach in IAS 39 to ensure that derivative fair value changes are recognised in profit or loss (instead of other comprehensive income as for available-for-sale).
8. Therefore, in the context of the IFRS 9 classification model for financial assets *retaining* a role of the derivative definition would *constitute* an exception to the classification approach as it is not used for classification purposes.
9. There are also the following considerations that relate to the new classification model of IFRS 9:
 - (a) **Judgement in differentiating derivatives and non-derivatives:** The definition of a derivative includes the initial net investment criterion.¹ This is not always straightforward to evaluate, eg for deep in the money options or partly prepaid forwards; hence, avoiding the use of the derivative definition would avoid this issue.

¹ Item (b) of the derivative definition: ‘it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’.

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- (b) **Future proofing IFRS 9:** As a result of the financial crisis the derivative markets are changing. Credit risk in relation to derivatives has moved into focus. This has resulted in more collateralisation and a push to subject more derivatives to central clearing. For some entities partial or full prepayments may evolve as a surrogate for collateralisation where the credit standing of one counterparty is high relative to that of the other. New products that evolve around such a design would put increased pressure on the initial net investment criterion (see (a) above). Allowing for that possibility would make IFRS 9 more future proof.
- (c) **Collateral treatment:** collateral mechanisms such as margin accounts are treated as separate assets that are accounted for separately.² Hence, a transaction structure for a cash instrument that puts the funded part of the instrument into a collateral arrangement might create a derivative for accounting purposes that would then be available for as a hedging instrument. The evaluation of whether there is a derivative and a collateral arrangement for these parts that need to be treated as one unit of account is judgemental.³ This structuring incentive and the related judgemental evaluation could be avoided by not linking the eligibility as a hedging instrument to the definition of a derivative.

Issue 2—practical application

10. The staff have received some initial feedback from informal outreach. That feedback was obtained at very short notice, and because cash instruments are not often used identifying scenarios in which they are used requires more time than we have had so far. Hence, some of our queries are still pending.
11. Broadly, most believed that the use of cash instruments would not be relevant for banks or similar entities.
12. However for some specific commodity risk related transactions there can be cases for which it would make a difference. Examples mentioned included

² See IAS 39 IG B.10.

³ See IAS 39 IG B.6. This could result in a conflict between IG B.10 and B.6.

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using exchange traded funds to hedge commodity positions (eg for oil or gold). Other potential applications identified include the situation in which a derivative is synthetically created by long and short bond positions.

13. Of course, the comment letter process is a mechanism that allows more response time and involving a much wider audience.

Conclusion

14. From a standard setting perspective the staff consider that retaining the distinction between derivatives and non-derivatives for hedge accounting purposes reflects the IAS 39 classification model for financial assets. Not the IFRS 9 classification model. Hence, retaining the distinction might help perpetuating the old model and involve unnecessary complexity regarding the application of the derivative definition for the purpose of identifying eligible hedging instruments.
15. While the outreach has been limited so far there is a danger of unintended consequences—in disallowing instruments assuming no need for designation as hedging instruments but later finding out about scenarios where hedge accounting would be precluded for no conceptual reason (only because they were not known—this relates to the aspect of ‘future proofing’ the standard).

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Question – Cash Instruments as hedging instruments

Does the Board want to adopt Alternative B (as set out in Agenda Paper 5 of the 5 October meeting)?

If not, what would the Board recommend and why?

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Appendix A

A1. The following extract from agenda paper 5 of the 5 October IASB meeting sets out the three alternatives discussed at that meeting:

10. However, despite acknowledging the rationale underlying the Board's decision when issuing IAS 39, the staff believe the limitation of the use of cash instruments as hedging instruments should be analysed in the context of the new accounting requirements for financial instruments that have been developed and are being developed as part of the project to replace IAS 39.
11. The staff believe that there are at least the following alternatives for the Board to consider:
 - (a) **Alternative A:** retain the restriction in IAS 39 that limits the eligibility of cash instruments as hedging instruments to hedges of FX risk.
 - (b) **Alternative B:** remove the restriction *only* for those cash instruments that are accounted for at fair value through profit or loss.
 - (c) **Alternative C:** remove the restriction for *all* cash instruments.