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Endorsement of the Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedge Items"

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

1. EFFECT STUDY

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for the Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedge Items" (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

2. BACKGROUND ON THE AMENDMENTS TO IAS 39

Explanation of the issue

Entities enter as part of their business into transactions that involve different risks, and one of the roles of management is to manage these risks. One way in which this can be done is to enter into transactions to fully or partially offset one or more of the risk incurred by the entity in other transactions. Such transactions are known as hedges.

The accounting standards permit to apply a special accounting treatment to these transactions when certain criteria are met. This is known as "hedge accounting" under IAS 39. The instrument used to offset the risk is known as the "hedging instrument" and the risk hedged is known as the "hedged risk" or the "hedged item". The result is that the hedging instrument and the hedge item are reported in ways that differ from the normal accounting principles. The objective of hedge accounting is to match the accounting effect of the hedged item with that of the hedging instrument in profit or loss.

If hedge accounting is applied, IAS 39 allows designating as a hedged item some risks or some portions of the cash flows of a contract.

The IASB added this project to its agenda after a request by IFRIC. IFRIC received a number of submissions requesting guidance on the designation of hedged items. The objective of the Amendment is to clarify how principles underlying hedge accounting should be applied in particular situations. Specifically, the amendment clarifies how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations.

How is the issue dealt with currently?

In existing IAS 39, there is diversity in practice about how to apply the Standard in two circumstances:

- In which situations inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39; and

- How hedge accounting can be applied to hedges where a hedging instrument is an option contract.

How does the amendment suggest dealing with the issue?

The amendment clarifies the two aspects where diversity in practice exists:

- Designation of inflation as a hedged risk

The Amendment allows the designation of inflation as a hedged risk only in very particular situations. In the case of an interest-bearing debt instrument, an entity can designate inflation as a hedged item if the inflation portion is a contractually specified portion of the cash flows of the debt instrument and the other cash flows of the instrument are not be affected by the inflation portion. For example, if an entity hold an inflation-indexed bond that pays interest at inflation plus 3 per cent, the inflation portion is identifiable and separately measurable, because inflation is a contractually specified cash flow and the remaining cash flows of the instrument (3 per cent) do not change when the inflation portion changes.

- Designation of an option contract as a hedging instrument

The Amendment clarifies the extent to which option contracts used as hedging instruments offset the risks in hedged forecast transactions. The fair value of option contracts comprise two component: a time value and an intrinsic value¹. The Amendment clarifies that if an option contract is designated as a hedging instrument, the part of the option contract related to the time value is not considered as part of the effective hedge. The reason, as the Amendment explains, is that a hedged forecast transaction does not contain a time value component that affect profit or loss.

The Amendments to IAS 39 become effective for annual periods beginning on or after 1 July 2009, with earlier application permitted.

IASB and EFRAG consultations

The IASB carried out a consultation according to its due process. The IASB published an Exposure Draft on September 2007 and received 75 comment letters. Taking into accounts the comments raised by respondents the IASB decided to focus on the two situations where diversity in practice existed. The final Amendment was published in July 2008.

The commentators to the EFRAG consultation shared EFRAG's assessment of the costs and benefits associated with the implementation of this Interpretation. EFRAG also discussed the potential cost and benefits with its User Panel and they were content with EFRAG's assessment.

3. EFFECT ANALYSIS

Main points identified in the EFRAG Effect Analysis

Usefulness of accounting information provided in the financial statements

¹ The time value of an option is the difference between the option value and the intrinsic value, being the latter the difference between the exercise price of the option and the current value of the underlying instrument.

EFRAG's analysis concluded that the additional guidance provided by the Amendment will result in a reduction of divergence in practice, thereby enhancing consistency and comparability of the information provided.

The Commission Services agree with the EFRAG analysis and conclude that the Amendment to IAS 39 will improve overall the quality of the financial information and therefore benefit users.

Costs for preparers and users

EFRAG's analysis gives an overview of the expected incremental costs for preparers and users. With regard to preparers, EFRAG concludes that the Amendment will not involve significant incremental year one costs for those preparers that have applied IAS 39 in a different manner than the amendment establishes. There will be no incremental ongoing costs.

The Amendment is unlikely to cause year one or ongoing incremental costs to users.

