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Clarity on qualifying risks and portions

On 6 September 2007, the International Accounting Standards Board (IASB) published an Exposure Draft (ED) **Exposures Qualifying for Hedge Accounting**, which would amend IAS 39 **Financial Instruments: Recognition and Measurement**. The proposals aim to clarify the Board's original intentions when hedge accounting financial items, specifically what risks can be hedged and what portion of fair value or cash flows may be hedged.

The IASB has requested comments on the proposals on or before 11 January 2008.

What risks and what portions?

IAS 39 has always permitted an entity to hedge a portion of fair value or cash flows of a financial item as opposed to hedging all of the fair value or cash flows. This applies to both fair value and cash flow hedges. The ED aims to clarify, firstly, what risks can be hedged and, secondly, what portions of fair value or cash flows are permitted to be hedged.

The ED clarifies that the following risks can be hedged: (i) interest rate risk (e.g. LIBOR), (ii) foreign currency risk, (iii) credit risk, (iv) prepayment risk, and (v) risks associated with contractually-specified cash flows of a recognised financial instrument (e.g. the cash flow variability of inflation-linked interest payments on inflation-linked debt).

When an entity hedges one of the risks above, it may also designate one or more of the following portions of a financial instrument as a hedged item:

(a) the cash flows for part of its time period to maturity (a 'partial term hedge');

(b) a percentage of the cash flows (a 'proportion');

(c) the cash flows associated with a one-sided risk of that instrument (e.g. the cash flows resulting from a foreign exchange rate falling below a specified level);

(d) any contractually-specified cash flows that are independent from the other cash flows of that instrument (e.g. the first four interest payments on a floating rate financial liability);

(e) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate; or

(f) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate (e.g. LIBOR).

Implications

Common hedging techniques

Most hedge accounting techniques currently being applied will be unchanged by this proposal as the risks and portions indicated above are generally being already applied in practice. The ED does however clarify that certain risks cannot be hedged in some circumstances, e.g. inflation risk. The ED clarifies that fixed rate debt cannot be fair value hedged for inflation risk, yet floating rate debt can, but only if the contractual floating rate cash flows of that recognised debt instrument are linked to changes in inflation.

Hedging with options

The ED also provides clarity on a previous IFRIC discussion on cash flow hedge effectiveness using options. If an entity hedges a non-optional exposure (e.g. floating rate interest payments on issued floating rate debt) with an option (e.g. by buying an interest rate cap), the entity cannot claim that the debt has optionality that is equivalent to that in the option and thereby defer all the fair value movements of the option in equity under a cash flow hedge. In order to achieve a highly effective hedge, the time value of the option will usually need to be excluded from the hedge designation and be fair valued directly in profit or loss.

Benefits to users

The IASB recognises that the ED proposes a series of rules, rather than a principle, but believes that the guidance would help clearly define what risks and portions can be hedged and in doing so would assist entities in designating their hedges in a manner that will minimise hedge ineffectiveness.

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