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| Project | <b>Financial Instruments (Replacement of IAS 39) – Hedge Accounting</b>           |
| Topic   | <b>Eligible hedging instruments - internal derivatives as hedging instruments</b> |

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## Introduction

### *Background*

1. This paper is one in a series of papers that address aspects of eligibility for designation as part of a hedging relationship.
2. For the purpose of this paper the terms ‘eligible’ and ‘eligibility’ are used in a broad sense to denote items that *could* be part of a hedging relationship. This paper does not address, or prejudge, the question of whether hedge accounting will be optional or mandatory. This will be address at a later stage of this project.

### *Purpose of the paper*

3. This paper discusses whether internal derivatives<sup>1</sup> should be eligible hedging instruments in the context of hedge accounting.
4. IAS 39 *Financial Instruments: Recognition and Measurement* does not allow internal derivatives to be used as hedging instruments in the consolidated financial statements, on the basis that:
  - (a) Consolidated financial statements provide financial information about an entity or group as a whole.

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<sup>1</sup> An internal derivative is defined as a derivative financial instrument that is entered into by two entities that are part of the same group/reporting entity. These derivative contracts are eliminated on consolidation.

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- (b) A fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full; permitting the designation of internal contracts would require a change to the consolidation principles.
  - (c) It is conceptually wrong to permit an entity to recognise internally-generated gains and losses, or to make any other accounting adjustments because of internal transactions. No external event has occurred.
  - (d) In addition, an ability to recognise internally-generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control associated risks. It is not the purpose of accounting to prescribe how entities should manage and control risks.
5. This paper is structured into the following sections:
- (a) summary of the outreach activities;
  - (b) overview of the issue and example;
  - (c) overview of the implications for hedge accounting;
  - (d) staff recommendation and question to the Board; and
  - (e) appendix A, setting out relevant accounting requirements of IAS 39 (including the Basis for Conclusions).

**Summary of the outreach activities**

6. During the outreach activities performed by the staff, the following issues have been raised:
- (a) Large financial institutions, large corporate entities and audit firms raised the issue that entities are sometimes required to hedge their risk exposures through internal derivatives with a centralised treasury function. This function then enters into transactions with external counterparties, which may or may not match the original internal derivatives, and hedge accounting is therefore difficult to achieve in the consolidated financial statements (within the restrictions imposed by the requirements in IAS 39).

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- (b) The same type of entities argued that because internal derivatives are not allowed as hedging instruments in the consolidated financial statements, the application of hedge accounting is difficult to understand and inconsistent with common risk management practice.
- (c) Some preparers and auditors raised the issue that the use of internal derivatives is permitted under US generally accepted accounting principles (GAAP) in limited circumstances, and so the new hedge accounting model should at least consider a similar solution (refer to *The US GAAP approach* on page 7).

**The issue**

- 7. Can internal derivatives be considered hedging instruments in the consolidated financial statements?

**Analysis and examples**

- 8. Entities follow different risk management models depending on the structure of their operations and the nature of the hedges.
- 9. Some use a centralised treasury or similar function (typically at a cluster or group level) that is responsible for identifying the exposures and managing the risks borne by the various entities (or other organisational units) within the cluster or group. Others implement risk management policies implemented at each individual entity level. Others use a combination of these two approaches.
- 10. One example of the use of a centralised treasury function is where an entity wishes to hedge an exposure to a particular risk (for example interest rate or foreign exchange (FX) risk) and does so by entering into a transaction with the centralised treasury function. This centralised treasury function then hedges the risk taken from the entity by entering into a transaction with an external counterparty, which may or may not match the terms of the internal transaction. Reasons for this include:
  - (a) the costs of hedging;

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- (b) different management strategies being followed by treasury and subsidiaries;
  - (c) limits faced by the treasury centre as well as consideration of minimising credit risk;
  - (d) timing differences between internal and external contracts; and
  - (e) the absence of contracts in the market that match the internal transactions.
11. While the example described above represents one way in which the centralised function can manage the relationship with the external counterparties, for risk management purposes the original hedging relationship is often assessed based on the cash flows of the internal hedges. This may happen for various reasons including:
- (a) measurement of the effectiveness of the hedging policy followed by each entity within the group; and
  - (b) assessment of the effectiveness of the hedging policy followed by the group as a function of the offset between internal and external trades.

This reflects a group's organisational structure, reporting lines and responsibilities of management at the respective levels.

### Implications for hedge accounting

12. Financial reporting needs a reference object, which is the reporting entity. The reporting entity is relevant for delineating what is reported on. Hence, mitigation or transformation (transfer) of risk is generally only relevant if it results in a layoff of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity is a non-event for that reference object.
13. However, there are different levels of reporting entities within a group, and risk can be transferred from the perspective of a lower level reporting entity (that is a subset of the higher level reporting entity, eg a subsidiary in a group or a branch of a company).

