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Project	<b>Financial Instruments (Replacement of IAS 39) – Hedge Accounting</b>
Topic	<b>Eligibility of ‘cash instruments’ as hedging instruments</b>

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## Introduction

### **Background**

1. This paper addresses the eligibility of ‘cash instruments’ as hedging instruments.
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 prejudice, the question of whether hedge accounting will be optional or mandatory. This will be addressed at a later stage of this project.

### **Purpose of the paper**

3. This paper discusses whether *non-derivative* financial instruments (cash instruments) should be eligible hedging instruments in the context of hedge accounting.
4. This paper considers whether the restriction in IAS 39 *Financial Instruments: Recognition and Measurement* in relation to the use of cash instruments should be removed and therefore non-derivative financial assets and liabilities would be eligible for designation as hedging instruments. This paper relates to paper 2 for this meeting, which addresses the use of hybrid financial assets as hedging instruments (see the discussion of the implications of risk components in paragraphs 15-17 below).
5. This paper is structured as follows:

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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.

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IASB Staff paper

- (a) the issue;
- (b) staff analysis; and
- (c) staff recommendation and question to the Board.

**The issue**

- 6. Should cash instruments be eligible hedging instruments in the context of hedge accounting?

**Staff analysis**

- 7. Cash instruments encompass non-derivative financial assets and non-derivative financial liabilities.
- 8. The eligibility criteria in IAS 39 allow non-derivative financial assets and non-derivative financial liabilities to be designated as hedging instruments only for a hedge of foreign exchange (FX) risk.<sup>1</sup>
- 9. The Basis for Conclusions of IAS 39<sup>2</sup> states that the Board decided to limit the use of cash instruments as hedging instruments to hedging of FX risk. The rationale was that permitting designation of cash instruments as hedging instruments in other cases than hedging FX risk:
  - (a) would add complexity because more financial instruments would be measured at an amount that is neither amortised cost nor fair value;
  - (b) would be susceptible to abuse in the form of voluntary discontinuation of hedge accounting (including deliberate failure of the qualification criteria after inception of the hedging relationship) thereby selectively avoiding the recognition of changes in fair value of the cash instrument in profit or

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<sup>1</sup> Refer to IAS 39.72.

<sup>2</sup> Refer to paragraphs BC144 and 145 of the Basis for Conclusions of IAS 39.

IASB Staff paper

loss (for fair value hedges) or other comprehensive income (for cash flow hedges);

- (c) would generally not be needed for non-derivative financial instruments that are *not* accounted for at fair value through profit or loss (as derivatives are) because they would not give rise to accounting mismatches;
  - (d) would create a difference to US GAAP;
  - (e) would not be needed to accommodate the area where cash instruments have the most significant use as hedging instruments (ie hedging foreign exchange risk).
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.

***Implications of risk components***

12. There is a cross-cutting issue that affects all these alternatives. That issue is whether the *hedging instrument* (irrespective of being a derivative or a non-derivative) can be disaggregated into risk components that are eligible hedging instruments. That issue has not formed part of the Basis for Conclusions of IAS 39 because components for *hedging instruments* were only explicitly addressed as two exceptions regarding the separation of the time value of an

IASB Staff paper

option and the forward points of a forward contract.<sup>3</sup> Hence, for hedging instruments this issue was not addressed as comprehensively as for hedged items.

*FX risk components in accordance with IAS 21*

13. The eligibility of cash instruments as hedging instruments for hedging FX risk under IAS 39 constitutes a designation of a hedging instrument on the basis of a risk component—the FX risk component of the cash instrument’s carrying amount determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.<sup>4</sup>
14. Since this FX risk component is determined in accordance with the foreign currency translation requirements of IAS 21 it is readily available for incorporation by reference in the financial instruments standard. Hence, facilitating the use of this risk component for hedge accounting purposes does not require separate, additional requirements for risk components in the financial instruments standard.

