

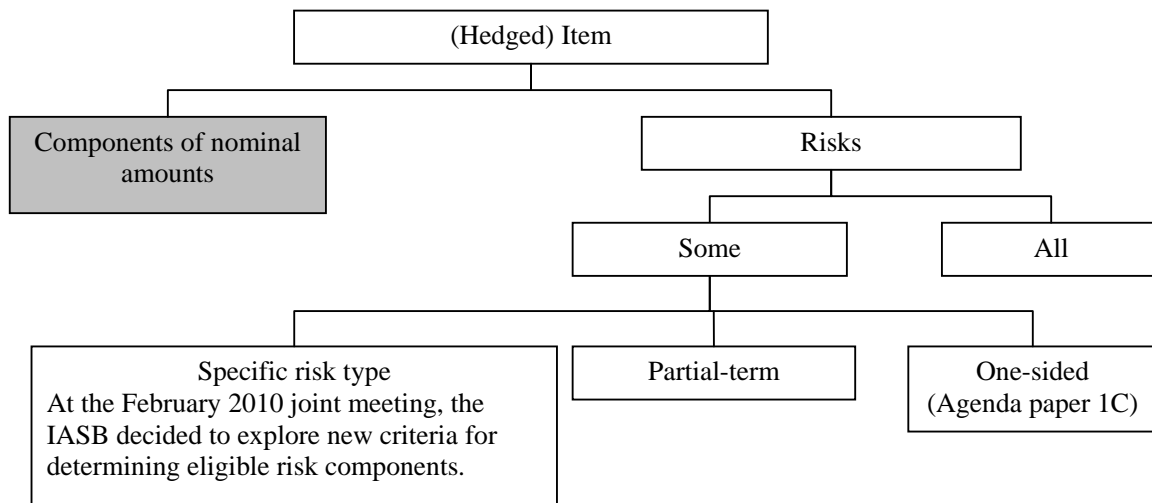


Project **Financial Instruments – phase 3 hedge accounting**

Topic **Eligible hedged items – components of nominal amounts**

Purpose of this paper

1. This paper addresses components of nominal amounts. The tree diagram below sets out the various types of components that could be eligible for hedge accounting.



2. **The purpose of this paper is to ask the Board whether components of nominal amounts should be eligible for designation as hedged items.**
3. This paper sets out:
 - (a) the issue;
 - (b) staff analysis;
 - (c) staff recommendation; and
 - (d) a question to the Board.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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The issue

4. Components of nominal amounts relate to a specified part of the metric of the hedged item.
5. Some common examples of components of nominal amounts include:
 - (a) 50% of the nominal value of a loan (ie a percentage of a contractual amount);
 - (b) The next 10m cash flows from CHF-denominated sales after the first 20m in March 201X for an entity with EUR as its functional currency (ie part of a monetary transaction volume);
 - (c) 50,000 cubic meters of the natural gas stored in location XYZ (ie part of a physical volume);
 - (d) The first 100 barrels of the oil purchases in June 201X (ie a part of a physical transaction volume).
- 6. The issue is whether components of nominal amounts should be eligible hedged items.**
7. For reference, Appendix A sets out the relevant paragraphs in IAS 39 relating to components of nominal amounts.

Staff analysis

8. The staff notes that designation of components of nominal amounts as hedged items is often relatively straight-forward. This is because these components are typically identifiable and measurable (they are some quantifiable nominal part of the total cash flows of the instrument). For example, a proportion of a known amount such as 50% of the nominal value of a loan shares all the characteristics of that loan ie is affected by all risks in the same manner. Hence, changes in value and cash flows for the 50% proportion are half of those for the entire instrument. Unlike a risk component, a component of a nominal amount does

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not have effects that change the fair value or the cash flows of the entire instrument.

9. However, some issues might arise when an entity designates a component of a nominal amount that is not known at the date of designation. For example an entity designates the first 100 barrels of oil purchases in June 201X and every subsequent month of that year. Issues arise because:
 - (a) often there is no single cash flow date for such hedged items. The entity might purchase 100 barrels over several weeks; and
 - (b) there is the question of whether the forecast transaction did occur on a different date or did not occur at all. For example, purchases might be pushed out into the next month.
10. However, the staff notes that the above issues of differing cash flow dates and changes in the cash flow dates of the hedged item relate to the effectiveness of the hedging relationship rather than the eligibility of components of nominal amounts as hedged items. This is because generally the components are still identifiable and their effects measurable.
11. Determining whether a transaction occurred on a different date or did not occur at all can be judgemental. For example, only 70 barrels are purchased in June 201X but 150 barrels in July 201X. The question is whether the 30 barrels shortfall in expected purchases in June is included in the 150 barrels purchased in July.
12. The risk of a forecast transaction not occurring is inevitably part of hedging this kind of item. There is no obvious alternative hedged item that could be designated instead (in its entirety) that would avoid the judgement required for hedging part of the monthly transaction volume (and still reflect the entity's risk management).
13. The staff notes that components of nominal amounts form the basis of many different risk management strategies and are commonly hedged in practice (often in combination with other components ie specific risks). Therefore, the

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staff believes that allowing components of nominal amounts is essential. Otherwise, many common hedging activities (particularly regarding forecast transactions) would not qualify for hedge accounting. Moreover, the staff notes that any criteria developed for risk components will be applicable to components of nominal amounts as they are the simplest type of component.

Staff recommendation and question to the Board

- 14. The staff recommends that the Board permit the designation of components of nominal amounts as hedged items.**

Question – Eligibility of components of nominal amounts as hedged items

The staff recommends that the Board permit the designation of components of nominal amounts as hedged items. Does the Board agree with the staff recommendation?

If the Board does not agree with the staff recommendation, what does the Board prefer instead and why?

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Appendix A

- 81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured.