



# On the Horizon for IFRS

August 11, 2008

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## IASB amends IAS 39 requirements for eligible hedged items

### **Introduction**

On July 31, 2008, the IASB [announced](#) the issuance of *Eligible Hedged Items*, an amendment to IAS 39, *Financial Instruments: Recognition and Measurement* (the Amendment). The Amendment clarifies the application of some of the requirements of IAS 39 on designation of a risk or a portion of cash flows for hedge accounting purposes. The issues addressed are:

- Designation of one-sided risks
- Designation of portions of cash flows of a financial instrument, with reference to inflation components
- Hedge effectiveness when hedging a one-sided risk with a purchased option

### Designation of one-sided risks

The Amendment introduces a new paragraph AG99BA to clarify that IAS 39 permits a designation based on either increases or decreases in cash flows or on the fair value of a hedged item above or below a specified price or variable (a one-sided risk). For example, an entity with a highly probable commodity purchase may designate a cash flow hedge based on the risk of the commodity price increasing.

The Amendment notes that the intrinsic value of a purchased option hedging instrument (but not its time value) reflects a one-sided risk. Changes in the hedging instrument's time value component are recognized in profit or loss as they arise.

### Designation of portions of cash flows of a financial instrument, with reference to inflation components

If the hedged item is a financial instrument, IAS 39.81 allows hedge designation based on a *portion* of the instrument's cash flows. The Amendment inserts new paragraphs AG99E and AG99F to clarify that designation based on a portion of the cash flows is permitted only when:

- The designated risks and portions are separately identifiable components of the instrument; and
- The changes in the cash flows or fair value of the entire instrument arising from those risks and portions are reliably measurable.

Put another way, the entity cannot impute cash flows or risks into an instrument if the instrument's terms do not specify those cash flows or risks.

### Eligible portions

The Amendment provides the following examples of risks and portions that are either separately identifiable or not:

#### *Separately identifiable*

- The risk of changes in fair value of a fixed rate asset or liability attributable to changes in a benchmark interest rate (also generally considered to be reliably measurable)
- The inflation component of cash flows of an inflation-linked bond, such as a bond for which the inflation component is contractually specified (subject also to other conditions)

#### *Not separately identifiable*

- The inflation component of cash flows of an interest-bearing bond for which the inflation component is not contractually specified

### Hedge effectiveness when hedging a one-sided risk with a purchased option

Subject to limited exceptions, IAS 39 requires that a hedging instrument is a derivative in its entirety. One of the exceptions is IAS 39.74(a)'s permission to exclude the time value of an option from the hedge accounting relationship. The Amendment inserts new paragraphs AG110A and AG110B to explain the interaction between this choice and the effectiveness of the hedge relationship.

### Hedging of a one-sided risk with a purchased option

If a hedge is designated based on a one-sided risk (see above “Designation of one-sided risks”) and the hedging instrument is an option:

- When the option's time value is excluded and only the change in the intrinsic value of the option is hedged, the hedge might be 100% effective assuming all other terms and conditions match. Movements in the time value component are reported immediately in profit or loss.
- When the option's time value is included, ineffectiveness arises because the designated risk is not subject to movements in time value. The ineffectiveness would be recognized in profit and loss. Put another way, it is not possible to designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option, including changes in the time value, are effective and recognized in other comprehensive income.

### Effective date and transition

The Amendment must be applied retrospectively for annual periods beginning on or after July 1, 2009. Early adoption is permitted.

Hedge accounting is optional in IAS 39 and is subject to strict conditions. These conditions include a number of detailed rules governing what can be designated as a hedged item, a hedging instrument and a hedged risk. These detailed rules are quite complex and give rise to application questions in practice.

This Amendment aims to clarify questions in relation to one-sided risks and inflation components. It is therefore very limited in scope and addresses relatively obscure issues. The Amendment is also intended to be a clarification rather than to introduce substantive changes. For these the majority of entities that apply IFRS will not be affected.

The clarification on assessing effectiveness when hedging a one-sided risk with a purchased option is perhaps the most important one. U.S. GAAP contains guidance known as DIG G20 that permits designation of a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option (including changes in the time value) are effective. Some commentators have argued that this *DIG G20 approach* is permitted by IAS 39. The Amendment confirms that it is not.

### IASC Foundation proposes enhancements to public accountability and IASB composition

#### Introduction

On July 21, 2008, the Trustees of the International Accounting Standards Committee (IASC) Foundation [announced](#) the issuance of a [discussion document](#), *Review of the Constitution: Public Accountability and the Composition of the IASB – Proposals for Change*. The IASC Foundation's Constitution includes the governance structure and the operating procedures for the Foundation and its independent standard-setting body, the IASB. The Constitution states that a review should take place every five years, with the last review having been completed in June 2005.

The first part of the IASC Foundation's Constitution Review contains the following proposals:

- Establish a formal link between the IASC Foundation and a Monitoring Group, which would be comprised of public authorities and international organizations that have requirements for accountability to public authorities
- Expand the membership of the IASB from 14 to 16 members and add new guidelines with respect to the geographical diversity of the IASB members

The comment period for the discussion document ends September 20, 2008. The Trustees expect to complete this part of the Constitution Review at their October 2008 meeting, with the changes effective January 1, 2009. The other elements of the Constitution will be reviewed subsequent to the October 2008 meeting and will result in the issuance of an additional discussion document during 2009, with the changes effective January 1, 2010.

#### **Enhancing public accountability**

The Constitution states that one of the objectives of the IASC Foundation is

“...to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions.”

The IASB, a private sector organization, is unique in that it has no authority to impose its standards on countries nor does it have a direct reporting mechanism to governments or other public officials. The discussion document proposes establishment of a Monitoring Group.

#### **Mandate of the Monitoring Group**

As an independent group, the Monitoring Group would be entitled to recommend candidates as Trustees, provide input on all elements of the nomination process, and approve the selection of Trustees. The Monitoring Group would review whether and how the Trustees are fulfilling their responsibilities for appointing the members of the IASB, reviewing the strategy of the IASC Foundation and the IASB (including consideration, but not determination, of the IASB's agenda), reviewing the IASB's operating procedures, consultative arrangements and due process, reviewing financing arrangements, and supporting the use and rigorous application of IASB standards.

A Memorandum of Understanding between the Monitoring Group and the Trustees would be developed after seeking public comment.

#### **Composition of the Monitoring Group**

The Monitoring Group would initially be comprised of the following seven public authorities and international organizations with a link to public authorities:

- The responsible member of the European Commission
- The managing director of the International Monetary Fund
- The chair of the IOSCO Emerging Markets Committee
- The chair of the IOSCO Technical Committee (or vice chair or designated securities commission chair in cases where either the chairman of an EU securities regulator, commissioner of the Japan Financial Services Agency or chairman of the US Securities and Exchange Commission is the chair of the IOSCO Technical Committee)

- The commissioner of the Japan Financial Services Agency
- The chairman of the U.S. Securities and Exchange Commission
- The president of the World Bank

**IASB composition**

The discussion document proposes to increase the size of the IASB from 14 to 16 members, which includes three part-time members. The members would be selected from the following geographical areas:

- Four members from the Asia/Oceania region
- Four members from Europe
- Four members from North America
- One member from Africa
- One member from South America
- Two members appointed from any area, subject to maintaining overall geographical balance

The changes in the IASB composition would be made over a transition period of four years.