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14. For example, a subsidiary might transfer cash flow interest rate risk from variable rate funding to the group's central treasury using an interest rate swap and the treasury decides to retain that exposure (rather than hedging it out to a party external to the group). In that case, the cash flow interest rate risk from the perspective of the subsidiary as the reporting entity has been transferred (the swap is an external derivative from the subsidiary's perspective). Conversely, from the group's consolidated perspective the cash flow interest rate risk has not changed but merely been re-allocated between different parts of the group (the swap is an internal derivative from the group's perspective).
15. That means that internal derivatives can still be relevant for hedge accounting; they reflect the reporting entity's structure and risk management process thereby providing a link between the exposures and whether and how the exposures are transferred outside the reporting entity.
16. Another aspect that increases the relevance of internal derivatives is their role in the hedging of foreign exchange risk. This is because there is no functional currency for the group reporting entity and therefore, the functional currency is rather specific to each individual entity within the Group.
17. Hence, when the consolidated financial statements are translated into the reporting entity presentation currency the gain or loss arising in the translation of an intragroup monetary item is not fully eliminated and therefore will affect the consolidated profit or loss. In this scenario, it can be argued that a combination of an intragroup monetary item and an intragroup FX derivative is in substance the same as an intragroup foreign currency denominated monetary item<sup>2</sup>. If the two instruments are considered together the internal derivative ceases to be a non-event and becomes something that might need to be considered in the context of hedge accounting. This issue will be addressed in a separate paper.
18. The real issue arises from the fact that the hedge accounting model in IAS 39 was largely designed with a view to accommodating (some) one-to-one hedging relationships. In contrast, internal derivatives are typically used to aggregate (pool) exposures of a group—often on a net basis—and then managing the resulting consolidated exposure. That is a matter of economic efficiency (see

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<sup>2</sup> Refer to paragraph 80 of IAS 39

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the reasons set out in paragraph 10). Hence, a centralised treasury or similar function in which the group's exposures are pooled acts like a financial intermediary between other parts of the group and the outside (ie parties external to the group).

19. This *intermediary role* means that many treasury functions face problems similar to those of banks when applying hedge accounting, including:
  - (a) aggregating exposures and managing the resulting (net) position makes hedge accounting difficult to achieve in an accounting model that does not accommodate net positions and allows groups of items to be hedged items only if they in effect behave like a single item;
  - (b) frequent adjustments of hedge positions (closer to dynamic hedging).
  
20. The staff consider that the main issue that is often discussed by reference to 'internal derivatives' is an *operational* one: the difficulty of tracking exposures (that are pooled using internal derivatives) and establishing links to external derivatives in order to qualify for hedge accounting. Hence, the solution to this problem is not allowing internal derivatives to be hedging instruments but to make hedge accounting operational for groups of items and net positions. In that context internal derivatives might be useful as a means to capture data about a group's exposure.
  
21. Consequently, the staff's view is that the assessment of whether an instrument is eligible as a *hedging instrument* should rely on the following principles:
  - (a) that an eligible exposure of the reporting entity is transferred to another party; and
  - (b) it is possible to demonstrate the linkage between the external derivative(s), the hedged item(s) (ie the risks being hedged).

This ensures that any eligible hedging instrument represents a transfer of risk outside the reporting entity and that a mere re-allocation of risk within the reporting entity is not represented as an economic event.

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***The US GAAP approach***

22. US GAAP permits hedge accounting for foreign exchange risk using internal derivatives, provided that some criteria are met. The US GAAP model also accommodates hedging of foreign exchange risk on a net basis.
23. US GAAP defines an internal derivative<sup>3</sup> as follows:
- ‘A foreign currency derivative contract that has been entered into with another member of a consolidated group (such as a treasury center or issuing affiliate as described in the ASC) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied’:
- (a) From the perspective of the member of the consolidated group using the derivative as a hedging instrument the criteria for foreign currency cash flow hedge accounting must be satisfied;
  - (b) The member of the consolidated group not using the derivative enters into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative.
24. US GAAP also considers the possibility of using internal contracts even if the treasury centre (or issuing affiliate as described in the ASC) offsets those contracts with third parties on a net basis. Hence, if the treasury centre chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:<sup>4</sup>
- (a) ‘The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives’.
  - (b) ‘The derivative instrument with the unrelated third party generates equal or closely approximating gains and losses when compared with

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<sup>3</sup> As per the ASC topic 815-20-25 -54 and 815-20-25-62 to 815-20-25-63

