

Hedge accounting moves closer to risk management

New standard provides more
hedging opportunities

November 2013, Issue 2013/19

IN THE HEADLINES

kpmg.com/ifrs



“Many preparers will support the new general hedge accounting standard. It provides a more principles-based approach that aligns hedge accounting more closely with risk management, which many constituents view as a positive step forward.”

– Enrique Tejerina,
KPMG’s global IFRS financial instruments deputy leader

Standard seeks to align hedge accounting more closely with risk management

On 19 November 2013, the IASB issued a new general hedge accounting standard – part of IFRS 9 *Financial Instruments* (2013) – which will align hedge accounting more closely with risk management. The new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness; however, under the new standard more hedging strategies that are used for risk management will qualify for hedge accounting.

More judgement needed to apply new requirements

More judgement will be required to assess the effectiveness of a hedging relationship under the new standard. A hedging relationship has to be effective at inception and on an ongoing basis, and will be subject to a qualitative or quantitative, forward-looking effectiveness assessment.

No voluntary termination of otherwise qualifying hedging relationships, but rebalancing may be required

An entity will not be allowed to voluntarily terminate a hedging relationship that continues to meet its risk management objective and all other qualifying criteria. An entity may be required to rebalance hedging relationships that are not behaving in the expected manner, by adjusting the quantities of the hedged item or the hedging instrument to maintain a hedge ratio that complies with the hedge effectiveness requirements.

Hedge accounting available for broader range of hedging strategies

Risk components of non-financial items and non-contractually specified inflation

Separately identifiable and reliably measurable components of both financial and non-financial items may be hedged items.

A non-contractually specified inflation component may qualify as a hedged item, subject to a ‘rebuttable presumption’ that unless inflation is contractually specified it would not be separately identifiable and reliably measurable.

Net positions and layer components

A group of items – including a group of items that constitute a net position – may be a hedged item only if:

- it consists of items that are eligible hedged items;
- the items in the group are managed together on a group basis for risk management purposes; and
- in the case of a cash flow hedge of items with offsetting risk positions, it is a hedge of foreign currency risk and the designation specifies certain details about the forecast transactions.

A layer component that includes a prepayment option may be a hedged item for a fair value hedge if the effect of the prepayment option is included in the effectiveness calculation.

Aggregated exposures

An aggregated exposure (a combination of a derivative and a non-derivative exposure) that is managed together for risk management purposes may be designated as the hedged item in a hedging relationship.

If the components that make up the aggregated exposure are already designated in a hedging relationship, then an entity will account for the second hedging relationship without having to terminate and restart the initial hedging relationship.

Equity investments at FVOCI

Under IFRS 9, an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in other comprehensive income (OCI). Under the new standard, an entity may hedge the foreign exchange risk exposure or equity price risk exposure of equity investments at fair value through OCI (FVOCI), with any hedge ineffectiveness recognised in OCI.

Cash instruments may be hedging instruments in more cases

Generally, non-derivative financial assets or liabilities measured at fair value through profit or loss (FVTPL) can be designated as hedging instruments in hedging relationships of any risk, and not only foreign currency risk.

For hedges other than hedges of foreign currency risk, the non-derivative financial instrument will have to be designated in its entirety or as a proportion of its nominal amount.

Differences from current practice

New fair value option for certain credit exposures whose credit risk is managed with credit derivatives

The new standard permits certain credit exposures to be designated at FVTPL if a credit derivative that is measured at FVTPL is used to manage the credit risk of the exposure.

A credit exposure may be a financial instrument in or outside the scope of IFRS 9 – e.g. loan commitments – that is managed for credit risk. The designation will be permitted if:

- the name of the credit exposure matches the reference entity of the credit derivative; and
- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

New fair value option for certain own-use contracts

The fair value option in IFRS 9 will be extended to contracts that can be settled net in cash and that meet the own-use scope exception if applying fair value accounting eliminates or significantly reduces an accounting mismatch.

This will address the accounting mismatch that occurs when:

- commodity contracts are outside the scope of IAS 39 *Financial Instruments: Recognition and Measurement*, and are therefore accounted for as executory contracts; and
- an entity enters into derivative transactions to economically hedge the commodity price exposure.

New 'cost of hedging' concept

In the new standard, an entity may exclude the time value of purchased options, the forward element of forward contracts, and foreign currency basis spreads from hedging relationships as a 'cost of hedging', and the cost of hedging may be deferred or amortised.

Additional disclosure requirements on risk management and hedging activities

For all hedged risk exposures to which hedge accounting is applied, an entity will be required to disclose additional information – e.g. the risk management strategy and the effect of hedge accounting on its financial statements. Even if an entity chooses to defer the application of the new general hedge accounting model, the new disclosures will be required if the entity adopts IFRS 9 (2013).

Systems considerations

The new model creates additional systems requirements if hedge accounting is applied – for example, to:

- track rebalanced hedging relationships;
- measure risk components of non-financial hedged items;
- calculate the fair value of components of forwards, purchased options and cross-currency swaps; and
- operationalise qualitative hedge effectiveness assessments.

Effective date and transition

The new standard removes the 1 January 2015 effective date of IFRS 9. The new mandatory effective date will be determined once the classification and measurement and impairment phases of IFRS 9 are finalised. When an entity adopts IFRS 9 (2013), it may choose as its accounting policy to defer application of the new general hedging model until the standard resulting from the IASB's project on macro hedging is effective. Early application of the new general hedging model is permitted only if all existing IFRS 9 requirements are applied at the same time or have already been applied.

However, the new standard allows an entity to change the accounting for financial liabilities that it has elected to measure under the fair value option, without applying any of the other requirements in IFRS 9. With that change, gains

and losses resulting from an entity's own credit risk would be recognised outside of profit or loss.

Transition to the new general hedging model will be prospective with limited exceptions. All qualifying criteria have to be met on the date of initial application of the new hedging model to apply hedge accounting from that date.

“Although the principles in the new standard will provide welcome relief, the application guidance in some areas remains complex. Significant effort may be needed to analyse the requirements and determine how best to apply them to a company's particular circumstances.”

– Enrique Tejerina,
KPMG's global IFRS financial instruments deputy leader

Basic facts

Since November 2008, the IASB has been working to replace its financial instruments standard (IAS 39) with an improved and simplified standard.

The IASB structured its project in three phases:

- Phase 1: Classification and measurement of financial assets and financial liabilities
- Phase 2: Impairment methodology
- Phase 3: Hedge accounting.

The new hedge accounting standard does not comprehensively address open portfolio hedging (macro hedging). The IASB has a separate active project to develop a new macro hedge accounting model.

Find out more

For more information on the proposals, please go to the IASB [announcement](#) on the general hedge accounting standard, or speak to your usual KPMG contact.

Timeline



19 November 2013:

New general hedge accounting standard issued – IFRS 9 (2013). Early adoption available



Q1 2014 (per IASB workplan):

Discussion paper on macro hedging



Not established:

Mandatory effective date of IFRS 9 including the new general hedge accounting model



Not established:

First annual financial statements in which entities are required to apply IFRS 9 including the new general hedge accounting model