Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Hedged items—risk components: introduction**

Introduction

1. This paper introduces a series of papers that address the designation of a *risk component* as the hedged item. Question 4 in the exposure draft *Hedge Accounting*'s (ED) invitation to comment relates to this issue.

2. There are five questions to the Board. All staff recommendations and questions to the Board are set out in paper 3C.

3. The staff recommend:

   (a) retaining the *notion* of risk components as eligible hedged items;

   (b) using a *criteria-based approach* to determining eligible risk components on the basis of the criteria proposed in the ED, ie that a risk component must be *separately identifiable and reliably measureable*;

   (c) using a single set of criteria for all items, ie that the criteria should apply *for all types of items*—risk components of financial *and non-financial* items; and

   (d) providing guidance on *how to apply* the criteria using examples that demonstrate the analysis required to conclude that a risk component is eligible for designation as a hedged item.

4. Question 5 is about how the Board wants to address inflation risk. The staff set out four alternatives for the Board (but without a staff recommendation).

Overview of the Board's proposal in the ED

5. The ED addresses the designation of risk components as hedged items in paragraphs 18(a) and B13-B18. Paragraphs BC52-BC62 of the Basis for Conclusions provide the rationale for the proposal.

Proposed change

6. The ED proposes permitting the designation of risk components as hedged items if and only if they are separately identifiable and reliably measurable—irrespective of whether the item that includes the risk component is a financial or non-financial item.

7. Hence, the ED proposes using the criteria that apply for determining eligible risk components of *financial items* under IAS 39 *Financial Instruments: Recognition and Measurement* but extend their application to *non-financial* hedged items. Importantly, the ED also requires assessing the eligibility of risk components in the context of the particular *market structure* to which the risk or risks relate and in which the hedging activity occurs.

8. The ED carried forward from IAS 39 the assertion that inflation is not separately identifiable and reliably measureable if it relates to a *financial* instrument and is not contractually specified (eg the inflation risk associated with a fixed rate instrument).

Rationale for the proposal

9. The rationale for the proposed change is:

    (a) *aligning* the eligibility of risk components for *financial and non-financial items*;

    (b) consistent with the general approach for the new hedge accounting model, aligning hedge accounting more closely with risk management; and

(c) as a consequence of the above, providing information that is more useful for users of the financial statements.

10. The proposed change would address one of the most common issues raised over many years during outreach activities and also in the comment letters received on the discussion paper *Reducing Complexity in Reporting Financial Instruments*. In particular, it would address the widely held criticism that the distinction of the eligibility of risk components on the basis of whether hedged items are financial or non-financial is arbitrary and conceptually unjustifiable.

Feedback from comment letters and outreach activities

Common themes

11. The feedback from comment letters as well as the outreach activities was overwhelmingly supportive. Commentators emphasised that the proposal on risk components was a key aspect of the new hedge accounting model and crucial for aligning hedge accounting with risk management. This reflects that in commercial reality *hedging risk components* is the *norm* and hedging items in their entirety is the exception.

12. Many commentators noted that IAS 39 is biased against hedges of non-financial items such as commodity hedges. They consider the distinction between financial and non-financial items for determining which risk components are eligible hedged items as arbitrary and without conceptual justification. Hence, they advocate that the requirements for financial and non-financial hedged items should be the same and therefore strongly support the proposal in the ED.

13. Commentators generally agreed with:

(a) using a *criteria-based* approach (with some noting this would be important to accommodate future market evolution, ie make the new requirements 'future-proof');

(b) the proposed criteria 'separately identifiable and reliably measureable' (with some noting they were already well established under IFRSs). Only very few commentators disagreed with allowing non-contractually specified risk components of non-financial items to be designated as hedged items because they believe this would result in no hedge ineffectiveness being recognised.

14. The *main requests* arising from the feedback relate to how guidance should be provided in the final requirements:

(a) Many commentators requested that the final requirements provide more guidance or clarifications, almost solely regarding non-contractually specified risk components of non-financial items. However, a number of commentators opposed doing so because in their view that tends to result in rule-based standard setting.

(b) Many commentators also requested that the final requirements not specifically and explicitly preclude designating risk components as hedged items for:

(i) inflation risk (if non-contractually specified for financial items);

(ii) credit risk;

(iii) prepayment risk;

(iv) situations in which the cash flows of the component exceed those of the item as a whole (commonly referred to as the 'sub-LIBOR' issue); some commentators raised this issue in the particular context of commodity hedging (eg a commodity trading at a discount to the commodity benchmark such as Brent 'minus x US dollars').

Staff analysis

15. The feedback on the proposal that risk components should be eligible hedged items and using the criteria-based approach set out in the ED was

overwhelmingly supportive. However, many explicitly requested additional guidance and clarity, and feedback from others indicated that they failed to properly understand the proposals thus indicating the need for greater clarity. Hence, the focus of the staff analysis is to address how guidance should be provided in the final requirements.

16. The staff note that most of the requests for additional guidance or clarifications (and the lack of understanding) related to non-contractually specified risk components of non-financial items. The staff consider that before addressing what guidance should be provided it is helpful to address some apparent misunderstandings both about the market structure and its relevance for risk components (particularly for non-financial items) and the consequences of expanding the eligibility of risk components for non-financial items. This will then provide a more solid basis for discussing the proposed guidance in this area.

17. Hence, the structure of the staff analysis is as follows:

    (a) **Agenda paper 3A**: background and misunderstandings about risk components.

    (b) **Agenda paper 3B**: guidance on determining eligible risk components (that should be provided in the final requirements).

    (c) **Agenda paper 3C**: staff recommendations and questions to the Board.