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IFRS

First Impressions: IFRS 9 (2013) – Hedge accounting and transition

December 2013

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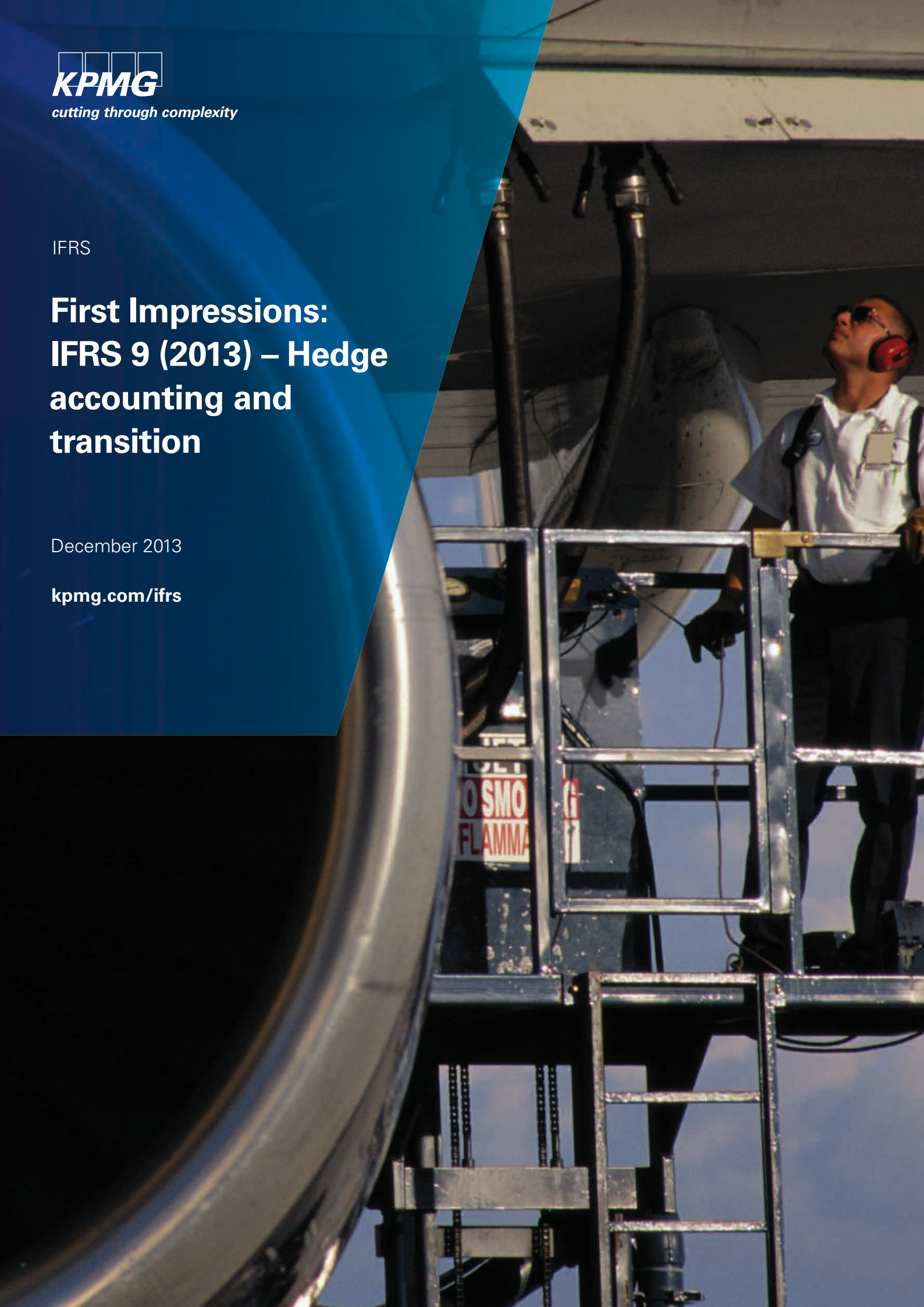

Contents

Closer alignment of hedge accounting and risk management

We welcome the IASB's new general hedge accounting model – part of IFRS 9 *Financial Instruments* (2013) – which was issued on 19 November 2013.

Many preparers will support the new 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.

Some entities in certain industries – e.g. banking and insurance – may believe that the new standard will not significantly change the 'status quo', as they await the IASB's macro hedging discussion paper in 2014. However, others may be keen to seize the opportunity to further align their hedge accounting with how they actually manage risk.

Airlines, manufacturers and others that have to manage significant commodity price exposures will have the most to gain from being able to apply hedge accounting for risk components of non-financial items. Those managing foreign exchange risk based on net exposures may also benefit from implementing the requirements. An entity will be able to reflect in its financial statements an outcome that is more consistent with how management assesses and mitigates risks for key inputs into its core business.

The new standard also removes the rigid 'bright line' for assessing hedge effectiveness, which will allow for a more flexible, principles-based approach to hedge accounting.

However, 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, consider alternatives and determine how best to apply them to an entity's particular circumstances. While some entities may be eager to implement the new hedging model, they may need to apply a greater degree of judgement to comply with it. In addition, to complement a more principles-based approach, additional disclosures will be required to inform users of how an entity is managing its risks.

The new standard removes the 1 January 2015 mandatory 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 the new standard, it may choose as an accounting policy to defer application of the new general hedge accounting model until the standard resulting from the IASB's project on macro hedge accounting is effective. However, the new disclosure requirements cannot be deferred if the new standard is adopted. Early application is permitted only if all existing IFRS 9 requirements are applied at the same time or have already been applied.

The new standard also allows an entity to change the accounting for financial liabilities that it has elected to measure under the fair value option, before 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. This will address an area of frustration expressed by some banks – generally the biggest users of the fair value option – related to profit or loss volatility.

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1 A new approach

- A more principles-based standard will align hedge accounting more closely with risk management
- The types of hedging relationships – fair value, cash flow and foreign operation net investment – remain unchanged, but additional judgement will be required
- There are new requirements to achieve, continue and discontinue hedge accounting
  - Hedge qualification will be based on qualitative, forward-looking hedge effectiveness assessments, rather than arbitrary bright lines
  - Hedging relationships may need to be rebalanced, without terminating hedge accounting, due to certain changes in circumstances
  - Voluntary termination of otherwise qualifying hedging relationships will be prohibited
- Additional exposures may be hedged items
  - Risk components of non-financial items and non-contractually specified inflation
  - Net positions and layer components of items
  - Aggregated exposures (a combination of a non-derivative exposure and a derivative)
  - Equity investments at fair value through other comprehensive income (FVOCI)
- The new standard carries forward the prohibition on hedging sub-LIBOR components
- Cash instruments may be hedging instruments in additional circumstances
- The time value of purchased options, the forward element of forward contracts and foreign currency basis spreads may be deferred or amortised
- New alternatives to hedge accounting are introduced
  - Certain credit exposures that are managed for credit risk with credit derivatives may be designated at fair value through profit or loss (FVTPL)
  - Entities may elect the fair value option for certain own-use contracts
- Extensive additional disclosures regarding an entity's risk management and hedging activities are required, to complement a more principles-based approach
- Effective date and transition
  - 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
  - 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 the new standard, it may choose as its accounting policy to defer application of the new general hedge accounting model until the standard resulting from the IASB's project on macro hedge accounting is effective; however, the new disclosures may not be deferred once the new standard is adopted
  - The new standard also 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

2 How this could affect you

- **A more judgemental approach.** The new standard takes a more principles-based approach that more closely aligns hedge accounting with risk management, including a qualitative, forward-looking effectiveness assessment that does not contain the current bright lines.
- **Taking advantage of the new opportunities.** Entities will have to ensure that risk management and hedge accounting processes are robust enough to enable them to take advantage of the new opportunities to apply hedge accounting.
- **Application of judgement.** Entities will need to determine:
  - whether current or new hedge accounting documentation provides sufficient evidence to support the link between each individual hedging relationship and the related risk management objective;
  - whether existing or new hedging relationships meet the new hedge effectiveness criteria;
  - when rebalancing is appropriate;
  - when discontinuing a hedging relationship is appropriate; and
  - whether the hedged item is transaction-related or time period-related when separately accounting for qualifying 'costs of hedging'.

- **New potential hedging strategies.**
  - *Risk components of non-financial items*: Entities will have to determine whether the relevant risk components are separately identifiable and reliably measurable based on the market structure.
  - *Non-contractually specified inflation*: Entities will have to determine whether they are capable of constructing an inflation curve based on observable real interest rates from a liquid market to assert that an inflation component of a fixed-rate debt instrument is separately identifiable and reliably measurable.
  - *Net positions*: Certain net positions may be designated as the hedged item. This will be a change from the current gross position approach in which an entity is required to identify an 'over-hang' position – e.g. an excess of financial assets over financial liabilities. For cash flow hedges of net foreign currency positions, entities will have to specify the period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.
  - *Aggregated exposures*: The ability to hedge an aggregated exposure (a combination of a derivative and a non-derivative exposure), which may or may not be designated in another hedging relationship, will provide flexibility but add complexity in terms of requirements for systems and processes.
- **Systems considerations.** The new model creates additional systems requirements – 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.

- **Extensive new disclosures.** The increased level of judgement and relaxation of hedging requirements are complemented by extensive new disclosure requirements.
- **Choice to early adopt IFRS 9 or wait.** Entities will have to evaluate the costs and benefits of adopting the new standard – which includes the existing IFRS 9 classification and measurement requirements – versus waiting to adopt IFRS 9 at a later date.
- **New 'own credit risk' presentation available.** 'Own credit risk' gains and losses arising on financial liabilities measured using the fair value option may be recognised outside of profit or loss, without applying any other requirements of IFRS 9.

3 Introduction

IFRS 9.IN8

The previous hedge accounting model under IAS 39 *Financial Instruments: Recognition and Measurement* was described as complex, not reflective of risk management activities and excessively rules-based, resulting in arbitrary outcomes. The new standard aims to address these criticisms by:

- aligning hedge accounting more closely with risk management activities, resulting in more useful information;
- establishing a more principles-based approach to hedge accounting; and
- addressing inconsistencies and weaknesses in the previous model.

IFRS 9.6.1.1, BC6.76–BC6.77

To meet these goals, the IASB defined the objective of hedge accounting: to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss, or in limited circumstances other comprehensive income (OCI). Hedge accounting provides an exception to the normal recognition and measurement requirements in IFRS in situations where the information that results from those normal requirements without applying hedge accounting is not useful or complete.

Consistent with its goals, the IASB decided to permit additional hedging instruments, hedged risks and hedged items to qualify for hedge accounting. As a consequence, more hedging strategies that are used to manage risk will be eligible for hedge accounting.

Observations – Expansion of strategies eligible for hedge accounting

The new standard significantly widens the breadth and complexity of hedging strategies that can qualify for hedge accounting – especially for corporates. Some entities may need to gain the expertise and put in place systems and processes to adequately implement, document and monitor these new strategies.

Observations – Alignment of hedge accounting with risk management

IAS 39.88(a), IFRS 9.6.1.1, 6.4.1, B6.5.15, B6.5.24, BC6.40

The new standard aligns hedge accounting more closely with risk management activities in two ways.

Firstly, the new standard expands the types of risk management activities that can qualify for hedge accounting (see Sections 5 and 6). This is a significant step towards addressing criticism that some entities are unable to fully reflect their actual risk management activities in their financial statements.

Secondly, the new standard requires that an entity's hedge accounting be more closely aligned with its actual risk management objectives. The new standard goes beyond the requirement of IAS 39 to formally document "the entity's risk management objective and strategy for undertaking the hedge" to qualify for hedge accounting. An entity's application of hedge accounting will now also have to be consistent with the new objective of hedge accounting – i.e. to reflect the effect of an entity's risk management activities in the financial statements. In addition, an entity may have to rebalance its hedging relationships to maintain alignment with risk management, and will also be prohibited from voluntarily de-designating a hedge accounting relationship that remains consistent with the entity's risk management objectives (see Sections 8 and 9).

Judgement will be required to assess how closely a hedge accounting designation needs to align with an entity's risk management objectives to be able to qualify for hedge accounting – e.g. the new standard also clarifies that some 'proxy hedging' strategies would be permitted (see 4.2.2).

Finally, hedge accounting remains voluntary, so an entity will not be forced to align its accounting with its risk management activities if it does not wish to apply hedge accounting.

Observations – Risk management strategies vs risk management objectives

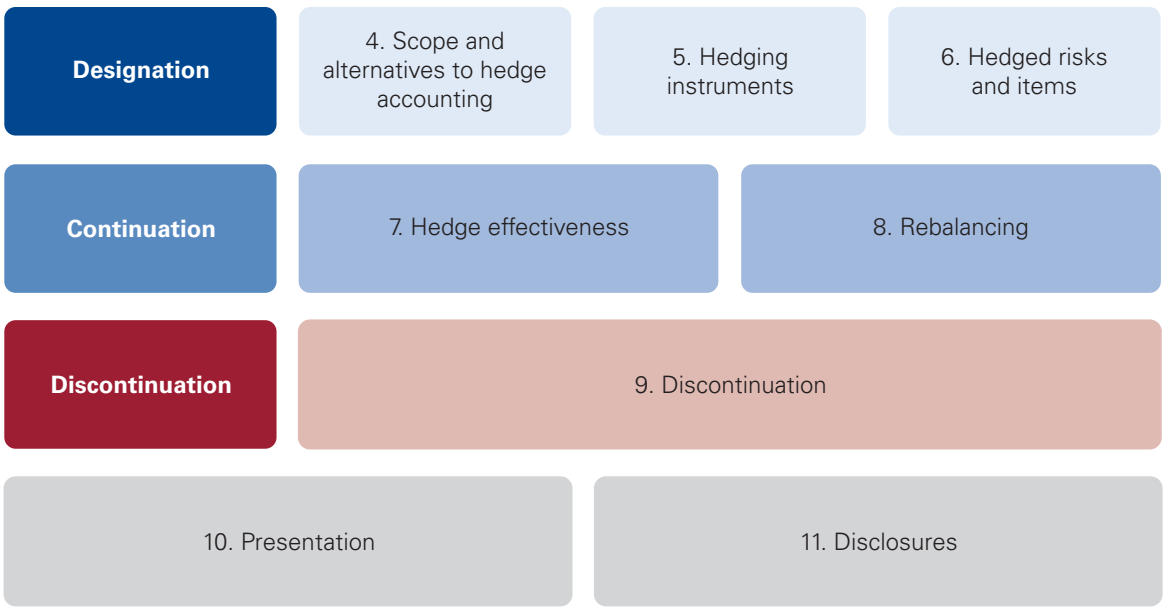
IFRS 9.B6.5.24

The new standard distinguishes between an entity's risk management *strategy* and its risk management *objectives*.

A risk management *strategy* is established at the highest level at which an entity determines how it manages risk. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk management strategy is usually long-term in nature and may include flexibility to react to changes in circumstances – e.g. different interest rate or commodity price levels that result in a different extent of hedging. Risk management strategies normally cascade down an entity through policies containing more specific guidelines.

A risk management *objective*, however, applies at the hedging relationship level. Therefore, a risk management strategy can involve many different hedging relationships that each has a risk management objective that contributes to executing that overall risk management strategy. The need for hedge accounting to be aligned with risk management objectives may require an entity to review and update its existing processes and documentation. That process could cause an entity to amend its current risk management policies or create new risk management policies. It could also lead to hedge accounting being applied to different types of hedges or being applied in different ways from before.

This publication has been structured to reflect the life cycle of a hedging relationship. The following diagram shows how the relevant sections map to each stage of the life cycle.



4 Scope and alternatives to hedge accounting

4.1 General hedge accounting

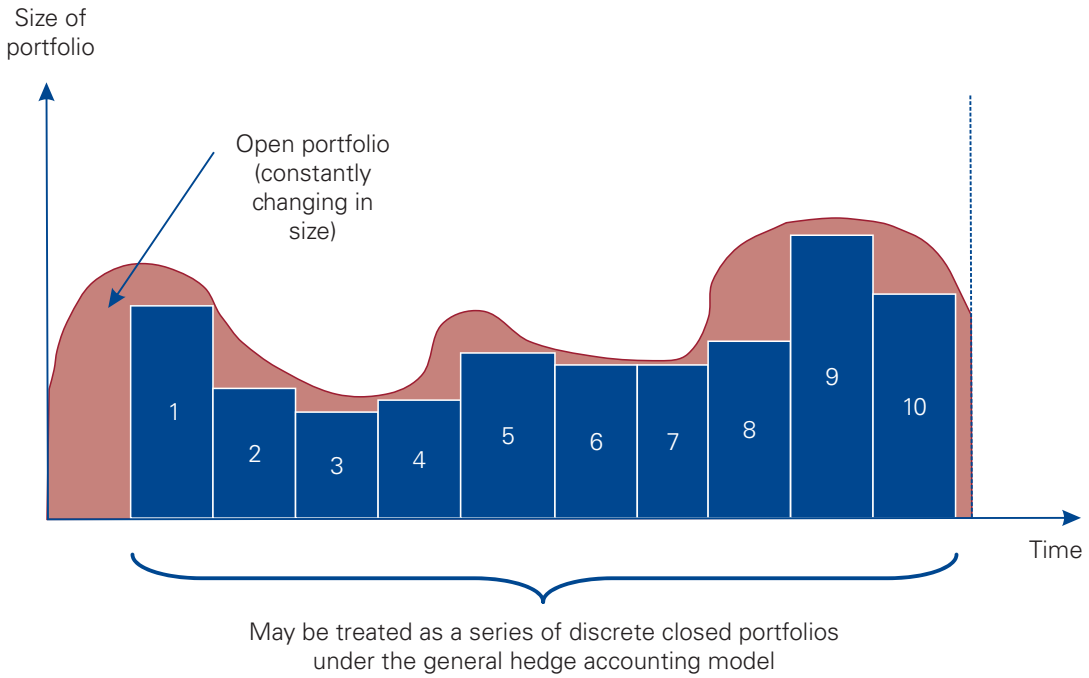
IFRS 9.IN8, BC6.84

The new standard is the result of the IASB's project to develop new requirements for general hedge accounting. 'General hedge accounting' refers to the accounting for hedging relationships that include a single hedged item or a closed portfolio of a group of items that constitute a gross or net position. A closed portfolio is a portfolio to or from which items cannot be added, removed or substituted without treating each change as the transition to a new portfolio or a new layer. The new standard replaces the requirements of IAS 39 for fair value and cash flow hedges of closed portfolios and hedges of net investments in foreign operations.

IFRS 9.6.1.3, BC6.85

However, an entity's risk management strategies often assess risk exposures on a continuous basis and at a portfolio level. Over time, new exposures are continually added to the hedged portfolios and other exposures are removed from them, which is why they are often referred to as 'open portfolios'. When an open portfolio is hedged as part of a risk management strategy, the general hedge accounting model can be applied by treating the open portfolio like a series of discrete closed portfolios, which exist for a shorter time period than the overall risk management strategy's time horizon. That is, the hedging relationship will be periodically discontinued and then a new relationship will be designated for the revised closed portfolio of items.

How an open portfolio may be modelled as a series of discrete closed portfolios



Observations – Practical challenges of treating open portfolios as a series of closed portfolios

IFRS 9.BC6.86

Although treating open portfolios as a series of discrete closed portfolios for accounting purposes is possible under the general hedge accounting model (as well as under IAS 39), it gives rise to several complexities – e.g. tracking the individual hedging relationships, amortising the hedge adjustments, and reclassifying gains or losses deferred in accumulated other comprehensive income (AOCI).

Sometimes, it may be impractical to fully align the accounting treatment with the way the exposures are viewed from a risk management perspective because the actual hedged open portfolios may be adjusted more frequently for risk management purposes than is practical for applying the general hedge accounting model.

Applying risk management to open portfolios is often referred to as 'macro hedging'. Recognising that the new general hedge accounting model does not work well in all situations where macro hedging is applied to open portfolios, the IASB has taken steps to further accommodate macro hedging strategies within IFRS (see 4.2).

Observations – Relationship of the scope of the general hedging model to open portfolios

Although the general hedging model is focused on hedging closed portfolios, it incorporates the concepts of:

- applying hedge accounting to:
  - layers of cash flows;
  - net positions; and
  - nil net positions; and
- rebalancing a hedging relationship's hedging instruments and hedged items.

All of these situations inherently have an element of an open portfolio.

4.2 Macro hedge accounting

4.2.1 Portfolio fair value hedges of interest rate risk

IAS 39.81A, 89A AG114–AG132, BC173–BC174

IAS 39 contains a separate hedge accounting model for fair value hedges of the interest rate exposure of open portfolios of financial assets or financial liabilities. This is sometimes described as 'portfolio fair value hedges of interest rate risk' under IAS 39. That model was provided as an exception to the general hedge accounting principles in IAS 39, in response to constituent concerns that common risk management strategies would not otherwise qualify for hedge accounting or could only be designated as cash flow hedges, with the result that reported equity would be volatile.

IFRS 9.6.1.3

Because the IASB decided to separately deliberate macro hedge accounting, it decided to retain the requirements of IAS 39 for portfolio fair value hedges of interest rate risk (and only for such hedges) in the new standard.

Observations – Applying the relevant provisions of IAS 39

IFRS 9.6.1.3, BC6.88, BC6.91, BC6.92(c)

In September 2012, the IASB posted a draft of the new general hedging standard (the review draft) on its website. After reading the review draft, some constituents were unclear whether, when using the scope exception for portfolio fair value hedges of interest rate risk after adopting the new standard, all of the hedge accounting requirements in IAS 39 apply, or only the specific paragraphs that are cited – i.e. IAS 39.81A, 89A and AG114–AG132.

In January 2013, the staff stated that they believed that it was clear that an entity using the scope exception for portfolio fair value hedges of interest rate risk applies all (applicable) hedge accounting requirements in IAS 39, and not only paragraphs 81A, 89A and AG114–132 of IAS 39. Paragraph BC6.91 of the new standard supports this view by saying that "an entity could continue to apply IAS 39" for portfolio fair value hedges of interest rate risk – i.e. those hedging relationships may continue unchanged.

Observations – Expanded disclosures for portfolio fair value hedges of interest rate risk

IFRS 9.6.1.3, C11

Under the new standard, entities will be able to continue to designate portfolio fair value hedges of interest rate risk using the guidance in IAS 39. However, those strategies will be subject to the new expanded disclosure requirements (see Section 11).

Observations – Portfolio fair value hedges of risks other than interest rate risk

IFRS 9.6.1.3

Under IAS 39, some entities may have analogised to the guidance for portfolio fair value hedges of interest rate risk and designated portfolio fair value hedges of other risks – e.g. foreign exchange risk. However, the new standard expressly limits the continued use of that guidance to portfolio fair value hedges of interest rate risk.

4.2.2 'Macro cash flow hedging' strategies

IAS 39.F.6.1–F.6.3

The implementation guidance of IAS 39 contains illustrative examples for applying cash flow hedge accounting when a financial institution manages interest rate risk on a net basis. Some financial institutions have implemented hedge accounting programs based on that guidance as an alternative to designating portfolio fair value hedges of interest rate risk (see 4.2.1). Sometimes those strategies are referred to as 'macro cash flow hedging' under IAS 39, although that implementation guidance is based on the general principles of IAS 39, and the strategies may rely on the de-designation and re-designation of hedges of closed portfolios.

IFRS 9.BC6.93

In response to the review draft, constituents requested that the IASB clarify whether the 'macro cash flow hedging' strategies illustrated in paragraphs IG.F.6.1– IG.F.6.3 of IAS 39 would be eligible under the new standard. In response to constituent concerns, the IASB added the following clarifications in the new standard.

IFRS 9.BC6.96–BC6.101	**'Proxy hedging'**	Some constituents were concerned about the need to use designations that do not exactly represent the actual risk management approach. This practice is sometimes referred to as 'proxy hedging'. For example: • using a gross designation when risks are actually managed on a net position basis; and • using designations of variable-rate debt instruments when risk management is actually based on the interest rate risk of fixed-rate debt instruments. The Board clarified that it was acceptable in certain situations for the designation for hedge accounting purposes to differ from the entity's risk management view of its hedging – e.g. when the designation reflects risk management, in that it relates to the same type of risk that was being managed and the instruments used for that purpose. Despite the objective to represent, in the financial statements, the effect of an entity's risk management activities, the Board considered that in many situations it would not be possible to designate an exact '1:1 copy' of the actual risk management perspective. For example, an entity will be permitted to designate a hedge of interest rate risk on a gross basis, even though the risk is actually managed on a net basis.
IFRS 9.BC6.93–BC6.95	**Implementation guidance**	Some constituents believed that deleting the implementation guidance related to 'macro cash flow hedge accounting' created the impression that the hedging relationships it illustrates will no longer be allowed. The Board clarified that not carrying forward the implementation guidance did not mean that it had rejected that guidance. Rather, it was concerned that selectively carrying forward only some of the implementation guidance would lead to further confusion.

Observations – Designating 'macro cash flow hedges' under the new standard

IFRS 9.7.2.16, BC6.102–BC6.104

It seems that the IASB's clarifications have removed several of the potential hurdles to designating 'macro cash flow hedging' relationships under the new standard. However, the Board acknowledged that some industry concerns remain, which is why it decided to allow an entity to choose as its accounting policy when it adopts the new standard to defer application of the new general hedging model until the standard resulting from the IASB's project on macro hedge accounting is effective (see Section 12).

4.2.3 Ongoing macro hedge accounting project

Although the new standard is generally more permissive than IAS 39, and carries forward the exception for portfolio fair value hedges of interest rate risk from IAS 39, it does not permit hedge accounting for many macro hedging strategies. For example, a bank may manage, on an open portfolio basis, its net interest risk exposure across wide groups of financial assets and financial liabilities, including demand deposits. Some entities want a new macro hedging model that permits a form of hedge accounting that could be applied to a wider variety of risk management strategies than is presently allowed.

The Board plans to issue a discussion paper on macro hedging in the first quarter of 2014.

Observations – Potential application to multiple industries

The Board's focus to date has been on developing a model that banks could apply to account for their macro hedges of interest rate risk. However, it intends to explore in the discussion paper whether the model can be generalised to apply to other risks (e.g. foreign exchange risk or commodity price risk) by entities in other industries (e.g. insurance, power and utilities, oil and gas or manufacturing).

So for non-banks, the message is 'stay tuned'.

4.3 Contracts to buy or sell a non-financial item

IFRS 9.C32 (IAS 39.5A)

One of the functions of hedge accounting is to mitigate the recognition and measurement mismatches between the accounting for the hedging instrument and the hedged item. The new standard provides a new election whereby an entity can mitigate measurement mismatches that would otherwise arise from certain contracts to buy or sell a non-financial item without using hedge accounting.

IFRS 9.BCA50 (IAS 39.BC24B–BC24C)

Under IAS 39, contracts to buy or sell a non-financial item that can be settled net in cash – including net settlement in another financial instrument, or by exchanging financial instruments – or by delivery of commodities that are readily convertible to cash are excluded from the scope of IAS 39 if the contracts were entered into, and continue to be held, for the purposes of the receipt or delivery of those non-financial items. This is commonly referred to as the 'own-use' scope exception in IAS 39, and mostly applies to commodity purchases or sales.

IFRS 9.BCA50 (IAS 39.BC24D)

Under IAS 39, if a commodity contract that can be settled net does not meet the own-use scope exception, then it is accounted for as a derivative contract and measured at FVTPL. If an entity enters into a separate derivative contract to hedge the changes in fair value of the commodity contract, then the derivative is also measured at FVTPL. Therefore, the entity does not need to apply hedge accounting to achieve an accounting offset.

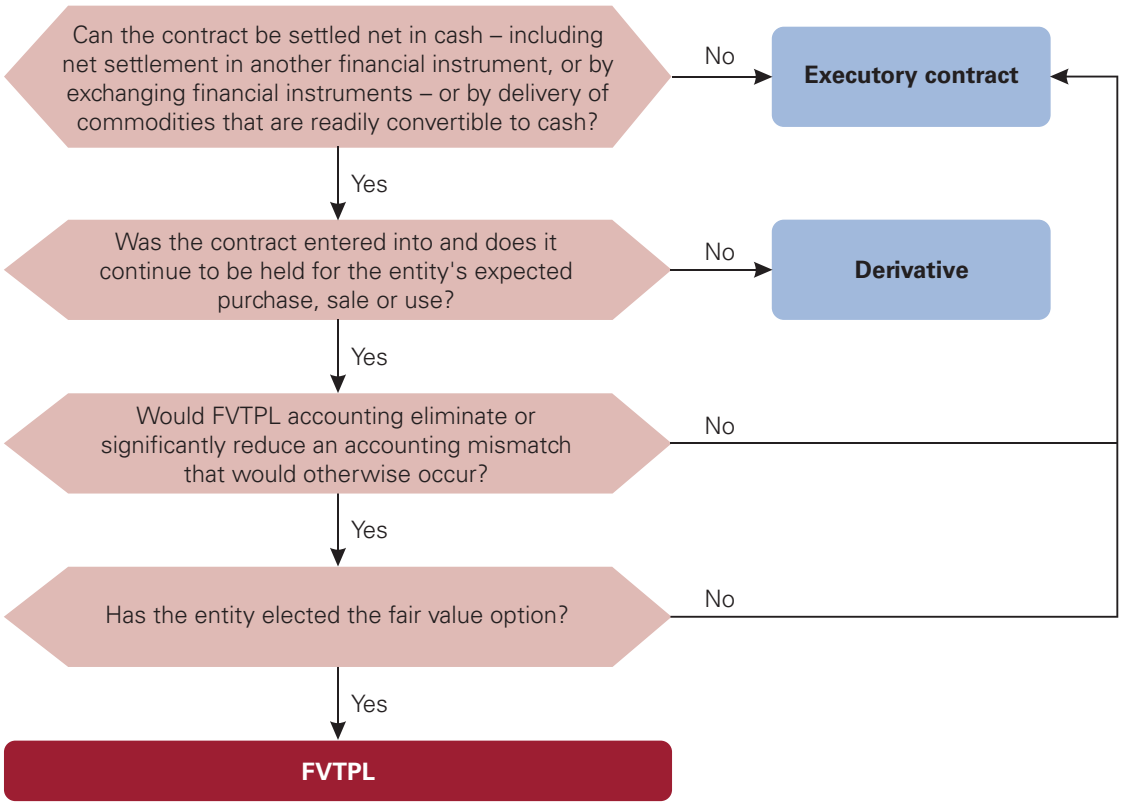
IFRS 9.BCA50 (BC24E–BC24F)

However, if the first contract above meets the own-use scope exception, then it is accounted for as a normal purchase or sales contract – i.e. an unrecognised executory contract. Therefore, if the entity enters into a derivative to economically hedge the changes in fair value of the executory contract, then there would be an accounting mismatch. To eliminate this accounting mismatch, an entity could apply hedge accounting. However, hedge accounting in these situations is administratively burdensome, because these contracts are typically entered into in large volumes and managed on a net basis.

IFRS 9.C26 (IAS 32.8), C32 (IAS 39.5A)

To mitigate the accounting mismatch and to provide more meaningful information in line with an entity's risk management approach, the new standard amends IAS 32 *Financial Instruments: Presentation* and IAS 39. The amendments will allow an entity to irrevocably designate a contract – at inception of the contract – to be measured at FVTPL if it meets the own-use scope exception. An entity may make the designation only if it eliminates or significantly reduces an accounting mismatch that would otherwise arise if the contract was accounted for as an unrecognised executory contract.

Analysis of contracts to buy or sell a non-financial item under the new standard



4.4 Managing credit risk using credit derivatives

4.4.1 Fair value option as a substitute for hedging credit risk

IFRS 9.BC6.469

Many financial institutions use credit derivatives to manage credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This may reduce the regulatory capital requirement for the loan or the loan commitment, while allowing the financial institution to retain nominal ownership of the loan and to preserve its relationship with the client. In another example, credit portfolio managers use credit derivatives to hedge the credit risk of a proportion of an exposure – e.g. a facility for a particular client – or the bank's overall lending portfolio.

IFRS 9.BC6.470, BC6.507

Financial institutions that manage credit risk using credit derivatives often do not achieve hedge accounting. This is because it is often very difficult or impossible to isolate credit risk in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable.

IFRS 9.BC6.471

As an alternative to hedge accounting, IAS 39 permits an entity to designate a financial instrument that would otherwise be measured at amortised cost as at FVTPL if doing so eliminates or significantly reduces an accounting mismatch (the 'fair value option'). This election is available only at initial recognition and is irrevocable. Moreover, the financial instrument is required to be designated in its entirety – e.g. the full nominal amount of a loan. Because of these limitations and restrictions, most financial institutions do not (and often cannot) apply the fair value option to their loans or loan commitments that are typically managed for credit risk within a flexible and active risk management strategy. For example, credit managers may hedge less than 100 percent of the loan or loan commitment, or hedge them for shorter periods than their contractual maturity.

IFRS 9.BC6.472

Consequently, financial institutions that use credit default swaps (CDSs) to hedge the credit risk of their loan portfolios often measure their loan portfolios at amortised cost and do not recognise most loan commitments. Because the changes in the fair value of the CDS are recognised in profit or loss every period, this creates an accounting mismatch and results in volatility in profit or loss. In many cases, this does not reflect the economic substance of the credit risk management strategy of financial institutions.

IFRS 9.6.7.1, BC6.543–BC6.544

To accommodate the management of credit risk, the new standard introduces a new fair value option for certain credit exposures as a substitute for hedge accounting. Under the new fair value option, if an entity uses a credit derivative that is measured at FVTPL to manage the credit risk of all, or a part of, a credit exposure, then it may designate that credit exposure (or a proportion of it) as measured at FVTPL. If only part of the credit risk of a credit exposure is managed using a credit derivative that is measured at FVTPL, then the credit exposure is measured at FVTPL only to the extent that it is managed using a credit derivative.

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 can be made only if:

- the name of the credit exposure – e.g. the borrower or the holder of a loan commitment – matches the reference entity of the credit derivative ('name matching'); and
- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

IFRS 9.6.7.1

An entity may make the designation at initial recognition or subsequently, or while the financial instrument is unrecognised. The entity is required to document the designation concurrently.

Observations – Documentation of fair value designation for credit exposures

IFRS 9.6.7.1

Although it is clear that documenting the designation of a credit exposure as at FVTPL is required, the level of detail for such documentation is not specified.

Example – Fair value option for a proportion of a loan commitment

Bank X extends a fixed-rate loan commitment of 900 to a client. Its risk management strategy is to hedge the credit risk exposure of any individual loan commitment to the extent that it exceeds 500. Therefore, Bank X enters into a CDS of 400 related to the potential borrower.

Accounting under IAS 39	Accounting under the new standard
X accounts for the CDS as it would any derivative – at FVTPL. However, X does not recognise the loan commitment under IAS 39. It is not accounted for under IAS 39 at FVTPL because it does not net settle and X does not have a past practice of selling the resulting loans for similar commitments. X also cannot elect the fair value option under IAS 39 for a proportion of an exposure (400 / 900). Therefore, the change in fair value of the CDS has no offset in profit or loss.	X accounts for the CDS as it would any derivative – at FVTPL. The new standard allows X to elect the fair value option for a proportion of the loan commitment, provided that certain conditions are met. If elected, the 400 / 900 proportion of the loan commitment is accounted for at FVTPL, and thereby provides an offset to the changes in fair value of the CDS.

Example – Fair value option for a debt investment elected after initial recognition

Company B invests in the debt of Company C and accounts for it at amortised cost. One year after making this investment, B decides to hedge C's credit risk with a CDS.

Accounting under IAS 39	Accounting under the new standard
B accounts for the CDS at FVTPL as it would any other derivative. It cannot designate the debt investment as at FVTPL under IAS 39 because this election is only available upon initial recognition. Therefore, the change in fair value of the CDS has no offset in profit or loss.	B accounts for the CDS at FVTPL as it would any other derivative. The new standard allows B to elect the fair value option for the debt investment, provided that certain conditions are met, after its initial recognition – thereby providing an offset in profit or loss to the future changes in fair value of the CDS. However, the cumulative change in the fair value of the debt is recognised in profit or loss upon election, which does not have a corresponding profit or loss offset.

Observations – No perfect profit or loss offset

In both of the examples above, the profit or loss offset provided by the new standard would not be perfect, because risks other than credit risk – e.g. interest rates – would affect the fair value of the item for which the fair value option was elected differently from its effect on the CDS.

4.4.2 Accounting for credit exposures designated at FVTPL

IFRS 9.6.7.2

Under the new standard, if a financial instrument is designated as measured at FVTPL after its initial recognition, or was previously not recognised, then any difference between the carrying amount and the fair value at the time of designation will immediately be recognised in profit or loss.

IFRS 9.6.7.3

An entity discontinues measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at FVTPL if:

- the conditions described in 4.4.1 (i.e. name matching and seniority) are no longer met – for example:
  - the credit derivative expires or is sold, terminated or settled; or
  - the credit risk of the financial instrument is no longer managed using credit derivatives – e.g. because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and
- the financial instrument that gives rise to the credit risk is not otherwise required to be measured at FVTPL – i.e. the entity's business model has not changed in the meantime in such a way that reclassification to FVTPL would be required.

Observations – Discontinuation of fair value designation for credit exposures

IFRS 9.BC6.478

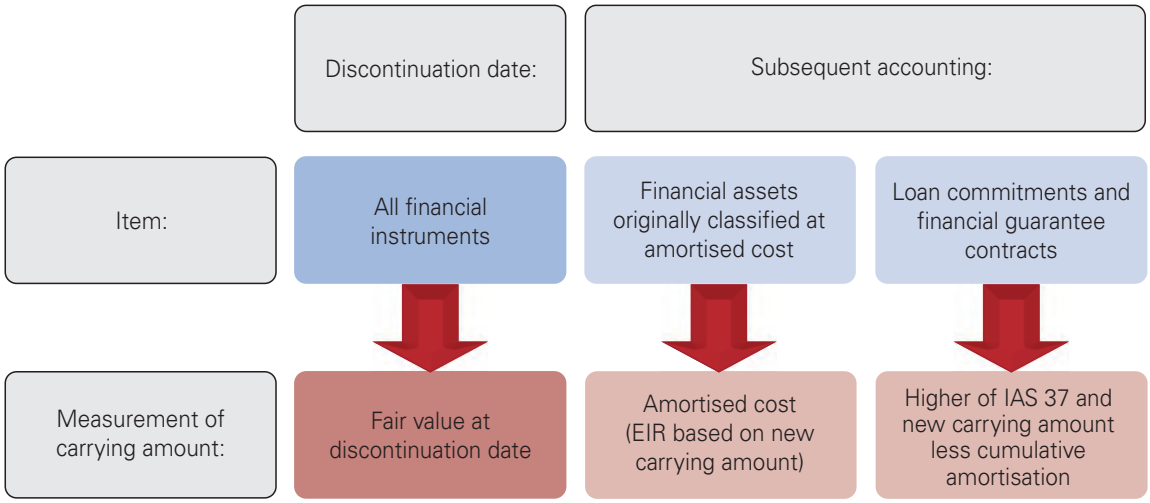
Under the new standard, when the discontinuation criteria are met, discontinuation of the fair value designation for the underlying credit exposures will be mandatory (rather than optional). This ensures alignment with the way that the exposure is managed – i.e. the credit risk will no longer be managed using credit derivatives.

IFRS 9.6.7.4

On discontinuation, the fair value of the financial instrument at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement basis that was used before designating the financial instrument at FVTPL should be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised cost will revert to that measurement and its effective interest rate will be recalculated based on its new carrying amount on the date of discontinuation. Similarly, a loan commitment or a financial guarantee contract will be measured at the higher of:

- the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
- the new carrying amount at the date of discontinuation less cumulative amortisation; the amortisation period is the remaining life of the instrument.

Measurement of carrying amount on discontinuation and subsequently



Observations – Fair value designation subsequent to initial recognition

IFRS 9.BC6.481

An entity may make the fair value designation for a credit exposure after its initial recognition. This means that election is available again for an exposure that was previously designated at FVTPL.

Consider the following scenario under the new standard. An entity uses a credit derivative to manage the deteriorating credit quality of a loan receivable. The qualifying criteria are met, and the entity designated the loan as measured at FVTPL. Subsequently, the credit risk of the loan improved and the entity sold the credit derivative. On the date on which the credit derivative was sold, the fair value of the loan became the new carrying amount, and it was subsequently measured at amortised cost. At a later date, the credit risk of the loan deteriorated again and the entity bought a new credit derivative to protect its exposure. The entity designated the loan at FVTPL (again) when it bought the new credit derivative. The difference between the amortised cost and fair value of the loan at the date of designation is recognised in profit or loss, thereby creating potential profit or loss volatility.

The above accounting outcome would reflect the entity's risk management strategy of protecting exposures that drop below a certain quality or risk level. This meets the IASB's objective of aligning accounting with risk management.

5 Hedging instruments

5.1 Overview

IFRS 9.6.2.1–6.2.3, B6.2.4

Under the new standard, the following contracts with a party external to the reporting entity may qualify as hedging instruments.

- All derivatives (including zero-cost collars), except:
  - written options not designated as offsets to purchased options; and
  - derivatives embedded in hybrid contracts that are not accounted for separately.
- Non-derivative financial assets or non-derivative financial liabilities – i.e. cash instruments – measured at FVTPL, except:
  - financial liabilities at FVTPL for which the amount of changes in fair value attributable to changes in credit risk is presented in OCI.
- For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability, except:
  - investments in equity instruments that an entity has elected to measure at FVOCI.

IFRS 9.6.2.4

In addition, an entity may exclude from hedging relationships as a 'cost of hedging':

- the time value of purchased options;
- the forward element of forward contracts; and
- foreign currency basis spreads.

Excluded costs of hedging may be deferred or amortised.

5.2 Cash instruments

IFRS 9.6.2.2

Under the new standard, non-derivative financial assets or non-derivative financial liabilities – i.e. cash instruments – measured at FVTPL may be designated as hedging instruments in hedging relationships (except for financial liabilities at FVTPL for which the amount of changes in fair value attributable to changes in credit risk is presented in OCI). These eligible instruments may be designated as a hedge of any risk – not only foreign currency risk.

IFRS 9.B6.2.5

For hedges other than hedges of foreign currency risk, the non-derivative financial instrument is required to be designated in its entirety or a proportion of it.

IFRS 9.6.2.2

For hedges of foreign currency risk, an entity may designate the foreign currency risk component of a non-derivative financial instrument as the hedging instrument. This is permitted only if the financial instrument is not an investment in an equity instrument for which an entity has elected to present changes in fair value in OCI.

Eligibility of cash instruments to be hedged items

Cash instrument:	May be designated as a hedge of FX risk	May be designated as a hedge of non-FX risk
Measured at fair value with *all* changes presented in P&L	✓	✓
Measured at fair value with changes in credit risk presented in OCI	✗	✗
Measured at amortised cost	✓	✗
Investment in equity instrument measured at FVOCI	✗	✗

Observations – Non-derivative financial instruments designated as hedging instruments in their entirety (or proportionally)

For hedges other than hedges of foreign currency, the total change in fair value of the non-derivative hedging instrument (or a proportion of it) is required to be included in the hedging relationship. This may limit the situations in which the hedge effectiveness requirements are met, or it may generate ineffectiveness.

Observations – Non-derivative financial instruments measured at FVTPL designated as hedging instruments

The new standard allows for a non-derivative financial instrument measured at FVTPL to be designated as a hedging instrument. If such an instrument were designated in a cash flow hedge, then the change in its value that is determined to be effective would be recognised in OCI, rather than in profit or loss.

IFRS 9.BC6.136–BC6.139

Whether a non-derivative financial instrument accounted for at FVTPL as a result of electing the fair value option may be used as a hedging instrument depends on the relevant facts and circumstances. Designation as a hedging instrument should not contradict the entity's election of the fair value option – i.e. it should not recreate the accounting mismatch that the fair value option addressed.