*Other risk components*

15. In contrast, all other risk components of non-derivative hedging instruments would require the development of requirements specifically for hedge accounting purposes. The componentisation of non-derivative hedging instruments is addressed in paper 2 for this meeting (refer to Alternative 2 in that paper). As set out in paper 2, exploring this issue would represent a significant expansion of the scope of project.
16. If the disaggregation of non-derivative hedging instruments into *other* risk components than FX risk (in accordance with IAS 21) is *not* allowed that has an implication for the likelihood of achieving hedge accounting. In most scenarios

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<sup>3</sup> Refer to IAS 39.74.

<sup>4</sup> Refer to IAS 39.89(a), which refers to the ‘...foreign currency *component* of its [the hedging instrument’s] carrying amount measured in accordance with IAS 21 (for a non-derivative hedging instrument)...’ [*emphasis added*].

## IASB Staff paper

hedging relationships will not achieve other than accidental offsetting and hence fail the effectiveness test. This is because the effectiveness test will compare the change in the fair value of the hedged item attributable to the hedged risk with the change in fair value of the non-derivative hedging instrument in its entirety. Therefore, the effect of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness testing.

17. As a consequence, the effectiveness test would only be passed in scenarios where:
  - (a) one risk component overwhelmingly dominates the entire fair value of the cash instrument and is aligned with the hedged risk; or
  - (b) there are several risk components and the cash instrument is used to hedge several types of risks that correspond to these risk components (similar to the designation of a derivative as a hedge of more than one type of risk in accordance with IAS 39.76).

***Evaluation of alternatives****Alternative A*

18. The restriction in IAS 39 that limits the eligibility of cash instruments as hedging instruments to hedges of FX risk is based on considerations (see paragraph 9) that do not necessarily apply to all scenarios in the new financial instruments accounting model. IFRS 9 uses a different classification than IAS 39 and the eligibility of cash instruments as hedging instruments does not necessarily result in an accounting change that is different from that for derivatives that are designated as hedging instruments (see Alternative B, which is evaluated below). In particular, the reason for treating non-derivatives that are accounted for at fair value through profit or loss differently than derivatives is unclear.

## IASB Staff paper

*Alternative B*

19. Removing the restriction *only* for those cash instruments that are accounted for at fair value through profit or loss would result in a requirement that (derivative and non-derivative) financial instruments classified as fair value through profit or loss *or* hedging FX risk are eligible as hedging instruments.
20. Alternative B would result in an eligibility criterion that is consistent in that the eligibility is based on a financial instrument being accounting for at fair value through profit or loss in relation to what becomes the hedging instrument (ie the fair value change under the financial instruments standard or the FX risk related value change determined under IAS 21, which is treated like the fair value change of the currency risk component by IAS 39<sup>5</sup>). This would:
  - (a) reduce the complexity by providing a consistent rationale for the eligibility as hedging instruments;
  - (b) facilitate an alignment of financial reporting and risk management in those scenarios where hedge accounting can be achieved (ie avoiding an arbitrary prohibition of hedge accounting in those cases).
21. At the same time, Alternative B would *not* give rise to most of the concerns cited in support of the restriction in IAS 39:
  - (a) Designating financial instruments accounted for at fair value through profit or loss as hedging instruments does not result in a carrying amount that is a mixture of fair value and amortised cost. Consistent with derivatives designated as hedging instruments the measurement remains (full) fair value.
  - (b) Discontinuing hedge accounting will be discussed at a future meeting. However, designating financial instruments accounted for at fair value through profit or loss as hedging instruments means that discontinuing hedge accounting cannot be used to change the measurement of the

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<sup>5</sup> Refer to IAS 39.89(a).

IASB Staff paper

hedging instrument. Consistent with derivatives designated as hedging instruments, the measurement after discontinuing hedge accounting remains fair value.

- (c) Financial instruments that are not accounted for at fair value through profit or loss would not be eligible for designation as hedging instruments. Hence, the argument that eligibility as hedging instruments would not be needed for financial instruments in other categories does not apply.
- (d) The hedging of FX risk would still be accommodated like under IAS 39. But the eligibility would not be limited to the most significant use but also avoid an arbitrary exclusion in cases where use is not as frequent but appropriate and as justified.

- 22. Hence, of the concerns cited in support of the restriction in IAS 39 only the potential divergence from US GAAP remains. However, there are many differences between the hedge accounting models in US GAAP and IFRSs today and also between the projects of both boards.

*Alternative C*

- 23. Removing the restriction for *all* cash instruments is the most fundamental change. This could allow the most comprehensive alignment regarding the eligibility of different financial instruments as hedging instruments as well as with risk management.
- 24. However, this alternative means that the eligible hedging instrument could be in *any* of the categories of IFRS 9. This has the following implications:
  - (a) For financial instruments at amortised cost the designation as a hedging instrument after initial recognition would result in a measurement that is neither amortised cost nor fair value when adjusting the hedging instrument for fair value changes since designation. This gives rise to one

## IASB Staff paper

of the concerns that resulted in the restriction in IAS 39.<sup>6</sup> Alternatively, if the financial instrument is remeasured to its fair value on designation, there will be a difference between amortised cost and fair value at that date. This is similar to the scenario arising on some types of reclassification between measurement categories under IAS 39, which has proven to be a difficult area. On dedesignation of the hedging instrument similar issues would arise. This might also give rise to one of the concerns that resulted in the restriction in IAS 39 regarding the abuse of discontinuing hedge accounting in order to change (again) the measurement basis.<sup>7</sup>

- (b) The only alternative to changing the measurement of the financial instrument (as a whole) would be the use of components thereby limiting the change in the accounting to those. However, exploring this would represent a significant expansion of the scope of project.<sup>8</sup>
- (c) For equity instruments classified as fair value through other comprehensive income (OCI) it would contradict the Board's earlier tentative decision to prohibit the application of hedge accounting to investments in equity instruments designated as at fair value through OCI.<sup>9</sup> The use of these items as hedging instruments would contradict the recognition of fair changes in OCI without recycling.

**Staff recommendation**

25. The staff consider that exploring the use of risk components of hedging instruments would represent a significant expansion of the scope of project. Hence, consistent with the staff recommendation in paper 2 for this meeting, the staff recommend not expanding the scope of this project. The staff note that this

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<sup>6</sup> See paragraph 9(a).

<sup>7</sup> See paragraph 9(b).

<sup>8</sup> See paragraph 15.

<sup>9</sup> See agenda paper 2 of the 24 August 2010 IASB meeting.



## IASB Staff paper

leaves the existing two exceptions regarding the separation of the time value of an option and the forward points of a forward contract<sup>10</sup> as well as the FX risk components in accordance with IAS 21<sup>11</sup> unaffected.

26. The staff believe that the main advantage of Alternative C is the possibility to analyse the eligibility of items as hedging instruments in the most fundamental way. However, this main advantage is undermined without the opportunity to also concurrently explore the use of risk components of hedging instruments. Hence, on balance, the staff consider that in the scope of this project the potential advantages of Alternative C are outweighed by the disadvantages.
27. The staff consider that in the context of the new financial instrument accounting model most of the concerns that resulted in mandating Alternative A in IAS 39 could be addressed by a more targeted response, which is Alternative B. The staff note that the only concern remaining under Alternative B is about the convergence with US GAAP. On the other hand, Alternative B has several advantages as set out in paragraph 20.
28. Hence, the staff recommend Alternative B, ie removing the restriction in IAS 39 regarding the eligibility of non-derivative hedging instruments *only* for those cash instruments that are accounted for at fair value through profit or loss.

**Question – Cash Instruments as hedging instruments**

Does the Board agree with the staff recommendation in paragraph 28?

If not, what would the Board recommend and why?

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<sup>10</sup> See paragraph 12.

<sup>11</sup> See paragraph 13.