EFRAG notes that the Amendment will result in some incremental year one cost for preparers but that these costs will not be significant. The Amendment will not cause users year one or ongoing incremental costs. The Commission Services share this analysis.

4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing the Amendment to IAS 39 and concluded that the benefits of adopting the Amendment outweigh the costs incurred.

The Commission Services believe that the Amendment to IAS 39 will have positive cost-benefits effects and that it should therefore be endorsed in the EU without delay.

Attachment 1

Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT TO IAS 39 "ELIGIBLE HEDGED ITEMS"

INTRODUCTION

- 1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* "Eligible Hedged Items" (the Amendment).
- 2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

- 3 EFRAG already carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENT

Hedges and hedge accounting explained

- 4 Most business activity involves risk and uncertainty, and one of the roles of management is to manage that risk and uncertainty. One way in which that can be done is to enter into transactions that expose the entity to risk and/or uncertainty that fully or partially offsets one or more of the entity's other risks and uncertainties. Such transactions are known as 'hedges'; the instrument acquired or incurred to

offset risk or uncertainty is known as 'the hedging instrument'; and the risk or uncertainty hedged is known as the 'hedged risk' or the 'hedged item'.

- 5 IAS 39 permits entities to apply special, so-called hedge accounting to the hedged item and the hedging instrument when certain criteria are met. The result is that hedging instruments and hedged items are reported in ways that differ from the accounting the normal accounting principles require. The aim of hedge accounting is to match the accounting effect of the hedged item and of the hedging instrument in profit or loss.
- 6 The criteria that IAS 39 requires to be met for hedge accounting to be applied are:
 - (a) the hedge relationship must be designated and documented at inception;
 - (b) the hedge must be expected to be effective. In other words, the hedging instrument needs to be effective (within prescribed parameters) in offsetting the fair value changes or cash flow variability of the hedged item;
 - (c) hedge effectiveness must be capable of being reliably measured on an ongoing basis. (Hedge ineffectiveness is required to be identified and reported in profit or loss; and, if ineffectiveness exceeds a certain limit, the use of hedge accounting is precluded);
 - (d) when hedging future variability in cash flows, there must be a high probability of those cash flows occurring and affecting profit or loss.
- 7 An entity may hedge risks and uncertainties that represent only some but not all of the risks or cash flows of a particular contract or forecast transaction. In order to enable entities to avoid reporting hedge ineffectiveness in such circumstances—relating to risks that are not being hedged—IAS 39 allows entities to apply hedge accounting to some (but not all) risks or cash flows of a contract. However, IAS 39 imposes further restrictions in such cases to ensure that hedge accounting is applied appropriately and that any ineffectiveness that exists in the hedge relationship is reported in profit or loss.

The Amendment explained

- 8 The Amendment clarifies two aspects of existing IFRS (IAS 39). They are (a) when inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39 and (b) how hedge accounting can be applied to hedges where a hedging instrument is an option contract. Henceforth we refer to these as Clarification 1 and Clarification 2 respectively.

Clarification 1

- 9 Consider the following example. A fixed rate bond is issued by an entity which then enters into an inflation-adjusted payment versus fixed rate receipt swap. (In other words, in economic terms the fixed rate bond has been transformed into a liability with an inflation-linked interest rate.) The question that has arisen and is addressed in this part of the Amendment is whether it is possible for accounting purposes to treat the fixed rate on the liability as being made up of an inflation-indexed component plus a real rate of interest and to apply hedge accounting in such a way that effectiveness is measured by comparing the offsetting effect of fair value changes of the swap against the fair value changes of the inflation-indexed component of the fixed rate liability.

- 10 Hedge accounting applied in this way would show no or little ineffectiveness. On the other hand, if hedge accounting is applied in such a way that the offsetting effect of fair value changes of the swap is measured against the fair value changes of the entire fixed rate liability, such a hedge would reveal ineffectiveness that would need to be reported in profit or loss and, depending on the extent of that ineffectiveness, might preclude the application of hedge accounting.
- 11 In developing its guidance on this question, the IASB noted that it is possible to designate something other than the entire instrument as a hedged item as long as the item is a separately identifiable component of the financial instrument and the effects on fair value or cash flow changes of the entire instrument arising from the designated component are reliably measurable.
- 12 The IASB concluded that inflation is not a separately identifiable component of the fixed rate financial instrument and its effects on fair value or cash flow changes of the fixed rate financial instrument are not reliably measurable. Following from this conclusion, it is not possible to apply hedge accounting to the inflation portion in a hedge where a hedged item is a fixed rate financial instrument.
- 13 On the other hand, it is possible to apply hedge accounting to a hedge of an inflation portion if the inflation component is contractually specified and does not affect other cash flows of the financial instrument. An example where this would be the case is an inflation-indexed bond paying interest at inflation plus 3 per cent.