Example – Non-derivative financial asset measured at FVTPL designated as a hedging instrument

Company R has a highly probable forecast purchase of a commodity that it wants to hedge. However, it is not cost effective for R to enter into a derivative to hedge the commodity price risk of its forecast purchase – e.g. the amount of the purchase is less than the standard notional size of the relevant commodity derivative contract offered in the marketplace.

Instead, R purchases shares in an investment fund that holds commodity-linked instruments with the objective of hedging its commodity price risk exposure from the forecast purchase. R purchases the number of shares that correspond to the notional exposure to the commodity risk.

The shares in the commodity investment fund would be measured at FVTPL, so R may be able to designate them as the hedging instrument in a cash flow hedge of the forecast commodity purchase.

5.3 Purchased options

IFRS 9.6.2.4(a), 6.5.15

Under the new standard, an entity may separate the intrinsic value and the time value of a purchased option contract and designate only the change in intrinsic value as the hedging instrument.

Observations – What does the time value of a purchased option represent?

IFRS 9.BC6.387–BC6.390

The time value of a purchased option represents the premium that the purchaser pays over the value of exercising the option immediately – i.e. the option's intrinsic value – based on the probability that the option will increase in value before expiry.

The time value may be considered to be a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes. This is similar to an insurance premium, which compensates the 'insurer' for assuming the downside risk of a particular item without its related upside potential.

The time value of an option is subject to 'time decay'. This means that it loses its value over time as the option approaches expiry, which occurs at an increasingly rapid rate. At expiry, the option's time value reaches zero. However, the time value of an option does not decay in a linear fashion. Under IAS 39, changes in the time value of an option are often excluded from hedging relationships but are then required to be measured at FVTPL, giving rise to volatility that many believe does not properly reflect its nature as a cost of the hedge.

Many typical hedged transactions do not involve a time value notion because they are not options. The IASB decided that the time value of a purchased option may be excluded from the designation of a hedging instrument – in which case, it is separately accounted for as a 'cost of hedging'.

If an entity designates only the change in intrinsic value of a purchased option as the hedging instrument in a fair value or cash flow hedge, then the change in fair value of the time value of the option is recognised in OCI to the extent that it relates to the hedged item. The method used to reclassify the amounts from equity to profit or loss is determined by whether the hedged item is transaction-related or time period-related.

Observations – Change in fair value of the time value of a purchased option recognised in OCI

A purchased option may be a hedging instrument in a fair value or cash flow hedge. If the hedged item does not contain a corresponding written option, then the recognition of the change in fair value of the time value of the option in OCI results in less profit or loss volatility, but more OCI volatility.

This issue is also relevant in the context of zero-cost collars (see 5.3.2), forward contracts and financial instruments with foreign currency basis spreads (see 5.4).

Observations – Synthetic collars

IAS 39.77, IFRS 9.6.2.6

IAS 39 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that combines a written option component and a purchased option component cannot qualify as a hedging instrument unless factors indicate that the combined instrument is not a net written option. Such factors include consideration as to:

- whether any net premium is received either at inception or over the life of the combined instrument; and
- whether the critical terms and conditions of the written option component and the purchased component are the same.

Also, IAS 39 precludes a combination of derivatives as a hedging instrument if one or more of those instruments is a written option. However, the new standard allows a stand-alone written option to be jointly designated with other instruments as long as in combination they do not result in a net written option.

5.3.1 Transaction-related vs time period-related hedged item

IFRS 9.6.5.15, B6.5.29

Under the new standard, an entity will determine whether a purchased option hedges a transaction-related or a time period-related hedged item based on the nature of the hedged item, including how and when it affects profit or loss, regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge.

IFRS 9.6.5.15, B6.5.29(a)

The time value of a purchased option relates to a *transaction-related* hedged item if the nature of the hedged item is a transaction for which the time value has the character of costs of the transaction.

IFRS 9.6.5.15, B6.5.29(a)

An example of a transaction-related hedged item arises when an entity hedges the future purchase of a commodity against commodity price risk. The transaction costs are included in the initial measurement of the inventory.

IFRS 9.6.5.15, B6.5.29(b)

The time value of a purchased option relates to a *time period-related* hedged item if the nature of the hedged item is such that:

- the time value has the character of the cost for obtaining protection against a risk over a particular period of time; but
- the hedged item does not result in a transaction that involves the notion of transaction cost as noted above.

IFRS 9.6.5.15, B6.5.29(b)

An example of a time period-related hedged item is an entity hedging its commodity inventory against fair value changes for six months using a commodity option with a corresponding life. Another example is the hedge of a net investment in a foreign operation for 18 months using a foreign exchange option.

Observations – New analysis required when hedging with purchased options

If an entity designates the intrinsic value of a purchased option as a hedging instrument, then the accounting for that option's time value depends on whether the hedged item relates to a transaction or a time period. Therefore, entities will need to analyse these hedging strategies to make this determination, because they may not have previously documented their option strategies in this manner.

Observations – Hedged item that is both transaction-related and time period-related

Many entities hedge the variability in cash flows arising from sales transactions denominated in a foreign currency with purchased options. In this case, the hedged risk could be considered the variability in cash flows arising from both a sale that takes place in one reporting period and the receivable created by that sale, which is collected in a subsequent reporting period. The hedged item would therefore be related to both a transaction (i.e. the sale) and a time period (i.e. the time period between the receivable's initial recognition and its collection). The new standard does not address hedged items that could be considered both transaction-related and time period-related. It appears that the time value of the purchased option could be related to a transaction-related hedged item and subsequently a time period-related hedged item without de-designating the hedging relationship if documented accordingly. We believe that the accounting for the option's time value follows that of a transaction-related hedged item and subsequently that of a time related-hedged item (see 5.3.2).

5.3.2 Accounting for the time value of a purchased option

IFRS 9.6.5.15(b), B6.5.29(a)

Transaction-related hedged items

Under the new standard, the change in fair value of the time value of a purchased option that hedges a transaction-related hedged item is recognised in OCI to the extent that it relates to the hedged item. The cumulative change in fair value is presented in a separate component of equity.

The hedged item may subsequently result in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied. In such cases, the entity removes the amount from the separate component of equity and includes it directly in the initial cost or other carrying amount of the item. This is not a reclassification adjustment under IAS 1 *Presentation of Financial Statements* and therefore does not affect OCI. In other cases, the entity will reclassify the amount from the separate component of equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss.

Any portion of the time value of a purchased option recognised in OCI that is not expected to be recovered in future periods will be immediately reclassified into profit or loss as a reclassification adjustment.

IFRS 9.6.5.15(c), B6.5.29(b), B6.5.30

Time period-related hedged items

The change in fair value of the time value of a purchased option that hedges a time period-related hedged item is recognised in OCI to the extent that it relates to the hedged item and is accumulated in a separate component of equity. The time value at the date of designation of the option as a hedging instrument, to the extent that it relates to the hedged item, is amortised on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or OCI, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI). This is also likely to be the hedged period. Therefore, in each reporting period, the amortisation amount is reclassified from the separate component of equity to profit or loss as a reclassification adjustment.

However, if the hedging relationship is discontinued, then the net amount that has been accumulated in the separate component of equity, inclusive of cumulative amortisation, is reclassified immediately into profit or loss as a reclassification adjustment.

Example – Period over which to amortise the time value of a purchased option that hedges a time period-related hedged item

IFRS 9.B6.5.30

An entity buys an interest rate option (a cap) to protect against increases in the interest expense on a floating-rate bond. The time value paid for the cap is amortised to profit or loss over the same period over which any intrinsic value of the cap would affect profit or loss – i.e. the hedged period.

Scenario 1

The cap commences on the day that the bond is issued, and expires in three years; it therefore hedges against increases in interest rates for the first three years of the five-year floating-rate bond. In this case, the time value paid for that cap is amortised over the first three years because that is the period over which any intrinsic value of the cap would affect profit or loss.

Scenario 2

The cap is a forward start option that commences on the first anniversary of the bond issuance, and expires on the third anniversary of the bond issuance; it therefore hedges against increases in interest rates for Years 2 and 3 of the five-year floating-rate bond. In this case, the time value paid for that cap is amortised during Years 2 and 3 because that is the period over which any intrinsic value of the cap would affect profit or loss.

IFRS 9.B6.5.31

Zero-cost collars

The accounting for the time value of purchased options described above also applies to a combination of a purchased and a written option (one being a put option and one being a call option) that, at the date of designation as a hedging instrument, has a net zero time value – i.e. a 'zero-cost collar'. In this case, an entity recognises any changes in time value in OCI – even though the cumulative change in time value over the total period of the hedging relationship is zero.

Therefore, if the time value of the collar relates to:

- a transaction-related hedged item, then the amount of time value that adjusts the hedged item or is reclassified to profit or loss at the end of the hedging relationship will be zero; and
- a time period-related hedged item, then the total amortisation expense for the time value is zero; this is because the amortisation expense is based on the time value at the date of designation as the hedging instrument, which is zero.

Observations – Zero-cost collars

IFRS 9.BC6.412

A zero-cost collar has no time value at inception; however, its time value fluctuates during the life of the hedge. Time value is subject to 'time decay', and the time value of both the purchased and the written option will decline over time as the collar approaches expiry. If changes in the time value were not included in OCI, they would affect profit or loss each period. For hedged items that do not contain a corresponding written option, recognising the time value of zero-cost collars in OCI reduces volatility in profit or loss, but increases volatility in OCI.

IFRS 9.BC6.413

Aligning the accounting treatment for changes in the time value of purchased options and zero-cost collars in OCI rather than profit or loss may potentially expand the use of these instruments as hedging instruments under the new standard.

5.3.3 Aligned time value vs actual time value

IFRS 9.B6.5.32

Under the new standard, the specific accounting guidance for the time value of purchased options described above applies only to the extent that the time value relates to the hedged item. This is referred to as the 'aligned' time value. An entity determines the aligned time value using the valuation of the option that would have critical terms perfectly matching the hedged item.

Observations – Aligned time value vs actual time value

The aligned time value is the time value of a purchased option with critical terms that perfectly match the hedged item. An entity will need to determine which features of the option it considers to be critical, including what type of option is appropriate – e.g. American, European, Bermudan etc. This will require the entity to use its judgement, which should be applied consistently.

IFRS 9.B6.5.33

The actual time value of the option – i.e. the time value included in the premium paid – may differ from the aligned time value. In this case, the entity will use the following method to account for the difference during the hedging relationship.

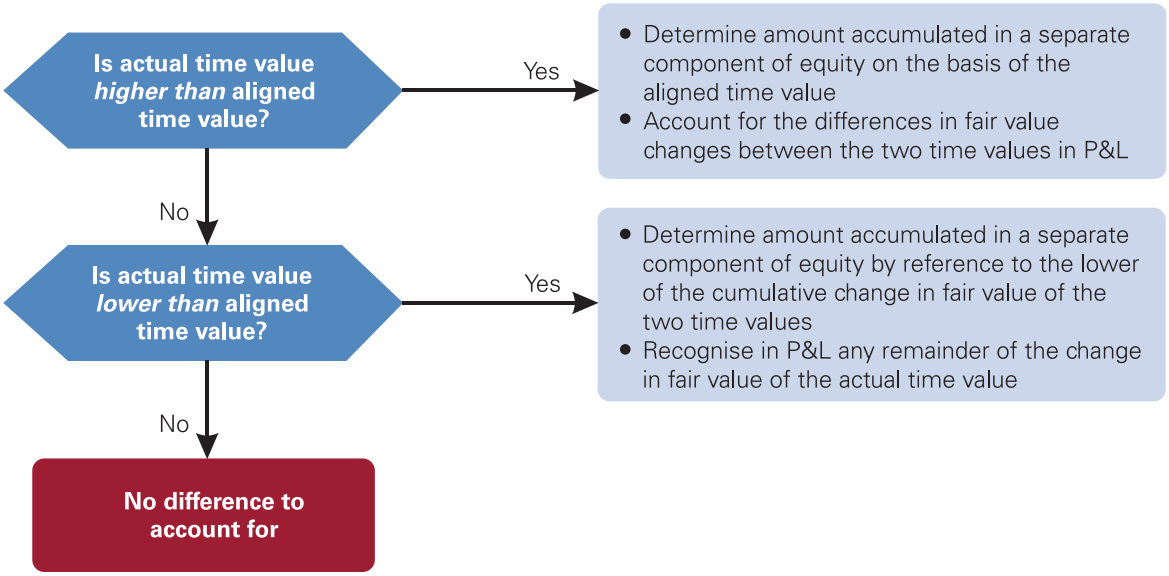
If, at inception of the hedging relationship, the actual time value is *higher* than the aligned time value, then the entity:

- determines the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
- accounts for the differences in the fair value changes between the two time values in profit or loss.

However, if at inception of the hedging relationship, the actual time value is *lower* than the aligned time value, then the entity:

- determines the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of the actual time value and the aligned time value; and
- recognises in profit or loss any remainder of the change in fair value of the actual time value.

Accounting for differences between actual time value and aligned time value



Observations – Aligned time value vs hypothetical derivative method

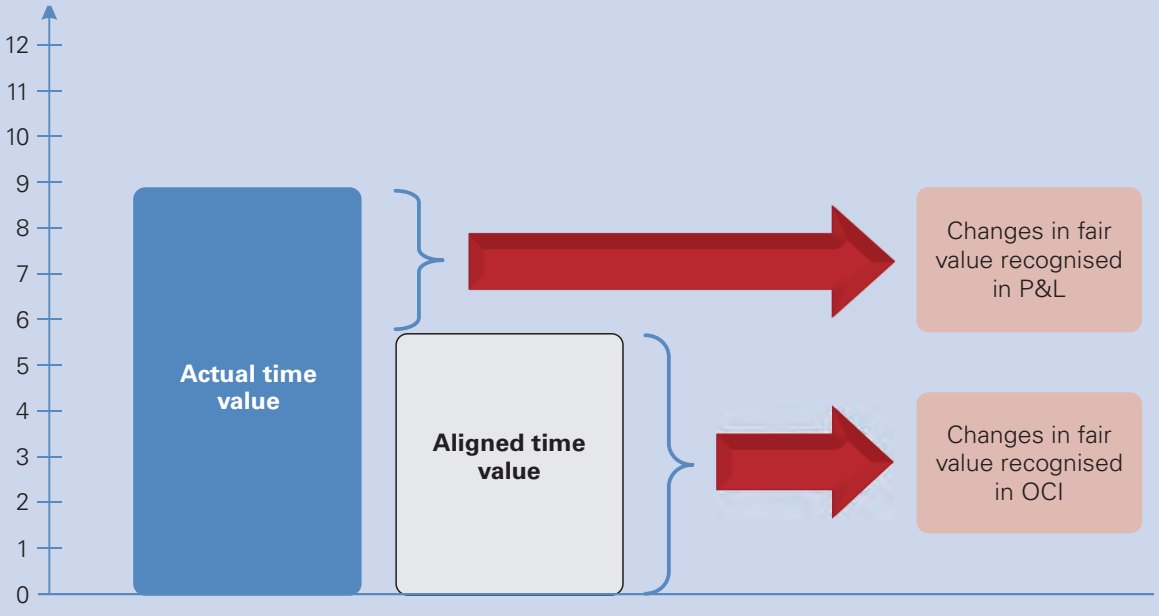
Under IAS 39, in applying the hypothetical derivative method to measure hedge ineffectiveness in a cash flow hedge, the time value of a purchased option is typically excluded from measurements of effectiveness. Any changes in the fair value of the time value of the option are recognised immediately in profit or loss.

Under the new standard, the accounting for the time value of a purchased option depends on whether the actual time value is higher or lower than the aligned time value.

IFRS 9.BC6.397

If, at inception of the hedging relationship, the actual time value is higher than the aligned time value – i.e. the entity pays a higher premium than would reflect the costs of hedging – then the amount that is subsequently recognised in OCI should be determined only on the basis of the aligned time value. The remainder of the actual time value is accounted for as a derivative at FVTPL.

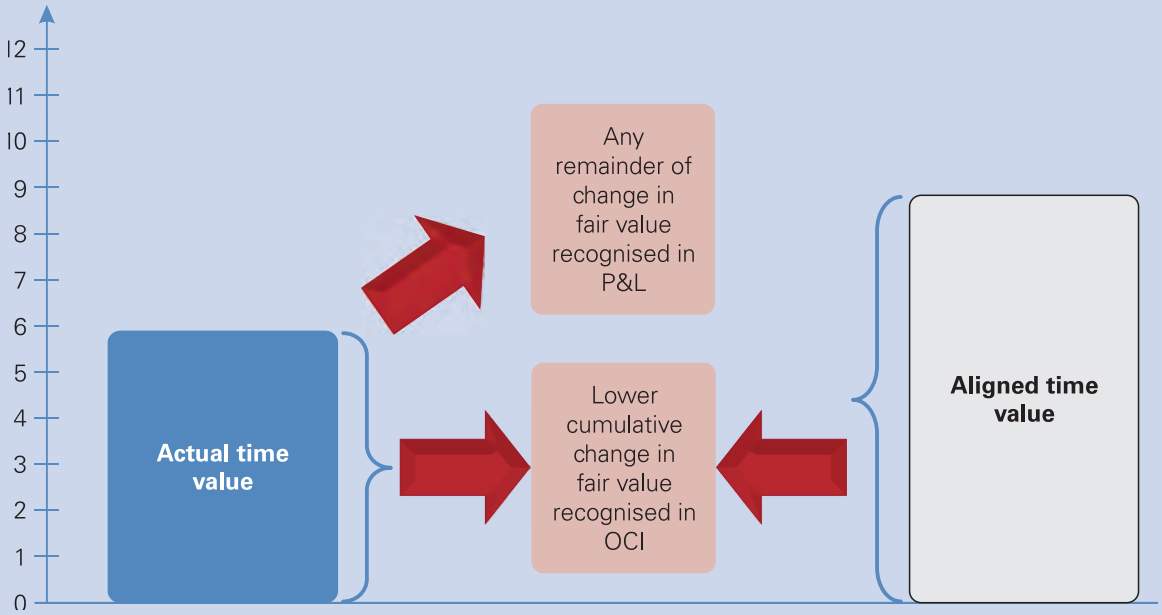
Accounting when actual time value is higher than aligned time value



IFRS 9.BC6.398

Conversely, if at inception of the hedging relationship the actual time value is lower than the aligned time value – i.e. the entity actually pays a lower premium than it would have to pay to cover the risk fully – then the amount that is subsequently recognised in OCI is the lower of the cumulative fair value change of the actual time value and that of the aligned time value. Any remainder of the change in fair value of the actual time value is recognised in profit or loss. This is to avoid accounting for more time value of a purchased option than was actually paid for by the entity.

Accounting when actual time value is lower than aligned time value



Example – Aligned time value vs actual time value

Company E uses purchased options to hedge its forecast commodity purchase. In doing so, it designates the option's intrinsic value as a hedging instrument.

In this case, the time value of the purchased option relates to a transaction-related hedged item, because the transaction costs would be included in the initial measurement of the inventory when the forecast commodity purchase occurs.

The accounting for the time value of such an option depends on whether its time value at inception of the hedging relationship is higher or lower than the aligned time value.

Scenario 1 – Actual time value is higher than aligned time value

Company E pays an up-front premium of 13 for the purchased option. On that day, it determines that the aligned time value is 10.

In accordance with the requirements in paragraphs B6.5.32 and 33 of the new standard, E accounts for the time value of the option as follows.

Overview of fair value of actual and aligned time value		**Actual**	**Aligned**					
Term (periods)		5	5					
Time value		13	10					
Period (end)		**t_0**	**t_1**	**t_2**	**t_3**	**t_4**	**t_5**	
Fair value of actual time value		13	11	13	9	7	-	
Fair value of aligned time value		10	7	11	8	6	-	
Statement of financial position								
Financial asset (option) – *time value only; excludes intrinsic value to simplify example*		13	11	13	9	7	-	
Retained earnings	(gain)/loss	-	(1)	1	2	2	3	
AOCI – *cumulative changes in fair value of aligned time value*	(gain)/loss	-	3	(1)	2	4	10	
		13	13	13	13	13	13	
Statement of profit or loss and OCI								**t_5 (cumulative)**
Profit or loss – *period-to-period movement in fair value of actual time value that does not relate to the hedged item*	(gain)/loss		(1)	2	1	-	1	***3***
OCI – *period-to-period movement in fair value of aligned time value*	(gain)/loss		3	(4)	3	2	6	***10***
Total comprehensive income			2	(2)	4	2	7	***13***

The aligned time value is determined using the valuation of an option that would have critical terms that perfectly match the hedged item.

Note that the amount that is accumulated in OCI is determined only on the basis of the aligned time value; the excess of the actual time value over the aligned time value of 3 (13 - 10) is accounted for as a derivative with cumulative fair value changes recognised in profit or loss/ retained earnings.

Scenario 2 – Actual time value is lower than aligned time value

Company E pays an up-front premium of 10 for the purchased option. On that day, it determines that the aligned time value is 12.

In accordance with the requirements in paragraphs B6.5.32 and 33 of the new standard, E accounts for the time value of the option as follows.

Overview of fair value of actual and aligned time value		**Actual**	**Aligned**
Term (periods)		5	5
Time value		10	12

The aligned time value is determined using the valuation of an option that would have critical terms that perfectly match the hedged item.

Period (end)		**t_0**	**t_1**	**t_2**	**t_3**	**t_4**	**t_5**
Fair value of actual time value		10	12	9	8	5	-
Fair value of aligned time value		12	15	11	11	7	-
Cumulative change of actual time value			2	(1)	(2)	(5)	(10)
Cumulative change of aligned time value			3	(1)	(1)	(5)	(12)
Lower of cumulative change			*2*	*(1)*	*(1)*	*(5)*	*(10)*
Statement of financial position							
Financial asset (option) – *time value only; excludes intrinsic value to simplify example*		10	12	9	8	5	-
Retained earnings	(gain)/loss	-	-	-	1	-	-
AOCI – *Lower of cumulative change*	(gain)/loss	-	(2)	1	1	5	10
		10	10	10	10	10	10

Because the actual time value is lower than the aligned time value a 'lower of' test is needed that compares the cumulative changes in fair value of the actual and aligned time values (see paragraph B6.5.33(b) of the new standard). This avoids accounting for more time value of an option than was actually paid for.

Note that the amount that is accumulated in OCI is determined by reference to the lower of the cumulative fair value change of the actual time value and the aligned time value – i.e. 10. The cumulative fair value change of the excess of the aligned time value over the actual time value of 2 (12 - 10) is not recognised in profit or loss/retained earnings. This avoids accounting for more time value than was actually paid for.

Statement of profit or loss and OCI							**t_5 (cumulative)**
Profit or loss – *period-to-period movement of remainder of change in fair value of actual time value*	(gain)/loss		-	-	1	(1)	-	**-**
OCI – *period-to-period movement of the lower of cumulative change*	(gain)/loss		(2)	3	-	4	5	***10***
Total comprehensive income			(2)	3	1	3	5	***10***

5.4 Forward contracts and financial instruments with foreign currency basis spreads

IFRS 9.6.2.4(b)

Under the new standard, similar to the accounting for purchased options, an entity can separate the forward element and the spot element of a forward contract and designate only the change in the spot element as the hedging instrument. Similarly, the foreign currency basis spread of a financial instrument may be separated and excluded from the designated hedging instrument.

Observations – What does the forward element of a forward contract represent?

IFRS 9.BC6.416

The forward element of a forward contract represents the difference between the forward price and the current spot price of the underlying.

The characteristics of forward elements depend on the underlying item – for example:

- for foreign exchange rate risk, the forward element represents the interest differential between the two currencies;
- for interest rate risk, the forward element reflects the term structure of interest rates; and
- for commodity risk, the forward element represents what is called the 'cost of carry' – e.g. storage costs.

Observations – What does the foreign currency basis spread of a financial instrument represent?

IFRS 9.BC6.295–BC6.296

Foreign currency basis spreads are commonly found in cross-currency swaps, but they may also be found in other financial instruments that involve exchanges of cash flows that are denominated in different currencies.

A foreign currency basis spread can be considered to be a charge to convert one currency into another. Foreign currency basis spreads are an economic phenomenon that would not exist in a perfect market because the existence of such a spread creates opportunities for economic arbitrage that would result in its reduction to zero. However, in actual markets for cross-currency swaps the foreign currency basis spread is not zero because of factors that prevent perfect arbitrage – for example:

- the credit risk embedded in the underlying reference rates of the currencies;
- the supply and demand for the particular cross-currency swap; and
- the interaction between the spot and the forward foreign exchange markets.

IFRS 9.6.5.16

If the forward element of a forward contract, or the foreign currency basis spread of a financial instrument, is separated and excluded from the designated hedging instrument, then the change in fair value of the excluded portion may be accounted for similarly to changes in the time value of a purchased option that is designated as a hedging instrument (see 5.3). That is, the excluded portion is treated as a 'cost of hedging'.

Observations – Accounting as 'cost of hedging' is required for purchased options but is optional for forward contracts and foreign currency basis spreads

IFRS 9.6.2.4, 6.5.15–6.5.16

Although accounting for a purchased option's time value as a 'cost of hedging' is required if the time value is excluded from the hedging instrument, it is optional for the forward element of a forward contract and the foreign currency basis spread of a financial instrument if those elements are excluded from the hedging instrument.

Therefore, for purchased options there is only one decision to make – i.e. whether to exclude the time value from the designation of the hedging instrument and account for it separately.

However, for forward contracts and financial instruments with foreign currency basis spreads, there are two decisions to make – namely:

- whether to exclude the forward element or foreign currency basis spread from the designation of the hedging instrument; and
- whether to account for any excluded element at FVTPL or to account for it as a 'cost of hedging'.

Observations – Change in fair value of the forward element recognised in OCI

Similar to the discussion of purchased options and zero-cost collars in 5.3, the recognition of the change in fair value of the forward element or foreign currency basis spread in OCI results in less profit or loss volatility, but more volatility in OCI.

5.4.1 Transaction-related vs time period-related hedged item

IFRS 9.B6.5.34, B6.5.39

Similar to the separate accounting for the time value of purchased options, the accounting for the excluded forward element of forward contracts and the excluded foreign currency basis spread of financial instruments depends on whether the hedged item is transaction-related or time period-related. An entity should assess the type of hedged item on the basis of the nature of the hedged item, regardless of whether the hedged item is a cash flow hedge or a fair value hedge.

IFRS 9.B6.5.34(a), B6.5.39

The forward element of a forward contract or the foreign currency basis spread of a financial instrument relates to a transaction-related hedged item if the nature of the hedged item is a transaction for which the forward element or foreign currency basis spread has the character of costs of that transaction.

IFRS 9.B6.5.34(a), B6.5.39

An example of a transaction-related hedged item arises when an entity hedges an inventory purchase denominated in a foreign currency against foreign currency risk. The transaction costs are included in the initial measurement of the inventory.

IFRS 9.B6.5.34(b), B6.5.39

The forward element of a forward contract or the foreign currency basis spread of a financial instrument relates to a time period-related hedged item if the nature of the hedged item is such that:

- the forward element or foreign currency basis spread has the character of the cost for obtaining protection against a risk over a particular period of time; but
- the hedged item does not result in a transaction that involves the notion of transaction cost as noted above.

IFRS 9.B6.5.34(b), B6.5.39

An example of a time period-related hedged item is an entity hedging its commodity inventory against fair value changes for six months using a commodity forward contract with a corresponding life. Another example is a net investment in a foreign operation that is hedged for 18 months using a cross-currency swap.

Observations – Hedging with forward contracts and financial instruments with foreign currency basis spreads

If an entity excludes the forward element of a forward contract or the foreign currency basis spread of a financial instrument from the designation of the hedging instrument, then the entity may account for the excluded element as a 'cost of hedging'. If it does, the accounting for that excluded portion depends on whether the hedged item relates to a transaction or a time period. Entities will need to analyse their hedging strategies that exclude forward elements and foreign currency basis spreads to make this determination, because they may not previously have documented their hedging strategies in this manner.

Observations – Hedged item that is both transaction-related and time period-related

Many entities hedge the variability in cash flows arising from sales transactions denominated in a foreign currency with forward contracts. In this case, the hedged risk could be considered to be the variability in cash flows arising from both a sale that takes place in one reporting period and the receivable created by that sale, which is collected in a subsequent reporting period. The hedged item would therefore be related to both a transaction (i.e. the sale) and a time period (i.e. the time period between the receivable's initial recognition and its collection).

The new standard does not address hedged items that could be considered both transaction-related and time period-related. We believe that the forward element of the forward contract could be related to a transaction-related hedged item and subsequently to a time period-related hedged item without de-designating the hedging relationship if documented accordingly. The accounting for the forward element would follow that of a transaction-related hedged item and subsequently that of a time period-related hedged item (see 5.4.2).

5.4.2 Accounting for the forward element of forward contracts and foreign currency basis spreads of financial instruments

IFRS 9.6.5.15(b), 6.5.16, B6.5.34(a), B6.5.39

Transaction-related hedged items

Under the new standard, the change in fair value of the forward element of a forward contract or the foreign currency basis spread of a financial instrument that hedges a transaction-related hedged item may be recognised in OCI to the extent that it relates to the hedged item. The cumulative change in fair value of the forward element or foreign currency basis spread is presented in a separate component of equity.

The hedged item may subsequently result in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied. In such cases, the entity removes the amount from the separate component of equity and includes it directly in the initial cost or other carrying amount of the item. This is not a reclassification adjustment under IAS 1 and therefore does not affect OCI. In other cases, the entity will reclassify the amount from the separate component of equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss.

Any portion of the forward element or foreign currency basis spread recognised in OCI that is not expected to be recovered in future periods will immediately be reclassified into profit or loss as a reclassification adjustment.

IFRS 9.6.5.15(c), 6.5.16, B6.5.34(b), B6.5.39

Time period-related hedged items

The change in fair value of the forward element of a forward contract or the foreign currency basis spread of a financial instrument that hedges a time period-related hedged item may be recognised in OCI to the extent that it relates to the hedged item and is accumulated in a separate component of equity.

The forward element or foreign currency basis spread at the date of designation of the hedging instrument, to the extent that it relates to the hedged item, is amortised on a systematic and rational basis over the period during which the hedge adjustment for the effective portion of the hedging instrument could affect profit or loss (or OCI, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI). This is also likely to be the hedged period. Therefore, in each reporting period the amortisation amount is reclassified from the separate component of equity to profit or loss as a reclassification adjustment.

However, if the hedging relationship is discontinued, then the net amount that has been accumulated in the separate component of equity, inclusive of cumulative amortisation, is reclassified immediately into profit or loss as a reclassification adjustment.

IFRS 9.B6.5.35

The characteristics of the hedged item – including how and when the hedged item affects profit or loss – also affect the period over which the forward element of a forward contract that hedges a time period-related hedged item is amortised – i.e. over the period to which the forward element relates. For example, if a forward contract hedges the exposure to variability in three-month interest rates for a three-month period that starts in six months' time, then the forward element is amortised during the period that spans months seven to nine.

IFRS 9.B6.5.36

Forward contracts with a forward element of zero

The accounting for the forward element of a forward contract described above also applies if, at the date on which the forward contract is designated as a hedging instrument, the forward element is zero. In this case, an entity recognises any changes in the fair value of the forward element in OCI – even though the cumulative change in the forward element over the total period of the hedging relationship is zero.

Therefore, if the forward element of a forward contract relates to:

- a transaction-related hedged item, then the amount of forward element that adjusts the hedged item or is reclassified to profit or loss at the end of the hedging relationship will be zero; and
- a time period-related hedged item, then the total amortisation expense for the forward element is zero; this is because the amortisation expense is based on the time value at the date of designation as the hedging instrument, which is zero.

5.4.3 Aligned forward element and foreign currency basis spread

IFRS 9.B6.5.37–B6.5.39

Under the new standard, the specific accounting guidance for the forward element of forward contracts and the foreign currency basis spread of financial instruments described above will apply only to the extent that the forward element or the foreign currency basis spread relates to the hedged item. This is referred to as the 'aligned' forward element or foreign currency basis spread. An entity will determine the aligned forward element or foreign currency basis spread using the valuation of the forward contract or financial instrument that has critical terms perfectly matching the hedged item.

Observations – Accounting for forward elements

IFRS 9.BC6.423–BC6.426

Some entities may have more funding in their functional currency than they could invest in financial assets in their functional currency. To generate an economic return on their surplus funds, such entities exchange these funds into a foreign currency and invest in assets denominated in that foreign currency. To manage their exposure to foreign exchange risk (and to stabilise their interest margin), such entities commonly enter into foreign exchange derivatives – e.g. a foreign currency forward. Usually, such transactions simultaneously involve the following components:

- swapping the functional currency surplus funds into a foreign currency;
- investing the foreign currency funds in a foreign currency-denominated financial asset for a period of time; and
- entering into a foreign currency forward, to convert the foreign currency funds back into the functional currency at the end of the investment period. This amount typically covers the principal plus interest at maturity.

The combination of the three components described above effectively allows the entity to 'lock in' a net interest margin and generate a fixed economic return over the investment period.

The new standard permits the forward points of the forward contract that exist at inception of the hedging relationship to be recognised in profit or loss over time on a systematic and rational basis and to accumulate subsequent fair value changes through OCI. Some constituents believe that this accounting treatment provides a better representation of the economic substance of the transaction and the performance of the net interest margin for those entities that choose to apply this method of hedge accounting for forward points.

6 Hedged risks and items

6.1 Overview

The new standard permits the following additional exposures to be designated as hedged items:

- risk components of non-financial items and non-contractually specified inflation;
- net positions and layer components of items; and
- aggregated exposures (a combination of a non-derivative exposure and a derivative).

Equity investments at FVOCI may also be hedged items. In addition, the new standard carries forward the existing prohibition on hedging sub-LIBOR components.

6.2 Risk components

Under the new standard, an entity may hedge a risk component of a non-financial item. Under IAS 39, foreign currency risk is the only risk component of a non-financial item that can be designated in a hedging relationship.

Observations – Risk management strategies involving components of non-financial items

Many entities use derivatives with non-financial underlyings as key components of their risk management activities. However, IAS 39 does not permit hedge accounting for a risk component of a non-financial item (other than foreign currency risk).

Entities that are exposed to non-financial risks in their businesses should evaluate whether any additional existing risk management activities will be eligible for hedge accounting under the new standard. For example, hedge accounting may be newly available for risk management activities that involve derivatives on:

- agriculture – grains and oilseeds (e.g. corn, wheat, soybeans, oats, rice, soybean oil, palm oil), livestock (e.g. cattle, hogs), dairy (e.g. milk, dry whey, butter, cheese), forest (e.g. lumber) and softs (e.g. cocoa, coffee, cotton, sugar);
- energy – crude oil, natural gas, ethanol, refined products (e.g. heating oil, gasoline, gas oil), electricity and coal;
- freight – forward freight agreements and container swaps; and
- metals – precious (e.g. gold, silver, palladium, platinum), base (e.g. aluminium, copper), ferrous (e.g. steel rebar, ferrous scrap, iron ore, steel coil) and coking coal.

In addition, some entities may have avoided entering into certain derivatives for managing risk components of non-financial items because hedge accounting was not available for them under IAS 39. Those entities may want to reconsider the potential costs and benefits of hedging activities for non-financial risks.

IFRS 9.6.3.7(a), B6.3.8–B6.3.15

To be eligible for designation as a hedged item:

- a risk component is required to be a separately identifiable component of the financial or non-financial item; and
- the changes in the cash flows or fair value of the item attributable to changes in that risk component are required to be reliably measurable.

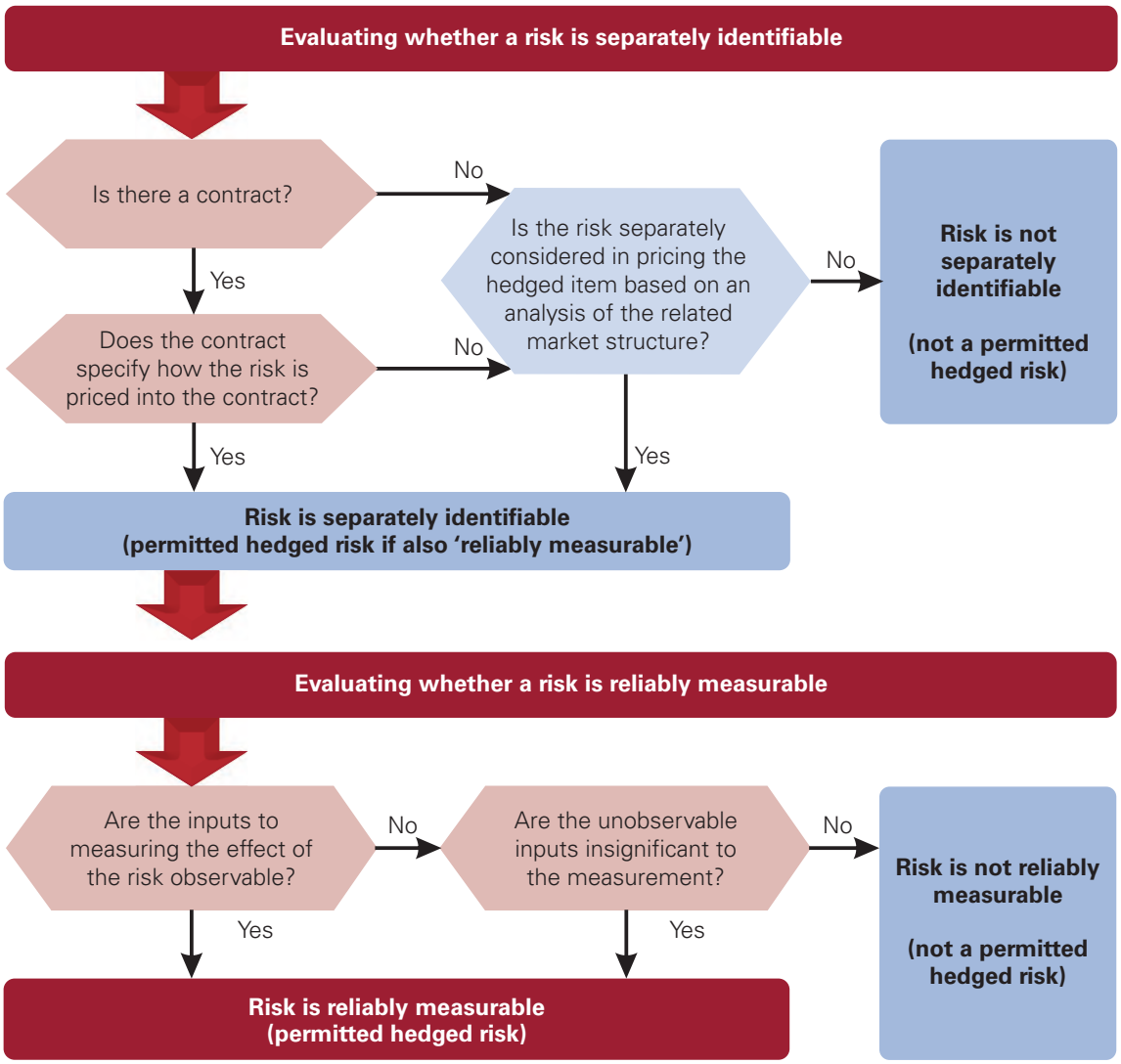
Under the new standard, when determining if a risk component is eligible for designation as a hedged item, an entity will assess the component in the context of the particular market structure to which the risk relates and in which the hedging activity takes place. This is true for both contractually specified and non-contractually specified risks, as well as for risks related to both financial and non-financial items.

Observations – Evaluation of separately identifiable and reliably measurable

IFRS 9.B6.3.8–B6.3.10

The evaluation of whether a risk component is separately identifiable and reliably measurable may require judgement. If a component is explicitly specified in a contract – e.g. a pricing formula that uses a reference to a benchmark commodity price – then concluding that it is separately identifiable may be straightforward. If the component is not contractually specified, then the entity will need to consider factors such as whether it is a price component of the entire item – e.g. crude oil prices may be a price component of jet fuel prices. Whether sufficient observable forward transactions for the component exist may be a factor to consider in concluding whether a component is reliably measurable. Knowledge of the relevant market structure will also be critical. There is no requirement that the component be the main or largest component, or that the movement of the fair value of the component be in the same direction as the value of the entire item.

Possible approach to evaluation of separately identifiable and reliably measurable



Observations – Qualifying items: risk components of non-financial items

IFRS 9.B6.3.8–B6.3.10

IAS 39 treats financial and non-financial items differently regarding the risk components that may be designated as hedged items.

Under IAS 39, financial items may be hedged for risks that are separately identifiable and reliably measurable, but non-financial items may only be hedged in their entirety for all risks or for foreign exchange risk. This has caused inconsistencies between risk management strategies and hedge accounting, which were commonly noted as concerns during the IASB's outreach activities.

The new standard applies the separately identifiable and reliably measurable criteria to both financial and non-financial items.

Manufacturers often hedge their inventory with derivatives that have underlyings related to the raw materials used to produce that inventory. For example, a tyre manufacturer may use a rubber forward contract to hedge its tyre inventory. Under IAS 39, the manufacturer can hedge the entire price risk in the inventory, but not the rubber component only. Also, entities may use derivative contracts to hedge the forecast sales or purchases of a commodity of a different grade. For example, a manufacturer of premium chocolate may use an exchange grade quality cocoa forward contract to hedge its forecast purchase of premium grade cocoa. Under IAS 39, the price risk of the entire purchase can be hedged, but not the exchange grade quality component only.

Under the new standard, such risk components may be eligible for hedge accounting. This will allow entities that use commodity derivatives greater flexibility in applying hedge accounting.

Example – Contractually specified risk component

IFRS 9.B6.3.10

Company B has a long-term supply contract to buy natural gas. The contract is priced using a contractually specified formula that references gas oil, fuel oil and transportation charges. B's risk management strategy is to hedge 100% of its exposure to gas oil price risk, and B enters into a gas oil forward contract to hedge that price risk. The contract explicitly specifies how the gas oil component is determined. In addition, there is a market for gas oil forward instruments that extends to the maturity of the supply contract. Thus, B determines that the gas oil price exposure is separately identifiable and reliably measurable. Therefore, the gas oil price exposure is an eligible risk component for designation as a hedged item.

Example – Non-contractually specified risk component

IFRS 9.B6.3.10

Company C has a long-term supply contract to buy jet fuel. C's risk management strategy is to hedge a portion of its exposure to jet fuel price risk based on expected consumption up to 24 months before delivery. C then increases the coverage volume as delivery gets nearer. C uses the following derivatives as hedging instruments based on the liquidity of the respective derivative markets and the time remaining until the forecast purchase:

- 12 months to 24 months: crude oil contracts;
- six months to 12 months: gas oil contracts; and
- under six months: jet fuel contracts.

Crude oil and gas oil are not contractually specified components of jet fuel prices. Therefore, C has to determine whether crude oil and gas oil are separately considered in pricing jet fuel. C analyses the market structure for oil and oil products and determines that there is a relationship between crude oil and gas oil prices, and jet fuel prices. C determines that the relationship results from different refining margins (also known as 'cracking spreads') that allow the price of jet fuel to be made up of building blocks. Therefore, C is exposed to these two risk components, even though they are not specified contractually: crude oil and gas oil prices. If C determines that the two risk components are separately identifiable and reliably measurable, then it may designate crude oil or gas oil as risk components of the forecast jet fuel purchases.

IFRS 9.B6.3.13–B6.3.15

The new standard states that there is a rebuttable presumption that, unless inflation is contractually specified, it is not separately identifiable and reliably measurable. Therefore, it is not an eligible risk component of a financial instrument.

The new standard notes that in limited cases it is possible to designate non-contractually specified inflation as a risk component of a financial instrument because of the particular circumstances of the inflation environment and the relevant debt market.

Observations – Qualifying items: inflation

IFRS 9.B6.3.14

If an entity wishes to hedge non-contractually specified inflation as a risk component, then it will have to determine whether it is capable of constructing an inflation curve based on observable real interest rates from a liquid market for the hedge period to rebut the presumption that non-contractually specified inflation is not separately identifiable and reliably measurable. This may be challenging in some environments.

The existence of a government-sponsored price index for a country – e.g. a consumer price index or producer price index – is not sufficient to construct an inflation curve using real interest rates for the hedge period. This is because price indexes are generally developed using historical and current prices, whereas an inflation curve represents expectations of future prices.

6.3 Layer components and net positions

6.3.1 Components of nominal amounts

IFRS 9.6.3.7(c), B6.3.16

Under the new standard, two types of components of nominal amounts can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component.

IFRS 9.B6.3.17

An example of a component that is a proportion of an entire item is designating 50 percent of the interest payments of a fixed-rate bond as the hedged item in a fair value hedging relationship.

IFRS 9.B6.3.18

A layer component may be specified from:

- a defined, but open, population; or
- a defined nominal amount.

Example – Layer components

IFRS 9.B6.3.18

Examples of layer components include:

- part of a monetary transaction volume – e.g. the next FC10 cash flows from sales denominated in a foreign currency after the first FC20 in March 20X1 (where 'FC' denotes foreign currency);
- part of a physical volume – e.g. the bottom layer, measuring 5 million cubic metres, of the natural gas stored in location XYZ;
- part of a physical or other transaction volume – e.g. the first 100 barrels of oil purchases in June 20X1 or the first 100 MWh of electricity sales in June 20X1; or
- a layer from the nominal amount of the hedged item – e.g. the last 80 of a 100 firm commitment, the bottom layer of 20 of a fixed-rate bond of 100 or the top layer of 30 from a total amount of 100 of fixed-rate debt that can be prepaid at fair value (the defined nominal amount is 100).

IFRS 9.B6.3.19

The layer component may be designated as the hedged item in a fair value hedging relationship, in which case an entity is required to specify it from a defined nominal amount. The ability to designate such a component is a change from current accounting under IAS 39.

To comply with the requirements for qualifying fair value hedges, an entity is required to remeasure the hedged item for fair value changes attributable to the hedged risk. The fair value hedge adjustment should be recognised in profit or loss no later than when the item is derecognised.

Consequently, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal amount from which it is defined – e.g. for a fixed-rate bond of 100, the total defined nominal amount of 100 will need to be tracked in order to track a bottom layer of 20 or a top layer of 30.

IFRS 9.B6.3.20

Under the new standard, a layer component of a contract that includes a prepayment option whose fair value is affected by changes in the hedged risk will be eligible as a hedged item in a fair value hedge only if the effect of the option is included in determining the change in fair value of the hedged item.

Observations – Layer component of a nominal amount

Designating a layer or proportion component of a nominal amount as the hedged item can give rise to different accounting outcomes.

For example, assume that a five-year, 100 debt instrument repays 20 per year. If the hedged component is designated as 20 percent of the debt instrument – i.e. a proportion component – then the determination of the gain or loss on the hedged component due to the hedged risk would consider 20 percent of all the cash flows of the instrument over its entire life. Alternatively, if the hedged component were the last 20 of principal of the debt instrument – i.e. a bottom layer – then the determination of the gain or loss on the hedged component would consider only the last payment of 20. This may result in a more effective hedging relationship.

6.3.2 Eligibility of a group of items as the hedged item

IFRS 9.6.6.1(a)–(b)

Under the new standard, a group of items, including both gross and net positions, will have to meet the following conditions to be an eligible hedged item for fair value and cash flow hedges:

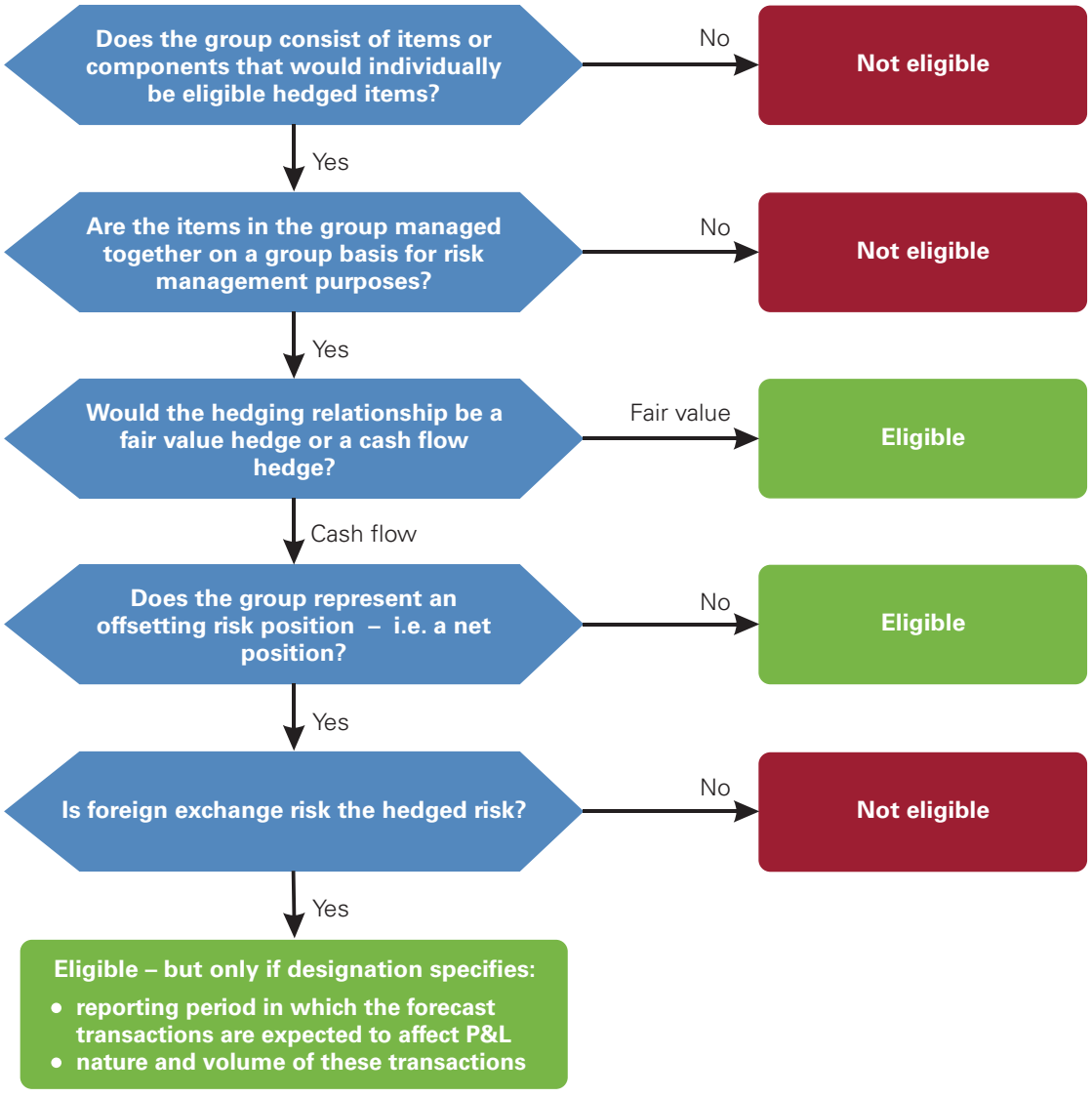
- the position consists of items, including components of items, that would individually be eligible hedged items; and
- the items in the group are managed together on a group basis for risk management purposes.

IFRS 9.6.6.1(c), B6.6.7–B6.6.8

In addition to meeting the two conditions above, for a cash flow hedge of a group of items whose variability in cash flows are not expected to be approximately proportional to the group's overall variability in cash flows so that an offsetting risk position arises, the net position is eligible as a hedged item only if:

- it is a hedge of foreign currency risk; and
- the designation specifies the reporting period in which the forecast transactions are expected to affect profit or loss as well as their nature and volume.

Eligibility of a group of items as the hedged item



Observations – Increased ability to hedge groups of items

IAS 39.83

Under IAS 39, for a group of items to qualify for hedge accounting, they need to meet additional criteria:

- the individual items within the group are required to have similar risk characteristics; and
- the change in the fair value attributable to the hedged risk for each individual item in the group is required to be approximately proportional to the overall change in the fair value of the group for the hedged risk.

IFRS 9.B6.6.8

These restrictions are not consistent with the way that many entities manage risk. The new standard does not require entities to meet these criteria to hedge a gross position. The 'similar risk characteristics' criterion is replaced by a requirement that the items in the group are managed together on a group basis for risk management purposes. In addition, the new standard may allow hedge accounting in some cases where the 'approximately proportional' test could not be met under IAS 39; however, cash flow hedges of net positions are limited to hedges of foreign currency risk.

Observations – Limitation for group cash flow hedges of risks other than foreign currency

IFRS 9.6.6.1(c)

Foreign exchange risk is the only risk permitted to be designated in a cash flow hedge of a group of items that contains offsetting risk positions – for example:

- a group comprises both forecast purchases and forecast sales; and
- the effect of the hedged foreign exchange risk on the forecast purchases serves to offset the effect of the hedged foreign exchange risk on the forecast sales.

Together, the forecast sales and forecast purchases create a net position with respect to foreign exchange risk – e.g. a top layer of foreign currency-denominated forecast sales of 100 and a top layer of foreign currency-denominated forecast purchases of 150.

An entity may manage the effect of other risks – e.g. commodity price risk – on the cash flows of groups of items that contain offsetting positions for risk management purposes, but it will not be able to achieve cash flow hedge accounting based on those groups. However, alternative hedge accounting strategies may be available – e.g. designating separate cash flow hedges of the gross positions of forecast sales and forecast purchases, or alternatively designating a single cash flow hedge of any excess purchases or sales – i.e. an 'over-hang' position.

Observations – No additional limitation on the hedged risk for fair value hedges of a group

IFRS 9.6.6.1

Unlike for cash flow hedges of net positions – which are limited to foreign currency risk – fair value hedges of groups may be designated for any otherwise eligible risk, as long as the following two criteria are met:

- the position consists of items, including components of items, that would individually be eligible hedged items; and
- the items in the group are managed together on a group basis for risk management purposes.

Example – Specifying the reporting period in which forecast transactions are expected to affect profit or loss as well as their nature and volume

IFRS 9.6.6.1(c), B6.6.8

Company R has a net position that consists of a top layer of FC100 of sales and a top layer of FC150 of purchases. Both sales and purchases are denominated in the same foreign currency.

The documentation for cash flow hedges of net positions for foreign currency risk will be required to specify the reporting period in which the forecast transactions are expected to affect profit or loss as well as their nature and volume.

To sufficiently specify the designation of the hedged net position, R specifies in its original documentation of the hedging relationship that sales can be of Product A or Product B and that purchases can be of Machinery Type A, Machinery Type B and Raw Material A.

R also specifies the volumes of the transaction by each nature, as follows.

Sales	Purchases
R documents that the top layer of sales (FC100) is made up of a forecast sales volume of the first FC70 of Product A and the first FC30 of Product B. If those sales volumes are expected to affect profit or loss in different reporting periods, then R will include that in its documentation. For example: • the first FC70 from sales of Product A that are expected to affect profit or loss in the first reporting period; and • the first FC30 from sales of Product B that are expected to affect profit or loss in the second reporting period.	R documents that the top layer of purchases (FC150) is made up of purchases of the first FC60 of Machinery Type A, the first FC40 of Machinery Type B and the first FC50 of Raw Material A. If those purchase volumes are expected to affect profit or loss in different reporting periods, then R will include in the documentation a disaggregation of the purchase volumes by the reporting periods in which they are expected to affect profit or loss. For example: • the first FC60 of purchases of Machinery Type A that are expected to affect profit or loss from the third reporting period over the next 10 reporting periods; • the first FC40 of purchases of Machinery Type B that are expected to affect profit or loss from the fourth reporting period over the next 20 reporting periods; and • the first FC50 of purchases of Raw Material A that are expected to be received in the third reporting period and sold – i.e. affect profit or loss – in that and the next reporting period.

Specifying the nature of the forecast transaction volumes would include aspects such as the depreciation pattern for items of property, plant and equipment of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items.

For example, if R uses items of Machinery Type A in two different production processes that result in straight-line depreciation over 10 reporting periods and the units of production method respectively, then its documentation of the forecast purchase volume for Machinery Type A would disaggregate that volume into those depreciation patterns that would apply.

IFRS 9.B6.6.1 A net position is eligible as a hedged item in a fair value or a cash flow hedge only if the entity hedges the exposure on a net basis for risk management purposes. Whether an entity hedges on a net basis is a matter of fact and is not based solely on assertion or documentation.

IFRS 9.B6.6.4 Under the new standard, if an entity applies hedge accounting to a net position, then it is required to designate the overall group of items that includes the items that make up the net position.

Example – Requirement to designate the overall group of items when applying hedge accounting to a net position

IFRS 9.B6.6.4 Company S has a group of firm foreign currency-denominated sale commitments in nine months' time for 100. It also has a group of firm foreign currency-denominated purchase commitments in 18 months' time for 120. In this case, when S designates the group that constitutes a net position as the hedged item, it cannot designate an abstract amount of a net position up to 20 – i.e. an over-hang position. Instead, it designates a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position in a cash flow hedge.

IFRS 9.B6.6.5 To determine whether a hedge of a net position is effective, an entity considers the changes in the fair value or cash flows of the items in the net position that have a similar effect to the hedging instrument in conjunction with the fair value change on the hedging instrument. (For more on assessing effectiveness, see Section 7.)

Example – Determining whether a hedge of a net position is effective

IFRS 9.B6.6.5, B6.6.9 Continuing the previous example, Company S hedges the foreign currency risk of the group that constitutes the net short position of 20 using a forward exchange contract for 20. When determining whether the hedge effectiveness requirements are met, S considers the relationship between:

- the foreign currency risk-related changes in:
  - the value of the group of 100 firm foreign currency-denominated sale commitments; and
  - the fair value changes of the hedging instrument contract for 20; and
- the foreign currency risk-related changes in the value of the group of 120 firm foreign currency-denominated purchase commitments.

When determining the amounts that are recognised in the cash flow hedge reserve, S compares:

- the fair value change on the forward exchange contract together with the foreign currency risk-related changes in the value of the sales transactions; with
- the foreign currency risk-related changes in the value of the purchase transactions.

However, S recognises only amounts related to the forward exchange contract in OCI until the sales transactions are recognised in the financial statements, at which time the gains or losses on these transactions are recognised – i.e. the change in the value attributable to the change in the foreign exchange rate between the designation of the hedging relationship and the recognition of revenue.

IFRS 9.6.6.6 An otherwise eligible group that is a nil net position – i.e. the hedged items among themselves fully offset the risk that is managed on a group basis – would be eligible to be designated as the hedged item in a hedging relationship that does not include a hedging instrument if:

- the hedge is part of a rolling net risk hedge strategy for a hedged position that changes in size over time;
- over the life of the rolling net risk hedge strategy, eligible hedging instruments would be used to hedge the net risk when the net position is not nil;

- hedge accounting is normally applied to such net positions when the net position is not nil, and it is hedged with eligible hedging instruments; and
- not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

IFRS 9.BC6.467

The IASB noted that a group that is a nil net position would be coincidental and would therefore be rare in practice.

Example – Determining whether a hedge of a net nil position is effective

IFRS 9.B6.6.6, B6.6.10

Continuing the previous example, suppose that Company S had a nil net position – e.g. a top layer of FC100 of sales and a top layer of FC100 of purchases that are both denominated in the same foreign currency and no separate foreign exchange forward contract. In this case, S would consider the relationship between:

- the foreign currency risk-related changes in the value of the group of firm foreign currency-denominated sale commitments; and
- the foreign currency risk-related changes in the value of the group of firm foreign currency-denominated purchase commitments

to determine whether the hedging relationship is effective.

When determining the amounts that are recognised in the cash flow hedge reserve, S would compare:

- the foreign currency risk-related changes in the value of the sales transactions; and
- the foreign currency risk-related changes in the value of the purchase transactions.

However, those amounts would be recognised only once the related transactions are recognised in the financial statements.

Example – Reclassification of profit or loss from the cash flow hedge reserve in a cash flow hedge of a net position

IFRS 9.B6.6.15

On 1 January 20X1, Company M entered into a group of firm foreign currency-denominated sale commitments in three months' time for FC100 and a group of firm foreign currency-denominated commitments to pay expenses in six months' time for FC80. It hedged the foreign currency risk of the group that constitutes the net position of FC20 using a forward exchange contract to sell FC20 after three months. In this case, the journal entries will be as follows.

LC = local currency

FC = foreign currency

Date	Spot rate*	Forward rate*	Fair value of forward
1 January 20X1	LC1 = FC1	LC1 = FC1	-
31 March 20X1	LC1 = FC0.5	LC1 = FC0.5	(20)
30 June 20X1	LC1 = FC0.4	-	-

* For simplicity, it is assumed that the spot rate and the forward rate are the same.

	Debit	*Credit*
1 January 20X1 No journal entry		
31 March 20X1 Cash Sales *To recognise sales of FC100 at the spot rate (FC100 ÷ 0.5 FC/LC).*	200	200
Cash flow hedge reserve Forward contract *To recognise change in fair value of forward.*	20	20
Profit or loss Cash flow hedge reserve *To recognise hedge adjustment for sale transaction. The 100 is composed of 20 of losses on the FX forward contract and 80 of FX losses on the expenses that will occur in 3 months. The result of the accounting is to reflect that the hedge fixed the sales price in LC terms at LC100.*	100	100
Forward contract Cash *To record settlement of forward contract.*	20	20
30 June 20X1 Expenses Cash *To record payment of expenses of FC80 at the spot rate (FC80 ÷ 0.4 FC/LC).*	200	200
Cash flow hedge reserve Profit or loss *To recognise hedge adjustment for expense transaction. The amount remaining in the cash flow hedge reserve is reclassified to profit or loss. The result of the accounting is to reflect that the net position made up of the sales and the expenses was hedged for foreign exchange risk with the forward contract for three months – i.e. from 1 January to 31 March.*	80	80

In summary, the increase in expenses (in LC terms) caused by foreign exchange movements – which normally would not be recognised until 30 June – and the loss on the foreign exchange forward contract offset the increase in sales (in LC terms) caused by foreign currency movements at 31 March (i.e. the net position was hedged for foreign exchange risk for the 3 months ended 31 March). The profit or loss for the period ending 30 June is adjusted to reflect the fact that 80 of the increase in expenses (in LC terms) caused by foreign exchange movements was already recognised in the period ended 31 March – i.e. its recognition was accelerated to effect the hedge accounting for the net position.

Observations – Hedges of net positions

Business units within an entity are exposed to various risks in the normal course of business. These business units often transfer the risks to one central business unit within the entity, using internal derivatives. Many of the risks transferred to the central business unit naturally offset one another. The central business unit in turn transfers risk to external parties on a net basis. This is a common risk management strategy used to reduce transaction costs and counterparty credit risk exposure.

IAS 39 does not allow net position hedging that would reflect the risk management strategy described above. By allowing net position hedging for fair value hedges and for cash flow hedges of foreign exchange risk, the new standard better aligns hedge accounting with this kind of risk management strategy.

Because the ability to designate net positions is new, entities will need to consider what information systems and internal procedures they need in order to operationalise hedge accounting on a net position basis. They may also need to consider how, if at all, hedge accounting that has been applied in the business units using the internal derivatives as hedging instruments needs to be documented differently or adjusted in group financial statements.

6.3.3 Designating a component of a nominal amount of a group of items

IFRS 9.6.6.2–6.6.3

Under the new standard, an entity could designate a proportion of an eligible group of items as a hedged item if it is consistent with the entity's risk management objective. An entity can also designate a layer component of an eligible group of items – e.g. the bottom layer – if the following requirements are met:

- the layer is separately identifiable and reliably measurable;
- the risk management objective is to hedge a layer component;
- the items in the overall group from which the layer is identified are exposed to the same hedged risk;
- for hedges of existing items, an entity can identify and track the overall group of items from which the hedged layer is defined; and
- the change in fair value of the hedged layer in a fair value hedge considers the effect of any prepayment options of individual items within the group if the fair value of the prepayment option is affected by the hedged risk.

IFRS 9.B6.6.8

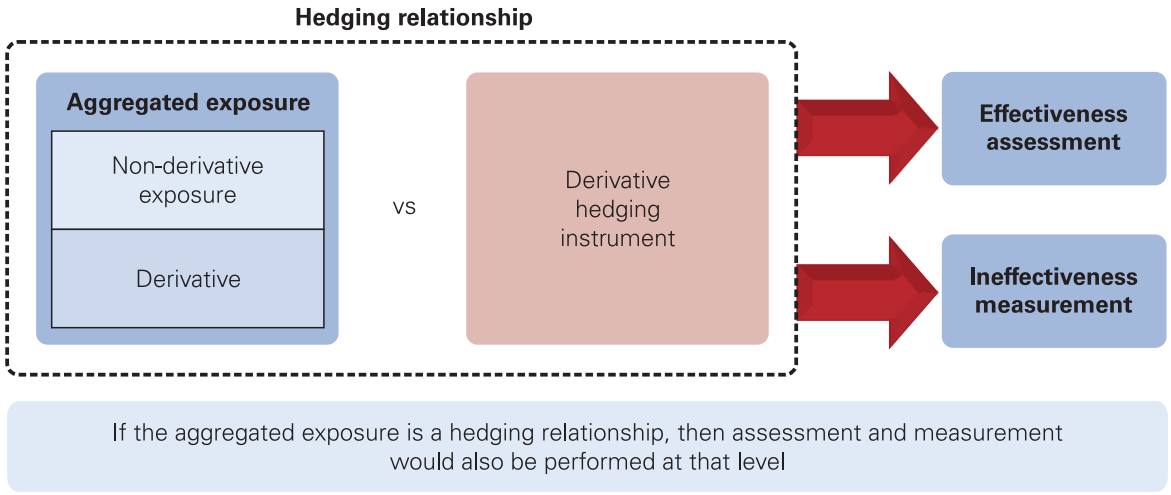
A hedging relationship can include layers from multiple different groups of items. For example, assume a net position hedge of a group of highly probable forecast sales and a group of highly probable forecast purchases: the hedging relationship can comprise, in combination, a layer component of the group of sales and a layer component of the group of purchases.

6.4 Aggregated exposures

IFRS 9.6.3.4

An aggregated exposure consists of a non-derivative exposure that could qualify as a hedged item and a derivative. Such a combination may create a different exposure that is managed as a single exposure for a particular risk or risks. Under the new standard, an entity may designate such an aggregated exposure as the hedged item. The components that make up the aggregated exposure do not need to be designated in a separate hedging relationship.

Effectiveness assessment and ineffectiveness measurement of a hedge of an aggregated exposure



If the aggregated exposure is a hedging relationship, then assessment and measurement would also be performed at that level

IFRS 9.B6.3.3

Entities are sometimes required economically to enter into transactions that can result in different aggregated risk exposures. These transactions may include a derivative. Under an entity's risk management strategy, these exposures may be managed together or separately. Under the new standard, entities will be allowed to hedge these exposures as one, even though they include a derivative.

Example – Aggregated exposure: cash flow hedge/cash flow hedge

IFRS 9.IE7–IE19

Company X is a euro functional currency entity. It hedges its US dollar-denominated 1,000 tonne forecast purchase of steel using a US dollar-denominated steel forward contract. The forward contract has a delivery date that matches the expected delivery of the forecast purchase. X documents this as a cash flow hedge and designates:

- the forecast steel purchase as the hedged item;
- the variability in US dollar cash flows from the forecast purchase due to steel prices as the hedged risk; and
- the forward steel contract as the hedging instrument.

One month later, X enters into a foreign currency forward contract to hedge the foreign exchange risk between the euro and the US dollar arising from both the US dollar-denominated forecast steel purchase and the US dollar-denominated forward contract, because it views the two collectively as a US dollar aggregated exposure.

The new standard will allow X to document this second-level hedge as a cash flow hedge in which it would designate:

- the aggregated US dollar fixed price exposure as the hedged item;
- the variability in euro cash flows related to the euro/US dollar foreign exchange risk as the hedged risk; and
- the foreign currency forward contract as the hedging instrument.

Example – Aggregated exposure: fair value hedge/cash flow hedge

IFRS 9.IE20–IE29

Company Y is a euro functional currency entity. It issues a 20-year, fixed-rate US dollar-denominated debt of 10,000 that pays interest semi-annually. It hedges the change in fair value of the debt due to foreign currency and interest rate risks by entering into a receive-fixed-US-dollar-interest pay-variable-euro-interest cross-currency interest rate swap. Y documents this as a fair value hedge and designates:

- the debt as the hedged item;
- the change in fair value of the debt due to foreign currency and interest rate changes as the hedged risks; and
- the cross-currency interest rate swap as the hedging instrument.

One year later, Y decides to hedge the variability of cash flows due to interest rate risk associated with this aggregated exposure for the next five years using a five-year euro-denominated receive-variable pay-fixed interest rate swap. Y views its US dollar-denominated fixed-rate debt and the cross-currency interest rate swap collectively as a euro-denominated variable-rate 20-year aggregated exposure.

The new standard will allow Y to document this second-level hedge as a cash flow hedge in which it designates:

- the next five years of interest payments from the 20-year aggregated exposure as the hedged item;
- the variability of euro cash flows from this aggregated exposure due to interest rate risk for the next five years as the hedged risk; and
- the five-year interest rate swap as the hedging instrument.

Example – Aggregated exposure: cash flow hedge/fair value hedge

IFRS 9.IE30–IE39

Continuing the example above, if Company Y's US dollar-denominated debt had a variable rate, then it could use a cross-currency interest rate swap – e.g. receive-variable-US-dollar interest, pay-fixed-euro interest – to fix the cash flows, designating the hedge as a cash flow hedge. The aggregated fixed rate euro exposure of the debt and cross-currency interest rate swap could then be the hedged item in a fair value hedge.

To the extent that the first-level cash flow hedge is effective, the accounting for the aggregated exposure would be analogous to that of a financial asset that is classified as available-for-sale under IAS 39. That is, the effective portion of the cross-currency interest rate swap in the first-level hedge would be recognised in OCI, as would the change in fair value of an available-for-sale asset.

As part of the accounting for the second-level fair value hedge, the change in fair value of the aggregated exposure attributable to the hedged risk would be reclassified from OCI to profit or loss, as would the change in fair value of an available-for-sale asset attributable to the hedged risk if it were a hedged item in a fair value hedge.

Observations – Interaction between first-level and second-level hedges

There is no need to de-designate and re-designate the first-level hedge when establishing the second-level hedge. This avoids complexity and increased ineffectiveness, because the derivative in the first hedge would probably have a fair value other than zero at that time.

Furthermore, the new standard does not require hedge accounting to be applied at the first level to apply hedge accounting to a second-level hedge. That is, if an entity fails to achieve hedge accounting for a first-level hedge or chooses not to apply hedge accounting, then the second-level hedge may qualify for hedge accounting.

6.5 Equity investments at FVOCI

IFRS 9.5.7.5, BC6.105–BC6.116

Under IFRS 9, an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of an investment in equity instruments in OCI if the investment is not held for trading. Under the new standard, an entity can designate such an investment as a hedged item in a fair value hedge. Changes in the fair value of the derivatives and hedged items will be reflected in OCI; therefore, any hedge ineffectiveness will be recognised in OCI. These changes will never be reclassified from AOCI to profit or loss.

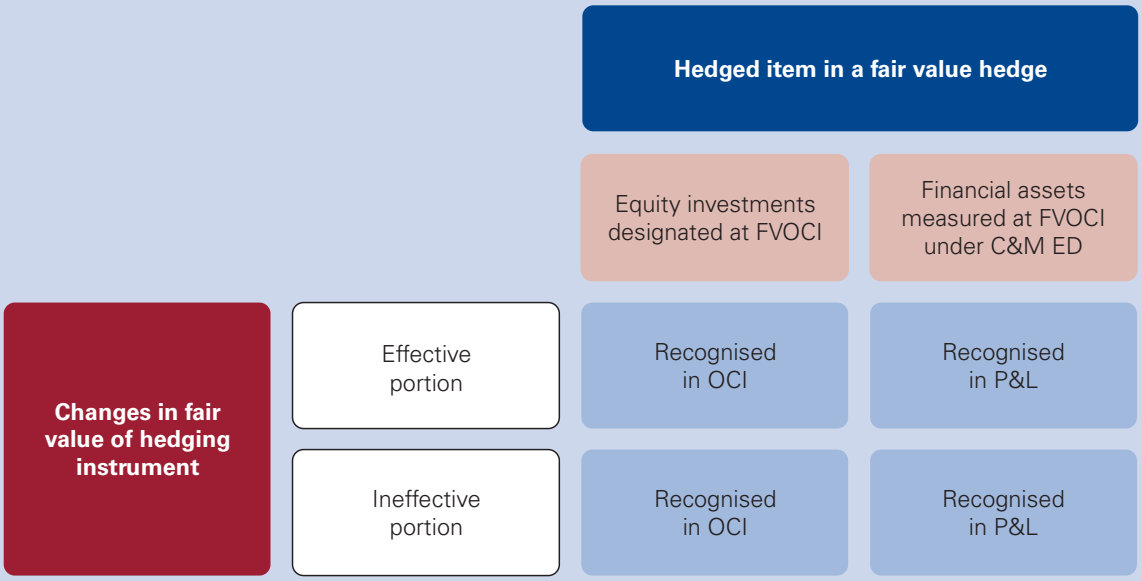
Observations – Fair value hedges of financial assets at FVOCI

The IASB issued its exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (the C&M ED) in November 2012. In the C&M ED, the IASB proposed requiring certain financial assets to be measured at FVOCI if:

- the financial assets are held in a business model in which assets are managed both to collect contractual cash flows and for sale; and
- the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

The hedge accounting requirements for those financial assets measured at FVOCI in accordance with the C&M ED would be different from those for equity investments at FVOCI described in 6.5. This is because for those financial assets measured at FVOCI in accordance with the C&M ED, interest income and gains and losses would be recognised in profit or loss as if the assets were measured at amortised cost. Accordingly, amounts recognised in OCI would be subject to reclassification from equity to profit or loss – e.g. when the financial assets are derecognised. Therefore, the general hedge accounting requirements – rather than those related to FVOCI investments in equity instruments – will continue to apply to hedges of cash flow or fair value risks arising from those financial assets measured at FVOCI in accordance with the C&M ED, including the recognition of hedge ineffectiveness in profit or loss.

Recognising changes in fair value



6.6 'Sub-LIBOR' prohibition

IFRS 9.B6.3.21–B6.3.22 The new standard retains the requirement from IAS 39 that a component of the cash flows of a financial or non-financial item designated as the hedged item should be less than or equal to the total cash flows of the entire item. The new standard reiterates that all of the cash flows of the entire item may be designated as the hedged item and hedged for only one particular risk. For example, in the case of a financial liability that has an effective interest rate below LIBOR, an entity cannot designate both:

- a component of the liability equal to interest at LIBOR (plus the principal amount in the case of a fair value hedge); and
- a negative residual component.

IFRS 9.B6.3.23 However, for example, in the case of a fixed rate financial liability whose effective interest rate is below the benchmark rate (e.g. 100 basis points below LIBOR), an entity may designate as the hedged item the change in the value of the entire liability (i.e. principal plus interest at LIBOR minus 100 basis points).

IFRS 9.B6.3.23 In addition, if a fixed rate financial instrument is hedged some time after its origination, and interest rates have changed in the meantime, then an entity can designate a risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designated the hedged item.

Example – Sub-LIBOR issue in a non-financial context

IFRS 9.B6.3.25

An entity has forecast sales of a specific type of crude oil from a particular oil field that is valued using Brent crude oil. Suppose that it sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at Brent minus 10 with a floor of 15. In this case, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in Brent. Therefore, as long as the forward price (for each delivery) does not fall below 25, the hedged item has the same cash flow variability as a crude oil sale at Brent (or with a positive spread). However, if the forward price for any delivery falls below 25, then the hedged item has a lower cash flow variability than a crude oil sale at Brent (or with a positive spread).

7 Hedge effectiveness

7.1 Overview

IFRS 9.B6.4.1

'Hedge effectiveness' is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item. 'Hedge ineffectiveness', however, is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item.

IFRS 9.B6.4.2

Under the new standard, when designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.

IFRS 9.6.4.1(c)

A hedging relationship will meet the hedge effectiveness requirements if:

- there is an economic relationship between the hedged item and the hedging instrument;
- the effect of credit risk does not dominate the value changes that result from the economic relationship;
- the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:
  - the hedged item that the entity actually hedges; and
  - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and
- the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness – whether or not it is recognised – to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

7.2 Economic relationship between the hedged item and the hedging instrument

IFRS 9.B6.4.4

Having an 'economic relationship' means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk – i.e. the hedged risk.

In other words, there is required to be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either:

- the same underlying; or
- underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged – e.g. Brent and West Texas Intermediate (WTI) crude oil.

IFRS 9.B6.4.5

It may be that the underlyings are not the same but are economically related. In this case, there can be situations when the values of the hedging instrument and the hedged item move in the same direction. An example is when the price differential between two related underlyings changes while the underlyings themselves do not move significantly. Such situations still meet the 'economic relationship' test if the values of the hedging instrument and the hedged item are still typically expected to move in the opposite direction when the underlyings move.

IFRS 9.B6.4.6 An entity should analyse the possible behaviour of the hedging relationship during its term, to ascertain whether the relationship can be expected to meet the risk management objective. The mere existence of a statistical correlation between two variables does not, by itself, demonstrate that an economic relationship exists.

7.3 Effect of credit risk

IFRS 9.B6.4.7 The hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item. Therefore, the effect of credit risk on the value of both the hedging instrument and the hedged item will impact hedge effectiveness.

The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is so great that the credit risk dominates the value changes that result from the economic relationship. That is, the loss (or gain) from credit risk frustrates the effect of changes in the underlyings on the value of the hedging instrument or the hedged item – even if those changes were significant.

Conversely, if during a particular period there is little change in the underlyings, then even small credit risk-related changes in the value of the hedging instrument or hedged item might affect the value more than the underlyings. However, this does not create dominance.

IFRS 9.B6.4.8 An example where credit risk could dominate a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, then the effect of changes in the counterparty's credit standing might start to outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas the changes in the value of the hedged item will continue to depend largely on the commodity price changes.

7.4 Hedge ratio

IFRS 9.B6.4.9 The hedge effectiveness guidance requires the hedge ratio of the hedging relationship to be the same as that resulting from the actual quantities of:

- the hedged items; and
- the hedging instruments used.

For example, an entity hedges 85 percent of the exposure on an item. The hedging relationship should be designated using a hedge ratio resulting from:

- 85 percent of the exposure; and
- the quantity of the hedging instrument that the entity actually uses to hedge that 85 percent.

Similarly, suppose that an entity hedges an exposure using a nominal amount of 40 units of a financial instrument. It should therefore designate the hedging relationship using a hedge ratio that is the same as that resulting from:

- that quantity of 40 units (and not based on a higher or lower quantity); and
- the quantity of the hedged item that it actually hedges with those 40 units.

IFRS 9.B6.4.10 The hedged item and hedging instrument should not be intentionally weighted to reflect an imbalance that would create hedge ineffectiveness – whether or not it is recognised – that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. An entity adjusts the hedge ratio if doing so is necessary to avoid such an imbalance.

Observations – Risk management and hedge effectiveness assessment

Establishing an appropriate hedge ratio is primarily a risk management decision. In other words, an entity should analyse the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective.

IFRS 9.B6.4.18

Entities are responsible for clearly defining and consistently applying their effectiveness assessment policies. Management information (or analysis) used for decision-making purposes can be used as a basis to assess whether a hedging relationship meets the hedge effectiveness requirements.

An entity cannot, under the guise of risk management, use a hedge ratio that results in a deliberate mismatch that creates ineffectiveness to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. This is a judgemental area.

IFRS 9.B6.4.11

In assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting, an entity considers:

- whether the intended hedge ratio is established:
  - to avoid recognising hedge ineffectiveness for cash flow hedges; or
  - to achieve fair value hedge adjustments for more hedged items, with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and
- whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though that creates hedge ineffectiveness.

Example – Commercial reason for particular weightings of the hedged item and the hedging instrument

IFRS 9.B6.4.11(b)

Company X hedges 100 tonnes of highly probable future coffee purchases using standard coffee futures contracts that have a contract size of 37,500 lb (pounds). Because the standard volume of the hedging instrument does not allow X to enter into exactly 100 tonnes of hedging instrument (a 'lot size issue'), X could only use either five or six contracts (equivalent to 85.0 and 102.1 tonnes respectively) to hedge the purchase volume of 100 tonnes – i.e. it is not practical to achieve the theoretical best hedge.

In this case, X designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

7.5 Frequency of and methods for assessing hedge effectiveness

IFRS 9.B6.4.12

Under the new standard, an entity assesses hedge effectiveness:

- at the inception of the hedging relationship; and
- on an ongoing basis – at a minimum, each reporting period or on a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.

The assessment relates to expectations about hedge effectiveness; therefore, the test will be only forward-looking or prospective.

IFRS 9.B6.4.13 The new standard does not specify a methodology, either quantitative or qualitative, for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity should use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness.

IFRS 9.B6.4.14 If the critical terms of the hedging instrument and the hedged item – e.g. the nominal amount, maturity and underlying – match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

IFRS 9.B6.4.15 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether hedge ineffectiveness arising from that fact could be of such a magnitude that a qualitative assessment would not adequately consider it.

IFRS 9.B6.4.16 Conversely, if the critical terms are not closely aligned, then there will be increased uncertainty about the extent of offset. Therefore, an entity may sometimes need to use a quantitative effectiveness assessment methodology to support its conclusion that an economic relationship exists between the hedged item and the hedging instrument. Similarly, the entity might also need a quantitative assessment of whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements.

Observations – Qualitative or quantitative assessment

IFRS 9.B6.4.14

If the critical terms of the hedging instrument and the hedged item match or are closely aligned, then a qualitative effectiveness assessment may be appropriate. In other cases, a quantitative assessment may be more appropriate. The new standard provides examples of critical terms, but does not define 'critical terms' or 'closely aligned'. These concepts are important in determining the type of effectiveness assessment that should be used; therefore, an entity will have to use its judgement in developing accounting policies to identify which terms it considers critical and what it considers to be closely aligned.

IFRS 9.B6.4.17 An entity would have to consider the need to change assessment methodologies if there were changes in circumstances that affected hedge effectiveness. This is to ensure that all relevant characteristics of the hedging relationship, including sources of hedge ineffectiveness, are still captured.

Observations – No more bright lines

The hedge effectiveness assessment under the new standard is forward-looking only and it does not prescribe an arbitrary bright line effectiveness range. This will require changes to systems and procedures, because they are currently focused on documenting that hedging relationships are retrospectively (and in some cases prospectively) effective within a range of 80 to 125 percent. Judgement will have to be applied to determine whether the entity's new hedge accounting documentation provides sufficient evidence that the hedging relationship meets the hedge effectiveness requirements.

7.6 Measurement of hedge ineffectiveness

IFRS 9.BC6.278–BC6.279

Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

IFRS 9.B6.5.4

When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

IFRS 9.B6.5.5

To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item. This is commonly referred to as a 'hypothetical derivative'. For the purpose of applying the new standard, using a hypothetical derivative is not a method in its own right, but is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and therefore results in the same outcome as if that change in value was determined by a different approach. Therefore, using a hypothetical derivative is a mathematical expedient. Consequently, a hypothetical derivative cannot be used to include features in the value of the hedged item that only exist in the hedging instrument, and not in the hedged item. An entity may also assess whether a hedging relationship meets the hedge effectiveness requirements by using a hypothetical derivative.

Observations – Using a hypothetical derivative to measure hedge ineffectiveness

IFRS 9.B6.5.5

The new standard makes clear that a hypothetical derivative cannot be used to include features in the value of the hedged item that only exist in the hedging instrument, and not the hedged item.

For example, a debt is denominated in a foreign currency. When using a hypothetical derivative to calculate the present value of the cumulative change in cash flows, an entity cannot simply impute a foreign currency basis spread in the hypothetical derivative – even though actual derivatives under which different currencies are exchanged might include such a charge – e.g. cross-currency interest rate swaps.

If an entity wants to prevent foreign currency basis spreads from affecting measurements of hedge ineffectiveness, then it should consider excluding the foreign currency basis spread of the hedging financial instrument from the designation of the hedging relationship (see 5.4).

Entities may have to reassess their current hedging strategies to ensure that their current methods of assessing effectiveness and measuring ineffectiveness are compliant with the requirements under the new standard.

Observations – Using a hypothetical derivative in a fair value hedge

IFRS 9.6.2.4(b)

Under IAS 39, hypothetical derivatives were only used for cash flow hedges. However, under the new standard the use of a hypothetical derivative will also be permitted for fair value hedges, as long as the hypothetical derivative was not constructed to include features in the value of the hedged item that only exist in the hedging instrument.

This change does not appear to have a practical consequence, because the new standard also clarifies that the measurement of the change in fair value of the hedged item caused by the hedged risk should be the same regardless of whether a hypothetical derivative is used.

8 Rebalancing

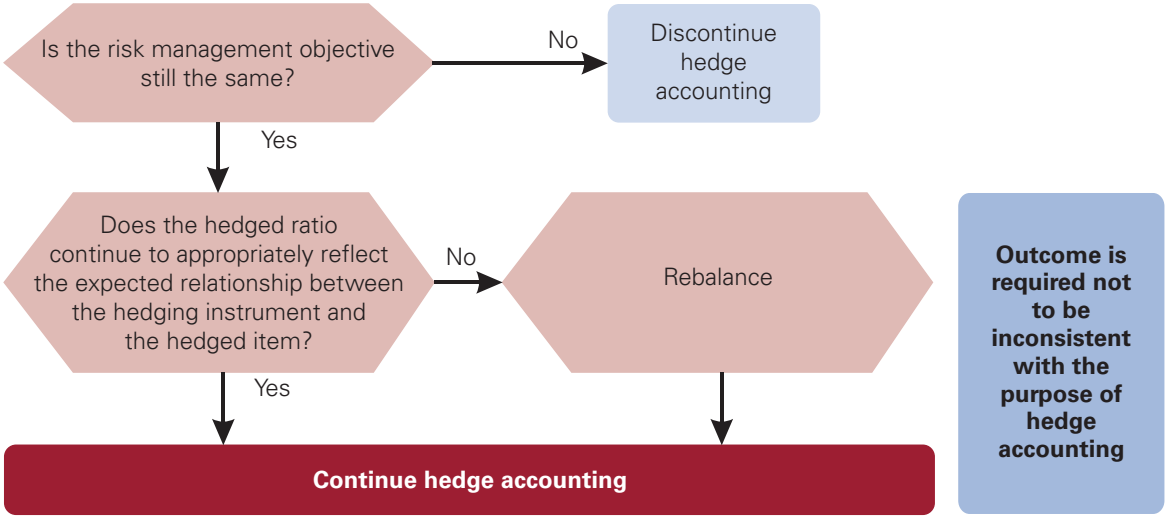
8.1 Overview

IFRS 9.6.5.5, B6.5.15

A hedging relationship may subsequently fail to meet the hedge effectiveness requirement regarding the hedge ratio – e.g. the hedge ratio may no longer represent what is actually used for risk management; however, the entity's risk management objective for that designated hedging relationship may remain the same. In this case, under the new standard an entity would adjust the hedge ratio so that it meets the qualifying criteria again. If the risk management objective for that designated hedging relationship has changed, then rebalancing does not apply. Instead, hedge accounting for that designated hedging relationship is discontinued.

IFRS 9.B6.5.7–B6.5.21

Rebalancing model for a change in the extent of offset of the hedging relationship



IFRS 9.B6.5.8

Rebalancing a hedging relationship would allow hedge accounting to continue in situations where the change in the relationship of the hedging instrument and the hedged item can be compensated for by adjusting the hedge ratio. Any hedge ineffectiveness to date would be recognised in profit or loss immediately before rebalancing the hedging relationship.

IFRS 9.B6.5.9

By adjusting the hedge ratio, an entity would compensate for changes in the relationship between the hedging instrument and the hedged item arising from the underlyings or risk variables. This adjustment would allow an entity to continue the hedging relationship when the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.

IFRS 9.6.4.1(c), B6.5.14

If the hedge ratio is adjusted through rebalancing, then it has to satisfy the same criteria that are required to qualify for hedge accounting in the first place – i.e. the hedge ratio:

- should typically reflect the quantities of the hedging instrument and the hedged item that the entity actually uses, but
- should not result in an accounting outcome that is inconsistent with the purpose of hedge accounting (see 7.4).

IFRS 9.B6.5.11

Not every change in the extent of offset constitutes a change in the relationship between the hedging instrument and hedged item. An entity would determine whether the changes in offset are:

- fluctuations around a hedge ratio that remains valid; or
- an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

Example – Evaluating changes in offset

IFRS 9.B6.5.10–B.6.5.11

Background

Company B hedges its price risk exposure to a forecast purchase of a commodity in Location C with exchange-traded contracts for the same commodity but of a different grade in Location D.

Hedge ratio remains valid – B should not rebalance

Due to fluctuations in transportation costs of the commodity in Location C, B recognises some ineffectiveness on the hedging relationship. B determines that:

- the fluctuations in transportation costs are within the expected range of fluctuations in its risk management policy; and
- there has not been a long-term or systematic change in the relationship between the price of the commodity in Location C and the price of the exchange-traded contracts for the commodity in Location D.

The amounts of the hedged item and the hedging instruments have not changed for risk management purposes; therefore, there would be an expectation that the hedging relationship would remain within the expected range. The change in the extent of offset is therefore a matter of measuring and recognising hedge ineffectiveness, but not of adjusting the hedge ratio.

Hedge ratio is no longer appropriate – B should rebalance

Assume that there is a change in the relationship between the two commodities; therefore, the correlation between the price of the commodity in Location C and the price of the exchange-traded commodity contracts in Location D is altered. In this case, rebalancing the hedge ratio to reflect the new correlation would ensure that the hedging relationship maintains a hedge ratio that complies with the hedge effectiveness requirements. An example of such a change might be a new use for one of the commodities, such that demand for it has been increased for the foreseeable future.

Hedge ratio is no longer appropriate – B should discontinue hedge accounting

If there was a default by the counterparty of the derivative commodity contract, then changing the hedge ratio would not ensure that the hedging relationship meets the hedge effectiveness requirements. Therefore, rebalancing does not enable B to continue a hedging relationship when the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.

IFRS 9.B6.5.21

If an entity rebalances a hedging relationship, then it updates its hedge documentation. This includes analysing the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term.

8.2 Mechanics

IFRS 9.B6.5.16

Under the new standard, a rebalancing adjustment of the hedging relationship can be effected as follows:

- an entity can increase the weighting of the hedged item either by increasing the volume of the hedged item or by decreasing the volume of the hedging instrument; or
- it can increase the weighting of the hedging instrument either by increasing the volume of the hedging instrument or by decreasing the volume of the hedged item.

The changes in volume refer to the quantities that are part of the hedging relationship. Decreases in volume do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur; instead, they mean that the items or transactions are not part of the hedging relationship. A rebalancing that results in a decrease in the volume of the hedged item is treated as a partial discontinuation of that part of the hedging relationship (see 9.2).

Summary of the mechanics of rebalancing

Adjustment	Measurement of fair value changes	
	Hedged item	Hedging instrument
Increase volume of hedged item	Previously designated volume unchanged; additional volume is included from date of rebalancing	Unchanged
Decrease volume of hedged item	Reduced volume unchanged; decrease in volume is discontinued from date of rebalancing	Unchanged
Increase volume of hedging instrument	Unchanged	Previously designated volume unchanged; additional volume is included from date of rebalancing
Decrease volume of hedging instrument	Unchanged	Reduced volume unchanged; decrease in volume is measured at FVTPL from date of rebalancing

Observations – Beginning amortisation after rebalancing

Rebalancing a fair value hedging relationship may involve decreasing the volume of a hedged item that is a financial instrument. In this case, the entity may need to begin amortising the amount related to the volume that is no longer part of the hedging relationship. This means that entities will have to keep track of the accumulated gains or losses for the risk being hedged at the level of the individual hedged items.

Observations – Effect of rebalancing on subsequent changes in value

Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect the measurement of the hedged item or the measurement of the previously designated hedging instrument. However, increasing the volume of the hedging instrument affects subsequent changes in the value of the instrument in two ways:

- subsequent changes in the value of the hedging instrument will reflect the increase in the volume of the hedging instrument; and
- it is likely that the original hedging instrument and the additional hedging instrument have different terms, because they were entered into at different times; therefore, subsequent changes in the value of the hedging instrument would be different, reflecting the difference in terms.

A similar effect occurs when an entity adjusts the hedge ratio by increasing the volume of the hedged item – e.g. increasing the size of a forecast transaction.

An entity may need to enhance its hedge accounting systems to be able to perform the necessary calculations for the above situations.

9 Discontinuation

9.1 Discontinuation of an entire hedging relationship

IFRS 9.6.5.6, B6.5.26

Under the new standard, a hedging relationship is discontinued in its entirety when as a whole it ceases to meet the qualifying criteria after considering the rebalancing of the hedging relationship (if applicable). Voluntary discontinuation when the qualifying criteria are met is prohibited. Examples of when discontinuation would be required include the following scenarios:

- the risk management objective for the hedging relationship has changed;
- the hedging instrument expires or is sold, terminated or exercised[1];
- there is no longer an economic relationship between the hedged item and hedging instrument; or
- the effect of credit risk starts dominating the value changes that result from the economic relationship.

IFRS 9.B6.5.28

If an entity discontinues a hedging relationship, then it can designate a new hedging relationship that involves the hedging instrument or the hedged item; however, that designation constitutes the start of a new hedging relationship, not the continuation of the old one.

Observations – Discontinuing a hedging relationship and starting a new hedging relationship with the same hedging instrument

Beginning a new hedging relationship with an existing hedging instrument that has a fair value other than zero may result in hedge ineffectiveness. This is because the initial fair value of the instrument is itself subject to change with market changes. Unless an offsetting fair value effect is also present in the hedged item, hedge ineffectiveness may result.

9.2 Partial discontinuation of a hedging relationship

IFRS 9.6.5.6, B6.5.27

A part of a hedging relationship is discontinued when only part of the hedging relationship ceases to meet the qualifying criteria. This may be as a result of rebalancing (see 8.2) or when some of the volume of the hedged item that is a forecast transaction is no longer highly probable to occur. When partial discontinuation applies, hedge accounting continues for the remainder of the hedging relationship.

IFRS 9.B6.5.27

For example, an entity fails to predict the volume of hedged highly probable forecast transactions accurately. As a result, the expected volume is lower than the originally designated volume. In this case, partial discontinuation would be appropriate.

1 This excludes scenarios in which the expiration or termination is a replacement or rollover of a hedging instrument into another that is part of, and consistent with, the entity's documented risk management objective. Discontinuation would not be required in these scenarios.

9.3 History of forecast transactions failing to occur

IFRS 9.B6.5.27

If an entity has a history of designating forecast transactions as hedged items and subsequently determining that the forecast transactions are no longer expected to occur, then this may call into question:

- the entity's ability to predict forecast transactions accurately; and
- whether similar forecast transactions would be highly probable and therefore eligible as hedged items.

9.4 Clearing derivatives with central counterparties

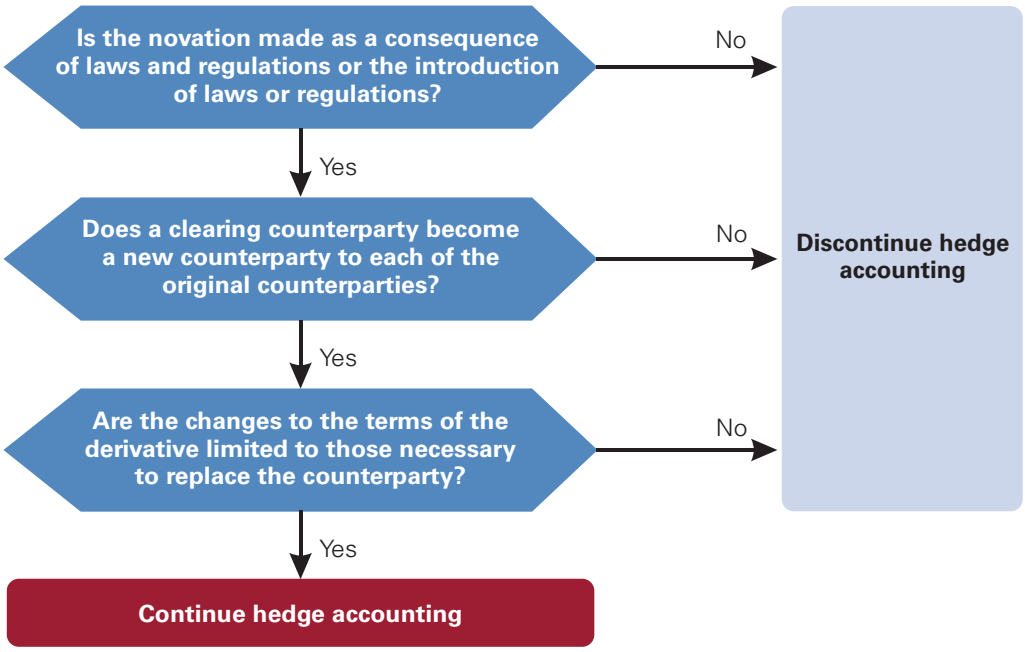
IFRS 9.6.5.6

The new standard carries forward amendments that were made in 2013 as part of *Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39)*[2] to provide relief from discontinuing an existing hedging relationship if a novation that was not contemplated in the original hedging documentation meets the following criteria:

- the novation is made as a consequence of laws or regulations or the introduction of laws or regulations;
- the novation results in one or more clearing counterparties becoming the new counterparty to each of the parties to the novated derivative; and
- any changes to the terms of the novated derivative are limited to those that are necessary to effect such a replacement of the counterparty, but only if those changes are consistent with the terms that would be expected if the novated derivative were originally cleared with the clearing counterparty; these changes include:
  - changes in the contractual collateral requirements of the novated derivative;
  - rights to offset receivables and payables balances with the clearing counterparty; and
  - charges levied by the clearing counterparty.

IFRS 9.6.5.6

How to apply the criteria



2 See our In the Headlines – Continuing hedge accounting after derivative novations for more information.

IFRS 9.6.5.6

If the parties to the hedging instrument replace their original counterparties with different counterparties, then relief is available only if each of those parties effects clearing with the same central counterparty.

Observations – Continuing a hedging relationship after the hedging instrument is novated to a clearing counterparty

For hedging relationships that continue after the hedging instrument is novated to a clearing counterparty, the new standard will still be applied as usual to account for the derivative and the hedging relationship. For example, any changes in the credit quality of the counterparty, or in the contractual collateral requirements, will be reflected in the fair value of the novated derivative and in the measurement of hedge ineffectiveness.

Observations – Relief from discontinuation not provided in all circumstances

The amendments provide relief when a novation meets the criteria listed above. However, there may be other situations in which a derivative is novated that will not be eligible under the amendments – e.g. an entity agrees to a counterparty novating an over-the-counter derivative to a third party as a consequence of laws or regulations, and no clearing counterparty is introduced.

To mitigate the risk that novation in circumstances not covered by the amendments would cause hedge accounting to be discontinued, an entity may wish to state in its hedge documentation that its intention is for the hedging relationship to continue if the hedging derivative is subsequently novated in other circumstances.

10 Presentation

10.1 Cash flow hedges

IFRS 9.6.5.11(d)

Under the new standard, for a hedge of a forecast transaction resulting subsequently in the recognition of a non-financial item, an entity will:

- remove the entire amount related to that transaction in the cash flow hedge reserve from equity; and
- include it directly in the initial cost or other carrying amount of the item.

This accounting will also apply to a forecast transaction subsequently resulting in the recognition of a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied.

For all other cash flow hedges – e.g. cash flow hedges over forecast transactions resulting in the recognition of financial instruments – the amount related to the transaction in the cash flow hedge reserve will be reclassified to profit or loss in the same period or periods during which the hedged cash flows affect profit or loss.

Observations – Cash flow hedges that result in recognition of non-financial items

IAS 39.98, 99, IFRS 9.6.5.11(d)

Under IAS 39, if a hedge of a forecast transaction later results in the recognition of a non-financial item, then an entity has an accounting policy choice to:

- treat the associated gains and losses that were accumulated in the cash flow hedge reserve as a basis adjustment; or
- retain these amounts in the reserve and reclassify them to profit or loss as the asset acquired or liability assumed affects profit or loss.

Under IAS 39, this accounting also applies to a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied.

The new standard removes this accounting policy election.

Observations – Reclassification adjustments vs basis adjustments

IFRS 9.6.5.11(d)(i)

Cash flow hedge reserves related to a non-financial item are recognised as an adjustment to the basis of the non-financial item. These basis adjustments are not presented in the statement of profit or loss and OCI. They are removed from the cash flow reserve – i.e. from equity. They will affect profit or loss (and be reflected in the statement of profit or loss and OCI) in the same manner and periods as the non-financial items to which they relate affect profit or loss – e.g. through depreciation expense for items of property, plant and equipment; cost of sales for inventories; or impairment because the adjustments are automatically included when a non-financial asset is tested for impairment.

IFRS 9.6.5.11(d)(ii)

However, the basis of a financial item is not adjusted for cash flow hedge reserves. The related cash flow hedge reserves remain in equity until the financial item affects profit or loss. The direct reclassifications from the cash flow hedge reserve in equity to profit or loss meet the definition of a 'reclassification adjustment' under IAS 1. All reclassification adjustments are reflected in the statement of profit or loss and OCI in the period during which they happen.

An entity's financial reporting systems will need to correctly distinguish between basis adjustments and reclassification adjustments arising from hedge accounting to prepare the statement of profit or loss and OCI and related disclosures.

10.2 Fair value hedges

IFRS 9.BC6.353–BC6.370

The IASB considered reducing the complexity of hedge accounting and improving the usefulness of the reported information by proposing some changes to the presentation and mechanics of fair value hedge accounting in its December 2010 exposure draft on hedge accounting. Most respondents supported providing the information proposed in that exposure draft – e.g. the change in the hedged items' fair value due to the risk being hedged; however, many disagreed with providing it on the face of the financial statements or changing the fair value hedge accounting mechanics. Consequently, during redeliberations the IASB decided to retain the fair value hedge accounting mechanics in IAS 39; however, the Board required additional disclosures so that users of financial statements could further understand the effects of hedge accounting on the financial statements.

10.3 Hedged groups

IFRS 9.6.6.5

For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss in the statement of financial position on the individual assets and liabilities is recognised as an adjustment of the respective individual items comprising the group.

IFRS 9.B6.6.14

For cash flow hedges or fair value hedges of a group of items that does not have any offsetting risk positions, the hedging instrument gains or losses (reclassified to profit or loss for cash flow hedges) will be apportioned to the line items in the statement of profit or loss and OCI that are affected by the hedged items on a rational basis. The net gains or losses arising from a single hedging instrument will not be grossed up.

IFRS 9.6.6.4, B6.6.15

Under the new standard, if a group of items in a fair value or cash flow hedge has offsetting risk positions affecting different line items in the statement of profit or loss and OCI, then any hedging instrument gains or losses in profit or loss (reclassified profit or loss for cash flow hedges) will be presented in a separate line from those affected by the hedged items. Therefore, in the statement of profit or loss and OCI the amount in the line item that relates to the hedged item itself – e.g. revenue or cost of sales – remains unaffected. The requirement to present the hedging instrument's net gains and losses in a separate line item avoids grossing up a single hedging instrument's net gains or losses into offsetting gross amounts and recognising them in different line items in the statement of profit or loss and OCI.

IFRS 9.B6.6.16

For some types of fair value hedges, the objective of the hedge is not primarily to offset the fair value changes of the hedged item but instead to transform the cash flows of the hedged item. For example, assume that an entity hedges the fair value interest rate risk of a fixed-rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap into profit or loss.

IFRS 9.6.6.16

In the case of a hedge of a net position – e.g. a net position of a fixed-rate asset and a fixed-rate liability – this net interest accrual is required to be presented in a separate line item in the statement of profit or loss and OCI. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising them in different line items – e.g. this avoids grossing up net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense.

11 Disclosures

11.1 Overview

IFRS 9.C11 (IFRS 7.21A) For those risk exposures that an entity hedges, and for which it elects to apply hedge accounting, an entity discloses:

- its risk management strategy and how it applies that strategy to manage risk;
- how its hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on its financial position and performance.

Observations – Judgement needed for new disclosures

IFRS 9.BCA26 (IFRS 7.BC35C–BC35D)

Financial statement users have expressed to the IASB that they do not find current hedge accounting disclosures helpful, and that the disclosures do not provide transparency on an entity's hedging activities. The IASB has therefore designed the new disclosure requirements to address these concerns.

The increased level of judgement inherent in the new hedge accounting requirements is complemented by extensive new disclosure requirements. Financial statement preparers will need to give thoughtful consideration and exercise judgement in providing information that is useful and relevant to users of the financial statements.

IFRS 9.C11 (IFRS 7.21B) Under the new standard, an entity will present the required disclosures in a single note or separate section in its financial statements. However, it will not need to duplicate information that is already presented elsewhere – e.g. management commentary or risk report – provided that this information is incorporated by cross-reference and is available to users of the financial statements on the same terms as the financial statements and at the same time.

IFRS 9.C11 (IFRS 7.21C) For those disclosures that will require an entity to separate by risk category the information disclosed, each category of risk will be determined on the basis of the risk exposures that the entity decides to hedge and for which hedge accounting is applied. Such determinations will be made consistently for all hedge accounting disclosures.

IFRS 9.C11 (IFRS 7.21D) Although an entity will be allowed to determine the extent of aggregation or disaggregation of the disclosures, it should consider the level of aggregation that it uses for other disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement*.

11.2 Risk management strategy

IFRS 9.C11 (IFRS 7.22A) The new standard includes the concept that an entity will explain its risk management strategy for each risk category of risk exposures that it decides to hedge and for which hedge accounting is applied. The explanation should enable users of financial statements to evaluate, for example:

- how each risk arises;
- how the entity manages each risk, including whether the entity hedges an item in its entirety for all risks or hedges a risk component(s) of an item and why; and
- the extent of risk exposures that the entity manages.

IFRS 9.C11 (IFRS 7.22B) Minimum disclosures to meet the above requirements will include a description of:

- the hedging instruments and how they are used to hedge risk exposures;

- how the entity determines the economic relationship between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness; and
- how the entity establishes the hedge ratio and what the sources of hedge ineffectiveness are.

IFRS 9.C11 (IFRS 7.22C) When an entity designates a specific risk component as a hedged item, it should disclose additional qualitative or quantitative information about:

- how it determined the risk component that is designated as the hedged item, including a description of the nature of the relationship between the risk component and the item as a whole; and
- how the risk component relates to the item in its entirety – e.g. the designated risk component historically covered on average 80 percent of the changes in fair value of the item as a whole.

11.3 Amount, timing and uncertainty of future cash flows

IFRS 9.C11 (IFRS 7.23A) Under the new standard, an entity discloses, by risk category, quantitative information to enable users of its financial statements to evaluate:

- the terms and conditions of hedging instruments; and
- how they affect the amount, timing and uncertainty of future cash flows of the entity.

IFRS 9.C11 (IFRS 7.23B) The following breakdown is required to meet the above requirement:

- a profile of the timing of the nominal amount of the hedging instrument; and
- if applicable, the average price or rate – e.g. strike or forward prices – of the hedging instrument.

IFRS 9.C11 (IFRS 7.23C) There are situations in which an entity frequently resets – i.e. discontinues and restarts – hedging relationships because both the hedging instrument and the hedged item frequently change – i.e. the entity uses a dynamic process in which both the exposure and the hedging instruments used to manage that exposure do not remain the same for long. In this case, the entity is exempted from providing the above quantitative disclosures. Instead, it discloses:

- information about what the ultimate risk management strategy is in relation to those hedging relationships;
- a description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
- an indication of how frequently the hedging relationships are discontinued and restarted as part of the entity's process in relation to those hedging relationships.

IFRS 9.C11 (IFRS 7.24D) When the volume of hedging relationships to which the above exemption applies is unrepresentative of normal volumes during the period – i.e. the volume at the reporting date does not reflect the volumes during the period – an entity discloses that fact and the reason it believes the volumes are unrepresentative.

IFRS 9.C11 (IFRS 7.23D–23E) For each risk category, an entity discloses a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. If other sources of hedge ineffectiveness emerge in the hedging relationship, then an entity:

- discloses those sources; and
- explains the resulting hedge ineffectiveness.

IFRS 9.C11 (IFRS 7.23F) For cash flow hedges, an entity discloses a description of any forecast transaction for which hedge accounting was used in the previous period, but that is no longer expected to occur.

11.4 Effects of hedge accounting on financial position and performance

IFRS 9.BCA26 (IFRS 7.BC35EE)

Users of financial statements have informed the IASB that they do not analyse an entity's hedging activities by type of hedging relationship – e.g. cash flow hedge or fair value hedge. Instead, users want to understand the risks that an entity manages and the results after hedging. However, to be effective, information on the effects of hedge accounting on financial position and performance should reflect the applied accounting treatment – e.g. cash flow hedge accounting or fair value hedge accounting. The IASB believes that information presented in a tabular format, prepared by risk category and by type of hedge, will provide sufficient links between the accounting information and the risk management information.