<sup>4</sup> CF ASC 815-20-25-62 and 815-20-25-63

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the aggregate or net losses and gains generated by the derivative instruments issued to affiliates’

- (c) ‘Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative instrument. Non-derivative contracts shall not be used as hedging instruments to offset exposures arising from internal derivatives.’
- (d) ‘Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative instrument. The offsetting net third-party derivative instrument related to that group of contracts shall meet all of the following criteria’:
  - (i) It offsets the aggregate or net exposure to that currency.
  - (ii) It matures within the same 31-day period.
  - (iii) It is entered into within three business days after the designation of the internal derivatives as hedging instruments.
- (e) ‘The issuing affiliate meets both of the following conditions:
  - (i) It tracks the exposure that it acquires from each hedging affiliate.
  - (ii) It maintains documentation supporting linkage of each internal derivative and the offsetting aggregate or net derivative instrument with an unrelated third party.’
- (f) ‘The issuing affiliate does not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate alters or terminates any offsetting third-party derivative (which should be rare), the hedging affiliate shall prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative instrument.’



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25. The US GAAP model assumes that the treasury centre and subsidiaries requesting the hedges are capable of tracking all the exposures on both a gross and net basis. Tracking and linkage of exposures might be operationally challenging, and involves significant judgement when the treasury centre enters into complex transactions with different cash flow profiles, timings, maturities etc.
26. Considering the rationale of the requirements in IAS 39 (refer to paragraph 4 above), the US GAAP model is difficult to replicate, because it would imply significant changes to the consolidation model. In addition, the principle of transfer of risk to an external party might not be achieved, and it would require entities to track all the exposures on a one-to-one basis, which is operationally difficult.

**Conclusion**

27. Internal derivatives should not be eligible hedging instruments in the consolidated financial statements because they do not represent an instrument that the group uses to transfer the risk to an external party (ie outside the reporting entity).
28. The use of internal derivatives contradicts the consolidation principles, because all intragroup transactions should be eliminated in full.
29. Entities should therefore rely on the link between the external derivatives, the hedged items and risks being hedged (irrespective of where they are held within the group) to establish their hedge accounting relationships in the consolidated financial statements.
30. The operational difficulties arising from the IAS 39 hedge accounting model in the context of group structures with centralised treasury functions similar to financial intermediaries should be resolved by developing more operational requirements for hedging groups of items and net positions (which is part of this hedge accounting project).

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**Staff recommendations and question to the Board**

31. The staff recommend that for hedge accounting purposes internal derivatives should *not* be eligible hedging instruments due to reasons outlined in paragraphs 27 to 30.
32. The staff's rationale is that the recommendation would ensure that:
- (a) Only derivatives that transfer the risk to an external party can be used as hedging instruments in the consolidated financial statements; and
  - (b) The financial statements reflect only transactions involving external counterparties; and
  - (c) Internally-generated gains and losses are not considered for the purpose of the consolidated financial statements.

**Question – eligibility of internal derivatives as a hedging instrument**

Does the Board agree with the staff recommendation that internal derivatives should not be eligible hedging instruments as described in paragraphs 31 and 32?

If the Board disagrees with the staff recommendation, what would the Board recommend and why?

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## Appendix A

**Outline of the existing IASB hedge accounting requirements**

- A1. Paragraph 73 of IAS 39 *Financial instruments: Recognition and Measurement* (IAS 39) states that only instruments that involve a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into transactions between them, such transactions may qualify only in the individual or separate financial statements of those individual financial statements, not in the consolidated financial statements.
- A2. This requirement aims to achieve the principle that the risks being hedged must be transferred to an entity outside the group. In practice, this results in only derivatives with external counterparties that can be linked to risks of the hedged items being eligible as hedging instruments in the consolidated financial statements. External derivatives may or may not be a ‘mirror image’ of the internal derivatives, and consequently discrepancies may occur between the designated hedging relationships at subsidiary level and the hedging relationships at group level.
- A3. In the Basis for Conclusions to IAS 39, the Board, following comments from respondents to the exposure draft to IAS 39 who objected to not being able to obtain hedge accounting in the consolidated financial statements, highlighted some of the principles that should be followed when applying hedge accounting to the consolidated financial statements:
- (a) Financial statements provide financial information about an entity or group as a whole.
  - (b) A fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts would require a change to the consolidation principles.

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- (c) It is conceptually wrong to permit an entity to recognise internally-generated gains and losses or to make any other accounting adjustments because of internal transactions. No external event has occurred.
- (d) An ability to recognise internally-generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control associated risks. It is not the purpose of accounting to prescribe how entities should manage and control risks.