Clarification 2

- 14 Entities might want to hedge the risk that the value of a future transaction will fall below or rise above a specified price. To achieve this objective, some entities purchase option contracts. An option contract gives its holder the right, but not the obligation, to buy (for a call option) or sell (for a put option) a specific amount of a given stock, commodity, currency, index, or debt instrument at a specified price (the strike price) during a specified period of time.
- 15 The value of an option contract is affected by its intrinsic value and its time value.
 - (a) The intrinsic value is the amount by which the current market price exceeds the strike price.
 - (b) The chance that the option contract will become profitable for its holder by the time the option contract expires is referred to as the time value of the option contract. The time value is positive at the time the option contract is entered into and will be zero when the option contract expires.
- 16 Consider the following example. An entity forecasts that in one year's time it will purchase 1,000 bushels of wheat at then current market price for use in its operations. The entity wishes to protect itself against an increase in the cost of wheat above the current market price of CU (currency units) 10 per bushel. It therefore purchases a 1-year option contract on 1,000 bushels of wheat, paying a total premium of CU 500—which is the time value of the option contract at the date the contract is entered into. Under the terms of the option contract, if the price of wheat is above CU 10 per bushel at the maturity (settlement) date, the counterparty will pay the company 1,000 times the amount by which it exceeds CU 10. If the price of wheat is CU 10 or below at the maturity date, the contract expires worthless. The company designates the purchased option contract as a hedge of the risk of the price increasing above CU 10 per bushel.

- 17 The issue that has arisen is whether the hedged item (the risk of the increase in the purchase price of wheat above CU 10 per bushel in the above example) includes a time value similar to the time value that is part of the value of the option contract.
- 18 This issue is important in deciding how effectiveness of the hedge should be measured. For example, if the fair value of the hedged item is considered not to contain a time value similar to that of the hedging option contract, the time value of the option contract will be considered an ineffective part of the hedge and would need to be reported in profit or loss. If, however, the fair value of the hedged item is considered to contain a time value similar to that of the hedging option contract, the changes in the time value of the option contract will be deferred in equity as part of the effective value changes on the option contract.
- 19 In the Amendment, the IASB reasons that the hedged item has no cash flows that are equivalent to the time value premium in an option contract that would affect profit or loss. It follows that the fair value of the hedged item should be considered not to contain a "time value". An implication of that is that the time value in a hedging option contract should be reported as ineffectiveness of the hedge. The Amendment also clarifies that entities have the possibility of excluding the time value of an option contract from hedge accounting entirely, in which case changes in the time value would be reported in the profit or loss in accordance with the normal accounting principles.

EFrag's INITIAL ANALYSIS OF COSTS AND BENEFITS OF THE AMENDMENT

- 20 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendment, both in year one and in subsequent years. The results of the initial assessment can be summarised as follows.
 - (a) EFRAG's initial assessment was that the Amendment was:
 - (i) likely to involve some preparers in some additional year one, but no ongoing, costs. However, EFRAG's initial assessment was that, when considered in aggregate, the additional year one costs would not be significant.
 - (ii) likely to involve users in no year one or ongoing incremental costs.
 - (b) EFRAG's initial assessment of the benefits that would arise from the Amendment was that the Amendment was likely to result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.
 - (c) EFRAG's initial assessment was that the benefits to be derived from implementing the Amendment in the EU were likely to exceed the costs involved in its implementation.
- 21 EFRAG published its initial assessment of the costs and benefits of implementing the Amendment in the EU and supporting analysis on 22 September 2008 and invited comment on it until 27 October 2008. In response, EFRAG received 8 comment letters. Two of those letters did not comment on EFRAG's initial assessment. The other 6 all agreed with EFRAG's initial assessment and had no additional comments, although one stated it had not carried out a detailed examination of the effects involved.

- 22 In addition, EFRAG consulted its User Panel in October 2008 on EFRAG's initial assessment and Panel members were content with the assessment.

EFrag's FINAL ANALYSIS OF THE COSTS AND BENEFITS OF THE AMENDMENT

- 23 Based on its initial analysis, comment letters received in response to that analysis and input from EFRAG's User Panel members, EFRAG's final analysis of the costs and benefits of the Amendment is presented in the paragraphs below.

Costs for preparers

Clarification 1

- 24 EFRAG's understanding is that the majority of entities in the EU are already applying IAS 39 in a way that is consistent with Clarification 1. The clarification will involve no additional costs for those entities and may even reduce costs a little by removing the uncertainty that did exist.
- 25 Some entities will however be required to change the way they account for certain of their hedges as a result of the clarification. In particular, where previously such entities would have treated a hedge of an inflation component in a fixed rate financial instrument as a hedge to which hedge accounting can be applied, henceforth the entity will not be able to apply hedge accounting. In terms of record-keeping, systems and procedures, applying hedge accounting is more costly than not applying hedge accounting, so the clarification will result in a decrease in ongoing costs for preparers, although implementing the Amendment will involve some change in procedures—and therefore some relatively insignificant year one costs. It is possible that such entities may pursue different hedging strategies as a result of this clarification, but uncertain behavioural implications of this kind are regarded by EFRAG as outside the scope of its assessment.

Clarification 2

- 26 EFRAG's understanding is that Clarification 2 will not result in a change in accounting for some entities. Therefore, for those entities no additional costs will arise and there may even be a small reduction in costs because the uncertainty that previously existed has been eliminated.
- 27 However, some other entities will be affected. In particular, previously they would have been treating the total changes in value of the purchased options (including the time value) as offsetting the changes in the value of the hedged forecasted cash flows and thus fully effective. Under Clarification 2 they will either:
- (a) treat those value changes as part of the hedge ineffectiveness and therefore recognise them in profit or loss immediately. They will also take those value changes in determining whether the hedge is insufficiently effective to be eligible for hedge accounting; or
 - (b) not apply hedge accounting provisions to the time value of option contracts and report changes in the time value in profit or loss.
- 28 EFRAG's assessment is that, when judged in terms of record-keeping, systems and procedures:

- (a) there may be some incremental year one costs for preparers as the change is implemented but those costs will not be significant, and
- (b) there will be no incremental ongoing costs.

Transitional arrangements

- 29 The Amendment requires both clarifications to be applied retrospectively for annual periods beginning on or after 1 July 2009. Retrospective application of changes to accounting standards can be complex, and therefore costly, to implement. However, in this case EFRAG's assessment is that, although the transitional arrangements will involve some incremental year one costs for preparers, those costs will be mitigated by the reasonably long lead time allowed by the standard (one year from the date of its publication) and, as a result, will not be significant.

Costs for users

- 30 In order to assess whether it will give rise to additional year one costs for users, EFRAG has considered the implications of the transitional arrangements particularly closely. EFRAG's analysis suggests that the overall effect of the Amendment and applying it retrospectively will be that, if an entity does not change its hedging strategy in any significant way economically but changes the way it designates its hedges to comply with the clarification, its financial statements are likely to report more volatility in the corresponding periods than in the current period. However, EFRAG notes that the use of hedge accounting is optional under IAS 39, so entities could stop or start hedge accounting at will at any time under existing IAS 39 irrespective of whether there are any economic changes in hedging strategies. For that reason EFRAG has concluded that the transitional arrangements will not introduce any new complexities for users and therefore that there will be no incremental year one costs for users.
- 31 EFRAG has also considered whether the Amendment will in some way increase the burden on users of financial statements. Its view is that it will impose no additional ongoing burden on users.

Benefits for preparers and users

- 32 In EFRAG's view the Amendment will result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This will be a benefit to all stakeholders.

Overall assessment

- 33 EFRAG's assessment is that the benefits that will arise from implementation of the Amendment in the EU are likely to exceed the insignificant costs involved.

Stig Enevoldsen
EFRAG, Chairman
12 November 2008

Attachment 2

Endorsement advice prepared by EFRAG

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

12 November 2008

Dear Mr Holmquist

Adoption of the Amendment to IAS 39 “Eligible Hedged Items”

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* “Eligible Hedge Items”, which was issued by the IASB in July 2008. It was issued as an Exposure Draft in September 2007 and EFRAG commented on that draft.

The Amendment clarifies two aspects of existing IAS 39. They are (a) when inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39 and (b) how hedge accounting can be applied to hedges where a hedging instrument is an option contract.

The Amendment becomes effective for annual periods beginning on or after 1 July 2009. The Amendment shall be applied retrospectively. Earlier application is permitted.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the ‘true and fair principle’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG's Endorsement Advice Letter on the Amendment to IAS 39 "Eligible Hedged Items"

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendment to IAS 39 Financial Instruments: Recognition and Measurement "Eligible Hedged Items".

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

INTRODUCTION

- 1 The Amendment clarifies two aspects of existing IFRS (IAS 39). They are (a) when inflation can be designated as a hedged item in a financial instrument under the hedge accounting provisions in IAS 39 and (b) how hedge accounting can be applied to hedges where a hedging instrument is an option contract. Henceforth we refer to these as Clarification 1 and Clarification 2 respectively.
- 2 EFRAG assessed whether the information resulting from the application of these two clarifications would meet the criteria for EU endorsement; in other words, whether:
 - (a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
 - (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Amendment.

- 3 Having formed tentative views on these issues and prepared a draft assessment, EFRAG issued that draft assessment on 22 September 2008 and asked for comments on it by 27 October 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

EVALUATION

Relevance and reliability

- 4 According to the IASB's Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the Amendment would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.
- 5 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered whether information resulting from the application of the Amendment exhibits those qualities.

Clarification 1

- 6 The IASB believes that, to ensure that hedge accounting techniques are applied in a way that results in the provision of information that is relevant and reliable, it is necessary for strict criteria to be met if hedges are to be eligible for hedge accounting. In particular, hedge accounting should be available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument that affect profit or loss. Underpinning this is the requirement that the effectiveness of the hedge can be reliably measured.
- 7 Risks and uncertainties that companies hedge may represent only some but not all risks or cash flows of a particular contract or forecast transaction. In order that entities do not have to report hedge ineffectiveness related to risks that they are not hedging, IAS 39 allows them to apply hedge accounting to something other than for example the entire contract provided that effectiveness can be measured reliably.
- 8 The issue that Clarification 1 addresses is whether the inflation portion of an interest-bearing financial instrument can be considered eligible for designation as a hedged item under the hedge accounting provisions.
- 9 The IASB concluded that, if a hedged item is something other than an entire contract, the hedged item has to be identifiable and separately measurable to meet the requirement that hedge effectiveness must be capable of being measured reliably. The IASB further concluded that this means, in the case of the inflation portion of an interest-bearing debt instrument, that inflation must be a contractually specified portion of the cash flows of the debt instrument and that the other cash flows of the instrument must not be affected by the inflation portion.
- 10 For example, an entity may hold an inflation-indexed bond that pays interest at inflation plus 3 per cent. The inflation portion in this example would be considered identifiable and separately measurable—because inflation is a contractually specified cash flow and the remaining cash flows of the instrument (the 3 per cent interest) do not change when the inflation portion changes—so the entity would be permitted to designate as a hedged item changes in the cash flows of the financial asset attributable to changes in inflation. However, an entity holding a fixed rate financial asset is not permitted to designate as a hedged item an inflation portion. That is because either the inflation component is not a contractually specified cash

EFrag's Endorsement Advice Letter on the Amendment to IAS 39 "Eligible Hedged Items"

flow or, if inflation is a contractually specified cash flow, the remaining interest payments will vary as the inflation portion varies to match the contractually specified total fixed interest rate; in other words, in this case inflation is not an identifiable and separately measurable portion in the cash flows of the debt instrument.

11 EFRAG believes the requirements that:

- (a) hedge accounting should be available for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument and
- (b) a hedged portion must be identifiable and separately measurable

ensure the relevance and reliability of the reported information when using hedge accounting. Taking into account the above observations, EFRAG further concurs with the conclusion that the inflation portion in a financial instrument should be considered identifiable and separately measurable (and therefore eligible for designation as a hedged item under the hedge accounting provisions) only if it is contractually specified and does not affect other cash flows of the financial instrument.

