Grant Thornton

Technical Accounting Alert

Eligible Hedged Items – Amendments to AASB 139

Overview
On 31 July 2008 the IASB published *Eligible Hedged Items,* an amendment to IAS 39 *Financial Instruments: Recognition and Measurement* (the Amendment). This was issued by the Australian Accounting Standards Board in August 2008. The Amendment aims to clarify the application of some of AASB 139's requirements on designation of a risk or a portion of cash flows for hedge accounting purposes; including:

- designation of one-sided risks;
- designation of portions of cash flows of a financial instrument, with reference to inflation components; and
- hedge effectiveness when hedging a one-sided risk with a purchased option.

Designation of one-sided risks
The Amendment introduces a new paragraph AG99BA in the Application Guidance to clarify that AASB 139 permits a designation based either on increases or decreases in cash flows or 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 is able to designate a cash flow hedge based on the risk of the commodity price increasing.

The Amendment notes that a one-sided risk does not include a 'time value' component. If the entity hedges a one-sided risk with a purchased option, the hedge will therefore be more effective if the hedging instrument's time value is excluded (see below). In that case, changes in the hedging instrument's time value are recognised in profit or loss as they arise.

Designation of portions of cash flows of a financial instrument
If the hedged item is a financial instrument, AASB 139.81 allows hedge designation based on a 'portion' of the instrument's cash flows. The Amendment inserts new paragraphs AG99E and AG99F to clarify 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
- 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 following are examples of risks and portions that are or are not 'separately identifiable' for this purpose.

'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 ie 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, AASB 139 requires that a hedging instrument is a derivative in its entirety. One of the exceptions is AASB 139.74(a)'s permission to exclude the time value of an option from the hedge accounting relationship and new paragraphs AG110A and AG110B 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) and the hedging instrument is an option:

- when the option's time value is excluded, the hedge might be 100% effective assuming all other terms and conditions match. In that case movements in the time value component are not part of the hedge accounting relationship and are therefore 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; i.e. 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 such that all changes in the fair value of the purchased option, including changes in the time value, are effective.

Effective date and transition

The Amendment is effective for annual periods commencing on or after 1 July 2009 and will apply retrospectively. Earlier application is permitted.

Grant Thornton Australia comment
Hedge accounting is optional in AASB 139 and is subject to strict conditions which are quite complex. These conditions include a number of detailed rules governing what can be designated as a hedged item, a hedging instrument and a hedged risk.

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.

The clarification on assessing effectiveness when hedging a one-sided risk with a purchased option is perhaps the most important one. US 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 AASB 139. The Amendment confirms that it is not.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia representative or a member of the National Audit Support team at NAS@grantthornton.com.au