

STAFF PAPER

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IASB Meeting

Project	Hedge Accounting (IFRS 9)		
Paper topic	Measurement of the hedged item—‘hypothetical derivatives’: due process aspects		
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Introduction

1. This paper addresses due process aspects raised by the feedback on the draft hedge accounting requirements regarding hypothetical derivatives.

Feedback received—due process aspects

2. A few commentators alleged that the application guidance regarding hypothetical derivatives had not been subject to the IASB’s due process because it had not been included in the exposure draft. Consequently, in their view, they did not have an adequate opportunity to comment on the issue.

Staff analysis

3. The exposure draft (ED) explicitly addressed the issue of using hypothetical derivatives to measure the change in the value of the hedged item.¹ In addition, the ED’s basis for conclusions devoted a separate subsection to

¹ See ED.B44-B45 (reproduced in Appendix A).

this issue (which was also prominent in the table of contents under the heading “Hypothetical derivatives”).²

4. In finalising the draft hedge accounting requirements, the following two changes were made to the drafting in the ED:
 - (a) The reminder of the fact that (under IFRSs) using a ‘hypothetical derivative’ for assessing or measuring hedge (in)effectiveness is not a method in its own right was relocated. It was *elevated from the ED’s basis for conclusions* to the application guidance of the draft hedge accounting requirements.
 - (b) The ED set out that using a ‘hypothetical derivative’ is one possible way of measuring the value of the hedged item. An *explanation* was added that as a *consequence*, it is not allowed to include features in the value of the hedged item that only exist in the hedging instrument simply because a ‘hypothetical derivative’ calculation can be used. This was supplemented with the example of hedging foreign currency denominated debt with a cross-currency interest rate swap.
5. Those drafting changes were made in response to feedback received on the ED. The staff consider that such drafting changes are customary in proceeding from the ED stage of a project to final requirements, and that the issue in question—the use of hypothetical derivatives—was explicitly and prominently addressed in the ED. The draft hedge accounting requirements merely reworded what was included in the ED.
6. In particular, that the ED set out the fact that using a hypothetical derivative is not a method in its own right but instead should replicate the hedged item and result in the same outcome as using a different approach made it clear that it is different from how hypothetical derivatives are used under US GAAP³.

² See BC103-BC105 of the ED (reproduced in Appendix A).

³ See paper 4A3.

7. The staff are of the view that this issue was subject to full exposure in the ED and thus interested parties were given the opportunity to comment. However, it is apparent that by more clearly articulating what was exposed, many interested parties have only now become aware of the practical consequences of the proposals in the ED and the effect it would have on the current practices adopted by many.
8. Therefore, the staff consider that due process concerns about this issue are not justified. However, because of the importance of this issue this series of papers brings the issue back to the Board for its reconsideration, which means that even the belated feedback on this issue will be taken into account in the Board's redeliberations.

Appendix A—Excerpts of the Exposure Draft *Hedge Accounting* and its Basis for Conclusions

A1. Paragraphs B44-B45 of the ED were as follows:

Measurement of hedge ineffectiveness

B43 [...]

B44 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item and would be at the money at the time of designation of the hedging relationship (this is commonly referred to as a ‘hypothetical derivative’). This is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach.

B45 The change in the value of the hedged item determined using a hypothetical derivative may also be used for the purpose of assessing whether a hedging relationship meets the hedge effectiveness requirements.

A2. Paragraphs BC103-BC105 of the ED’s Basis for Conclusions were as follows:

Hypothetical derivatives

BC103 The Board considered the use of a ‘hypothetical derivative’, which is a derivative that would have critical terms that exactly match those of a hedged item and would be at the money at the time of designation of the hedging relationship. The Board considered the use of a hypothetical derivative in the context of the hedge effectiveness assessment as well as for the purpose of measuring hedge ineffectiveness.

BC104 The Board noted that the purpose of a hypothetical derivative is to measure the change in the value of the

hedged item. Consequently, a hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods (for example, statistical methods or dollar-offset) to assess the effectiveness of the hedging relationship or measure ineffectiveness.

BC105 Hence, the Board proposes that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The Board noted that this notion of a hypothetical derivative means it is one possible way of determining the change in the value of the hedged item and would result in the same outcome as if that change in the value was determined by a different approach.