Clarification 2

- 12 As mentioned earlier, to ensure that hedge accounting techniques are applied in a way that results in the provision of information that is relevant and reliable, it is necessary that hedge accounting is available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument.
- 13 The issue that Clarification 2 addresses is the extent to which option contracts used as hedging instruments offset risks and uncertainties in hedged forecast transactions. This issue is important in deciding how the effectiveness of a hedge should be measured when an option contract is used to hedge a one-sided risk, i.e. the cash flows resulting from the price falling below a specified level.
- 14 The objective of hedging with options is in effect to fix the value of the transaction at a certain price. Some consider that the hedged item includes a possibility that, even if the price is below or above the specified level today, this may not continue to be the case. Economically the objective of the hedge will be successfully achieved if the terms of the option contracts (such as its notional amount, underlying, and maturity date, etc.) completely match the related terms of the hedged forecast transaction. In view of this, some conclude that in such circumstances it would be appropriate to treat fair value changes of the option contract, including the changes in the time value, as fully effective in offsetting the fair value changes in the hedged item.
- 15 The IASB concluded that the hedged forecast transaction does not contain a time value component that affects profit or loss. Therefore, if an option contract is designated as a hedging instrument in its entirety the time value of the option contract should be reported as hedge ineffectiveness in profit or loss. However, IAS 39 gives entities the possibility of separating the intrinsic value of an option contract and designating only the change in the intrinsic value of the option contract as a hedging instrument. Such a designation may result in a hedging relationship that is perfectly effective. If such an approach is adopted, the time value of an option contract will be reported in profit or loss following normal accounting requirements.

EFRAG's Endorsement Advice Letter on the Amendment to IAS 39 "Eligible Hedged Items"

- 16 EFRAG notes that the existing hedge accounting requirements in IAS 39 stipulate that a forecast transaction that is the subject of a hedge must present an exposure to variations in cash flows that could ultimately affect profit or loss. The cash flows resulting from the forecast transaction described above will when recognised affect profit or loss as revenue, cost of sales, an interest expense etc. However, there are no cash flows associated with the possibility that, if the price of the hedged forecast transaction is currently below or above the specified level, this will not continue to be the case. On the other hand, when one buys an option contract, one pays a premium. Unless the option is deeply in-the-money, most of that premium will be time value. That is a cash flow that will affect profit or loss.
- 17 Therefore, EFRAG concurs with the IASB's conclusion that there is no offset between the cash flows relating to the time value of the option contract and the cash flows associated with the hedged item and that, as a result, under the hedge accounting requirements the time value of hedging option contracts is not considered as part of the effective hedge.
- 18 EFRAG believes the clarification is an appropriate application of the existing hedge accounting requirements that hedge accounting should be available only for those hedges that are effective in offsetting risks and uncertainties between the hedged item and the hedging instrument that affect profit or loss ensuring relevance and reliability of the reported information.

Transitional arrangements

- 19 The Amendment requires both clarifications to be applied retrospectively for annual periods beginning on or after 1 July 2009. Usually when a change in accounting standard is applied retrospectively, issues of relevance and reliability do not arise (and the comparability and understandability of the information is maintained because users are able to identify the effect that the change in accounting has had on previously-reported numbers and to take that into account in their long-term trend information). EFRAG notes that in this case:
- (a) some hedges that have previously been designated for hedge accounting treatment not in accordance with the clarifications will no longer be eligible for hedge accounting, so the effects of accounting for them using hedge accounting techniques will need to be reversed out of the financial statements;
 - (b) as IAS 39 requires contemporaneous designation of hedges if hedge accounting is to be applied, no alternative hedges can be substituted for the hedges referred to in (a); and
 - (c) going forward, entities will be able to get hedge accounting for hedges that are identical economically to those described in (a), except that the way the hedge has been designated is different.

The overall effect is that, if an entity does not change its hedging strategy in any significant way economically but changes the way it designates its hedges to comply with the clarifications, its financial statements are likely to report more volatility in the relevant preceding periods than in the current period.

- 20 Some might question whether this results in a loss of relevance or reliability (or maybe understandability). However, EFRAG notes that in any case application of hedge accounting is optional and it can be stopped and started at will even if the

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entity does not change its hedging strategy and the economics do not change in other ways. Bearing this in mind, EFRAG does not believe that the retrospective application of the clarifications make reported information less relevant or reliable. Moreover, EFRAG generally supports retrospective application of an Amendment or a clarification provided there is sufficient lead time to implement a new or clarified requirement. These clarifications have a lead time of one year from the date of their publication, which EFRAG thinks is sufficiently long.

Comparability

- 21 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 22 EFRAG notes that both clarifications are designed to eliminate causes of diversity in current practice. EFRAG's assessment is that they will achieve that objective, and therefore enhance the comparability of the information provided.
- 23 EFRAG has also considered whether the clarifications create any new inconsistencies.
- 24 EFRAG has also considered whether there are inconsistencies between the clarifications and other parts of IAS 39.

Clarification 1

- 25 EFRAG notes that IAS 39 allows the application of hedge accounting to a hedge of a benchmark interest rate portion of an interest-bearing financial instrument *even if it is not contractually specified*. For example, a benchmark interest rate portion such as, say, a Euribor portion of a fixed rate debt instrument can potentially qualify for application of hedge accounting. EFRAG believes that the difference between application of hedge accounting to the benchmark interest rate portion and inflation portion is justifiable and does not create any new inconsistencies. That is because there is an observable effect on the fair value of a fixed rate instrument when the market benchmark interest rate (such as Euribor) changes, while there is no clear relationship between the inflation index (which is calculated using many financial and non-financial inputs from across the whole economy) and the inflation risk in a fixed rate financial instrument. Therefore, it is reasonable that a benchmark interest rate portion is considered identifiable and separately measurable in a fixed rate financial instrument while inflation is not.

Clarification 2

- 26 Before the IASB issued this clarification, some considered it appropriate to measure changes in the fair value of the hedged forecast transaction using an option pricing model and to measure ineffectiveness as the difference between the actual derivative used and the change in value of the hedged item calculated using an option pricing model. Such a method is referred to as a hypothetical derivative method to measure hedge effectiveness. However, as a result of the clarification it will no longer be possible to measure changes in the value of the hedged item using an option pricing model. Some commentators find this inconsistent with the fact that IAS 39 mentions the hypothetical derivative approach as being one among many possible ways to measure effectiveness.

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- 27 EFRAG thinks this concern is misplaced. In accordance with Clarification 2, it is inappropriate to calculate the value changes of the hedged item using an assumption that the hedged item contains time value when it does not. That implies that it is not that the hypothetical derivative method cannot be used to value the hedged item, but rather that the option pricing methodology would not be appropriate in this case because it would not replicate the cash flows of the hedged item. Thus, EFRAG does not think that there is any inconsistency between the clarification and IAS 39 allowing the use of a hypothetical derivative method to measure hedge ineffectiveness.
- 28 EFRAG has therefore tentatively concluded that the Amendment meets the comparability criterion.

Understandability

- 29 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.
- 30 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability because information that, for example, represents something as similar when it is in fact dissimilar is not understandable. The one aspect of understandability that EFRAG believes is not covered involves the complexity of the information provided and of the methodologies underlying the information. EFRAG's initial assessment is that neither clarification adds to the complexities that already exist.
- 31 EFRAG has therefore concluded that the information that results from the application of the two clarifications meets the understandability characteristic.

True and Fair

- 32 Having concluded that the information that results from the application of the Amendment will meet the criteria of relevance, reliability, comparability and understandability and, being unaware of any other reason to be concerned about the accounting effect of the Amendment, EFRAG thinks there is no reason to believe the Amendment is inconsistent with the true and fair view requirement.

European Interest

- 33 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its initial assessment is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

CONCLUSION

- 34 EFRAG's overall conclusion is that the Amendment satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.
- 35 EFRAG has considered whether the Amendment has any additional implications in the EU bearing in mind that certain requirements relating to hedge accounting in

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IAS 39 are not included in the endorsed version. EFRAG's assessment is that there is no incompatibility between the Amendment and IAS 39 as adopted in the EU.