11.4.1 Hedging instrument

IFRS 9.C11 (IFRS 7.24A)

Under the new standard, an entity discloses, in a tabular format, the following amounts related to items designated as hedging instruments, separately by risk category for each type of hedge:

- the carrying amount of the hedging instruments, separating financial assets from financial liabilities;
- the location of the hedging instrument in the statement of financial position;
- the change in fair value of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period; and
- the nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.

IFRS 9.IGA14 (IFRS 7.IG13C)

The following example illustrates how the above information might be disclosed.

	Nominal amount of the hedging instrument	Carrying amount of the hedging instrument		Line item in the statement of financial position where the hedging instrument is located	Changes in fair value used for calculating hedge ineffectiveness for 20X1
		Assets	Liabilities		
Cash flow hedges					
Commodity price risk • Forward sales contracts	xx	xx	xx	Line item xx	xx
Fair value hedges					
Interest rate risk • Interest rate swaps	xx	xx	xx	Line item xx	xx
Foreign exchange risk • Foreign currency loan	xx	xx	xx	Line item xx	xx

11.4.2 Hedged item

An entity discloses, in a tabular format, the following amounts related to hedged items separately by risk category for the types of hedges as follows.

IFRS 9.C11
(IFRS 7.24B(a))

Fair value hedges	• The carrying amount of the hedged item recognised in the statement of financial position, separating assets from liabilities. • The accumulated amount of fair value hedge adjustments on the hedged item included in the above carrying amount. • The location of the hedged item in the statement of financial position. • The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period. • The balance of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses.

IFRS 9.C11
(IFRS 7.24B(b))

Cash flow hedges and hedges of a net investment in a foreign operation	• The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period. • The balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges. • The balances remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting is no longer applied.

IFRS 9.IGA14
(IFRS 7.IG13D)

The following example illustrates how the above information might be disclosed.

	Carrying amount of the hedged item		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Line item in the statement of financial position in which the hedged item is included	Change in value used for calculating hedge ineffective-ness for 20X1	Cash flow hedge reserve	Foreign currency translation reserve
	Assets	Liabilities	Assets	Liabilities				
Fair value hedges								
Interest rate risk								
• Loan payable	-	xx	-	xx	Line item xx	xx	N/A	N/A
• Discontinued hedges (loan payable)	-	xx	-	xx	Line item xx	xx	N/A	N/A
Foreign exchange risk								
• Firm commitment	xx	xx	xx	xx	Line item xx	xx	N/A	N/A
Cash flow hedges								
Commodity price risk								
• Forecast sales	N/A	N/A	N/A	N/A	N/A	xx	xx	N/A
• Discontinued hedges (forecast sales)	N/A	N/A	N/A	N/A	N/A	N/A	xx	N/A
Hedges of net investment in a foreign operation								
Foreign exchange risk								
• Long-term receivable from subsidiary	N/A	N/A	N/A	N/A	N/A	xx	N/A	xx
• Discontinued hedges (long-term receivable from subsidiary)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	xx

11.4.3 Hedge ineffectiveness and hedging gains or losses

An entity discloses, in a tabular format, the following amounts separately by risk category for each type of hedge.

IFRS 9.C11 (IFRS 7.24C(a))	**Fair value hedges**	• Hedge ineffectiveness – i.e. the difference between the hedging gains or losses of the hedging instrument and the hedged item – recognised in profit or loss (or OCI for hedges of an equity instrument for which an entity has elected to present changes in fair value in OCI). • The location of the recognised hedge ineffectiveness in the statement of profit or loss and OCI.
IAS 1.7, 92, IFRS 9.C11 (IFRS 7.24C(b))	**Cash flow hedges and hedges of a net investment in a foreign operation**	• Hedging gains or losses of the reporting period that were recognised in OCI. • Hedge ineffectiveness recognised in profit or loss. • The location of the recognised hedge ineffectiveness in the statement of profit or loss and OCI. • The amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (see IAS 1), differentiating between: – amounts for which hedge accounting has previously been used, but for which the hedged future cash flows are no longer expected to occur; and – amounts that have been transferred because the hedged item has affected profit or loss. • The location of the reclassification adjustment (see IAS 1) in the statement of profit or loss and OCI. • For hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of profit or loss and OCI.

IFRS 9.IGA14 (IFRS 7.IG13E)

The following example illustrates how the above information might be disclosed.

Fair value hedges	Ineffectiveness recognised in profit or loss	Ineffectiveness recognised in OCI	Line item(s) in profit or loss and OCI (that include(s) hedge ineffectiveness)
Interest rate risk	xx	N/A	Line item xx
Foreign exchange risk	xx	N/A	Line item xx
Equity price risk	N/A	xx	Line item xx

	Separate line item recognised in profit or loss as a result of a hedge of a net position[b]	Change in the value of the hedging instrument recognised in OCI	Hedge ineffective-ness recognised in profit or loss	Line item in profit or loss (that includes hedge ineffective-ness)	Amount reclassified from the cash flow hedge reserve to profit or loss	Amount reclassified from the foreign currency translation reserve to profit or loss	Line item affected in profit or loss because of the reclassific-ation
Cash flow hedges[a]							
Commodity price risk							
• Commodity X	N/A	xx	xx	Line item xx	xx	N/A	Line item xx
• Discontinued hedge	N/A	N/A	N/A	N/A	xx	N/A	Line item xx
Hedges of net investment in a foreign operation							
Foreign exchange risk							
• Long-term receivable from subsidiary	N/A	xx	xx	Line item xx	N/A	xx	Line item xx
• Discontinued hedges (long-term receivable from subsidiary)	N/A	N/A	N/A	N/A	N/A	xx	Line item xx

(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.
(b) This disclosure applies only to cash flow hedges of foreign currency risk.

Observations – Hedge ineffectiveness recognised in profit or loss

IFRS 9.BCA26 (IFRS 7.BC35LL)

Entities are required to disclose the change in fair value of the hedging instrument and the change in value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of profit or loss and OCI.

The difference between these amounts in the table for hedged items and in the table for hedging instruments should be equal to the amounts disclosed in the table for hedge ineffectiveness recognised in the statement of profit or loss and OCI.

11.4.4 Reconciliation

IFRS 9.C11 (IFRS 7.24E–24F), BCA26 (IFRS 7.BC35EE)

An entity provides a reconciliation of AOCI in accordance with IAS 1, either in the statement of changes in equity or in the notes to the financial statements, separately by risk category. The reconciliation should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of profit or loss and OCI. Therefore, the reconciliation should differentiate, at a minimum, between:

- hedging gains or losses of the reporting period that were recognised in OCI in respect of cash flow hedges and hedges of a net investment in a foreign operation;
- the amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (differentiating between amounts for which hedge accounting was previously used but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss);

- the amount removed from the cash flow hedge reserve and included directly in the initial cost or other carrying amount of:
  - a non-financial asset or a non-financial liability that is recognised subsequent to a hedged forecast transaction; or
  - a firm commitment that results from a hedged forecast transaction for a non-financial asset or non-financial liability for which fair value hedge accounting is applied;
- the amount reclassified from the cash flow hedge reserve into profit or loss as a reclassification adjustment in relation to a loss (or a portion of it) that the entity does not expect to recover in one or more future periods;
- the amounts associated with the time value of purchased options that hedge transaction-related hedged items and amounts associated with the time value of purchased options that hedge time period-related hedged items (when an entity designates as the hedging instrument only the change in intrinsic value of the option); and
- the amounts associated with the forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge transaction-related hedged items and amounts associated with the forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge time period-related hedged items (when an entity designates as the hedging instrument only the change in the value of the spot element of the forward contract or excludes the foreign currency basis spread).

11.4.5 Credit exposures designated at FVTPL

IFRS 9.C11 (IFRS 7.24G) Under the new standard, if an entity designated a financial instrument, or a proportion of it, as measured at FVTPL because it uses a credit derivative to manage the credit risk of that financial instrument, then it will disclose:

- a reconciliation of each of the nominal amount and the fair value at the beginning and end of the period of the credit derivatives that have been used to manage the credit risk;
- the gain or loss recognised in profit or loss on designation of a financial instrument (or a proportion of it) as measured at FVTPL; and
- on discontinuation of measuring a financial instrument (or a proportion of it) at FVTPL, that financial instrument's fair value that has become the new carrying amount and the related nominal or principal amount[3].

IFRS 9.C11 (IFRS 7.8) In addition, the entity discloses separately the carrying amount of the financial instruments that have been so designated, either in the statement of financial position or in the notes.

IFRS 9.C11 (IFRS 7.9) IFRS 7 also requires an entity to provide additional disclosures if the entity has designated as measured at fair value a financial asset – or group of financial assets – that would otherwise be measured at amortised cost. If an entity uses a credit derivative to manage the credit risk of a financial asset and designates the financial asset as measured at FVTPL, then the entity discloses the following:

- the maximum exposure to credit risk of the financial asset (or group of financial assets) at the reporting date;
- the amount by which any related credit derivatives mitigate that maximum exposure to credit risk;
- the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk; and
- the amount of change in the fair value of any related credit derivative that has occurred during the period and cumulatively since the financial asset was designated.

3 Except for providing comparative information in accordance with IAS 1, an entity does not need to continue this disclosure in subsequent periods.

12 Effective date and transition

12.1 Effective date

IFRS 9.7.1.1

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. At its November 2013 meeting, the IASB tentatively decided that the mandatory effective date of the final IFRS 9 would be no earlier than annual periods beginning on or after 1 January 2017.

IFRS 9.7.11

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.

Observations – Pros and cons of early application

An entity considering whether to early adopt the new standard – e.g. for annual periods beginning on or after 1 January 2014 – may need to carefully weigh the pros and cons of early adoption. These may include the following.

Pros	Cons
• *Early access to benefits*: Entities may obtain the benefits of the new general hedging model more quickly – e.g. qualitative effectiveness assessments, hedging components of non-financial items, recognising forward points of forward contracts, time value of option contracts, and foreign currency basis spreads as 'costs of hedging'. • *Opportunity to play a leading role in the development of interpretations*: Entities that early adopt will be setting the early precedents for how the new standard may be applied.	• *Acceleration of other accounting changes*: This might include adopting the classification and measurement requirements of IFRS 9 (2010) and the additional hedge accounting and risk management disclosures of the new standard. • *Additional costs*: More time and expense may be required as a result of being among the first to deal with application issues and a greater risk that interpretative decisions might be superseded. • *Potential for two transitions*: Entities may have to transition to new classification and measurement requirements twice – once for IFRS 9 (2010) and again for the final classification and measurement amendments planned for release in 2014. • *Potential lack of comparability*: Peer companies may be located in jurisdictions where the new standard is not yet endorsed or otherwise available for application.

IFRS 9.7.1.2

The 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.

Observations – Early adoption of 'own credit risk' presentation

IFRS 9 (2010) requires that changes in the fair value of financial liabilities designated under the fair value option that are attributable to changes in the entity's own credit risk are generally presented in OCI and not in profit or loss.

The IASB decision to add the new split presentation for changes due to own credit risk to IFRS 9 (2010) was driven by feedback from constituents, including the Financial Crisis Advisory Group, who raised concerns about recognising the impact of changes in own credit risk in profit or loss when non-trading financial liabilities are measured at fair value. Many constituents were concerned, because banks and other entities that had designated financial liabilities under the fair value option recognised large gains in profit or loss as credit spreads on their own debt widened during the financial crisis. Banks have generally been the biggest users of the fair value option for financial liabilities, often in the context of interest rate and other economic hedging strategies. Some have been frustrated by the profit or loss volatility caused by these changes in credit spreads – including the losses recognised – as credit spreads subsequently narrowed.

However, because the mandatory effective date of IFRS 9 was first deferred from 1 January 2013 to 1 January 2015, and then subsequently removed entirely, many constituents have asked the IASB to amend IAS 39 to include the same separate presentation of own credit risk changes as IFRS 9 (2010). However, the IASB decided to permit an entity to early adopt only that portion of IFRS 9 instead.

That may be most helpful for entities in jurisdictions that do or will permit application of IFRS 9 before the entire standard is finalised. However, for entities in other jurisdictions, early adoption of the new separate presentation of own credit risk changes may remain unavailable for some time – e.g. endorsement of IFRS 9 for use in the EU is not expected to be considered until IFRS 9 is finalised.

IFRS 9.7.2.16

When an entity adopts the new standard, 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. However, the new disclosure requirements are not eligible to be deferred if the new standard is adopted.

Observations – Pros and cons of choosing an accounting policy to defer application of new general hedging model

When the final mandatory effective date of IFRS 9 arrives, it may still be several years before the IASB's project on macro hedging is completed. Entities considering whether to choose an 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 may need to carefully weigh the pros and cons of deferring application. These may include the following.

Pros	Cons
• *Deferring accounting change*: This enables existing IAS 39 hedging strategies, systems and processes to continue. • *Second-mover benefits*: Entities may allow practice to develop for applying the new general hedging model before having to apply it for the first time.	• *Forgoing the benefits of the new general hedging model for several years*: For example, qualitative effectiveness assessments, hedging components of non-financial items, recognising forward points of forward contracts, time value of option contracts, and basis spreads in cross-currency swaps as 'costs of hedging'. • *Potential lack of comparability*: Some peers may adopt the new general hedging model and use newly available hedging strategies.

Pros	Cons
• *Avoiding two potential changes*: An entity would have the benefit of seeing the outcome of the macro hedging project before deciding on changes to risk management and hedge accounting strategies.	• *Unintended consequences*: There may be some unintended consequences of adopting IFRS 9 when it becomes mandatorily effective but deferring application of the general hedging model – e.g. entities that currently hedge available-for-sale equity securities under IAS 39 would no longer be able to hedge equity securities measured at FVOCI because realised gains and losses on those securities would no longer affect profit or loss.

Observations – Potential diversity in financial instruments standards applied

The multi-phased approach to the development of IFRS 9 and the multiple adoption alternatives have created the potential for significant diversity in financial instruments accounting to exist for many years.

With the release of the new standard, there are now a number of permutations of application that are possible:

- applying IAS 39 in its entirety;
- applying IAS 39 plus early adopting the new 'own credit risk' presentation of IFRS 9 (2013);
- applying IFRS 9 (2009);
- applying IFRS 9 (2009) plus early adopting the new 'own credit risk' presentation of IFRS 9 (2013);
- applying IFRS 9 (2010), including the new 'own credit risk' presentation;
- applying IFRS 9 (2013), but electing an accounting policy to apply IAS 39 for all hedge accounting; and
- applying IFRS 9 (2013), including the new general hedging model.

Assuming that the final classification and measurement and impairment parts of IFRS 9 are finalised in 2014, at least two additional permutations appear likely to be possible:

- applying IFRS 9 (2014), but electing an accounting policy to apply IAS 39 for all hedge accounting; and
- applying IFRS 9 (2014), including the new general hedging model of IFRS 9 (2013).

While many of these possible permutations will go away once the eventual mandatory effective date of IFRS 9 is reached, an entity will still be permitted to 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. The final macro hedging standard may create additional diversity in application, depending on whether application of the eventual macro hedging model will be mandatory or optional – i.e. whether hedge accounting for macro hedges:

- will be required depending only on an entity's actual risk management activities; or
- will be an election whose availability is dependent on those activities.

The bottom line for preparers and users is that it will be several years before IFRS will have a single platform of financial instruments guidance.

12.2 Transition

IFRS 9.7.2.17, 7.2.21

The new hedge accounting requirements will be applied prospectively with limited exceptions.

- Retrospective application of the accounting for the time value of purchased options as a cost of hedging will be required for all hedging relationships in which the hedging instrument is designated under IAS 39 as the intrinsic value of an option. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.
- Retrospective application of the accounting for the forward element of forward contracts as a cost of hedging will be permitted for hedging relationships in which the hedging instrument is designated under IAS 39 as the spot element of a forward contract, provided that this election is applied consistently. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, then it is required to apply it to all hedging relationships that qualify for this election.
- Retrospective application of the accounting for foreign currency basis spreads as a cost of hedging is permitted for those hedging relationships that existed at the beginning of the earliest period or were designated thereafter.
- Retrospective application is mandatory for the requirement that there is not an expiration or termination of the hedging instrument if it meets the criteria in paragraph 6.5.6 of IFRS 9 related to clearing derivatives with central counterparties (see 9.4).

Observations – Retrospective application for foreign currency basis spreads

The new standard requires that – to retrospectively apply the accounting for the time value of purchased options or the forward element of forward contracts as a cost of hedging, among other things – the intrinsic value of the options or the spot element of the forward contracts should have been designated as the hedging instrument in the original hedging relationships under IAS 39. This is not required for the retrospective application of such accounting for foreign currency basis spreads.

IFRS 9.7.2.18, 7.2.20(a)

All qualifying criteria are required to be met as at the date of initial application of the new hedge accounting requirements in order to apply hedge accounting from that date. An entity may start to apply the new hedge accounting requirements from the point in time at which it ceases to apply the hedge accounting requirements in IAS 39. This would avoid any time lag and therefore significant changes in fair value on transition to the new model.

IFRS 9.7.2.19, 7.2.20(b)

Hedging relationships that qualify for hedge accounting in accordance with IAS 39 that also qualify under the new standard (after taking into account any rebalancing on transition) will be regarded as continuing hedging relationships. When applicable, an entity is required to use the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship. Any gain or loss from such a rebalancing is recognised in profit or loss.

Observations – Transition to the new general hedge accounting model

The new hedge accounting requirements will be applied prospectively to all hedging relationships – these include new hedging relationships as well as existing qualifying hedging relationships under IAS 39. For an existing qualifying hedging relationship under IAS 39 to be regarded as a continuing hedging relationship under the new hedge accounting requirements, the hedging relationship is required to meet all of the new hedge accounting requirements, including the hedge effectiveness requirements, at the time of transition to the new model. These include:

- ascertaining that an economic relationship exists between the hedged item and the hedging instrument – i.e. the hedging instrument and the hedged item have values that generally move in the opposite direction because of the hedged risk during the remaining term of the hedging relationship;
- ascertaining that the effect of credit risk does not dominate the value changes that result from the economic relationship; and
- identifying the sources of ineffectiveness and determining the hedge ratio. When applicable, an entity rebalances the hedge ratio using the hedge ratio in accordance with IAS 39 as the starting point. Any gain or loss arising from the rebalancing will be recognised in profit or loss.

Entities will have to update their hedge accounting documentation to ensure that any continuing hedging relationships meet the new requirements on the date of initial application.

IFRS 9.C37 (IAS 39.108E)

At the date of initial application, an entity may irrevocably designate an existing contract that meets the own-use scope exception to be measured at FVTPL (see 4.3), but only if it designates all similar contracts. The change in net assets resulting from such designations on transition will be recognised as an adjustment of retained earnings.

13 Development of IFRS 9

13.1 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 objective of the IASB's multi-phased project to replace IAS 39 is to improve and simplify the reporting for financial instruments. The IASB and the FASB (the Boards) are both working to overhaul the accounting for financial instruments. However, the Boards' projects are not in sync, and the IASB's work on hedge accounting has progressed at a quicker pace than the FASB's corresponding project. The IASB's general hedging model represents a more significant change than the FASB's proposed amendments.

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

13.2 Timeline to completion

19 November 2013:
New general hedge accounting model issued – part of 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

14 FASB proposals and convergence

The FASB issued its comprehensive proposals on financial instrument accounting in May 2010. Late in 2010, the IASB and the FASB published a progress report acknowledging that they have diverged on some important technical issues. In February 2011, the FASB issued an invitation to comment, *Selected Issues about Hedge Accounting,* to solicit input on the IASB exposure draft, in order to improve, simplify and bring about convergence of the financial reporting requirements for hedging activities. In August 2011, the FASB discussed the feedback received on the invitation to comment, but reached no decisions. In November 2011, the IASB staff presented to the FASB an education session on the IASB hedge accounting model. The FASB will redeliberate hedge accounting in the future and will consider all input.

Significant differences between the IASB's new general hedging model and the FASB's proposed model include the following.

Differences between	IFRS 9 – General hedging model	FASB's proposed model
Approach	Comprehensive review led to fundamental change.	Review addressed specific issues. The proposed model would retain most of the current provisions of hedge accounting and would make only several key changes.
Scope	Does not address macro hedges and carries forward the guidance in IAS 39 for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities. (The IASB is discussing macro hedging as a separate project.)	Includes all hedging relationships.
Non-derivative financial instruments designated as hedging instruments for foreign currency risk	Will be permitted under all hedging models.	Would be permitted for a hedge of a net investment in a foreign operation and a fair value hedge of a firm commitment.
Non-derivative financial instruments measured at FVTPL (fair value through net income) designated as hedging instruments for risks other than foreign currency	Will be permitted, unless the non-derivative is: • an equity instrument for which an entity has elected to present changes in fair value in OCI; or • a liability that has been designated under the fair value option for which the amount of changes in fair value attributable to changes in credit risk is presented in OCI.	Would be prohibited.

Differences between	IFRS 9 – General hedging model	FASB's proposed model
Allowable hedged risk components for financial instruments	Risk component will need to be separately identifiable and reliably measurable. It could be either contractually or non-contractually specified, and could combine different risk components. There will be a rebuttable presumption that unless inflation risk is contractually specified, it will not be an allowable hedged risk component. Certain credit exposures will be permitted to be designated under the fair value option as a substitute for hedge accounting.	Benchmark interest rate risk, foreign currency risk and credit risk, as well as a combination of these risks, would be allowed.
Allowable hedged risk components for non-financial items	Will be the same as financial instruments.	The entire risk of the item would have to be hedged; foreign currency risk could also be hedged.
Fair value hedge of a layer component	Will be permitted if certain criteria are met.	Would be prohibited.
Effectiveness assessment requirement	Assessment will be based on the existence of an economic relationship, the lack of credit risk dominance and the existence of a proper hedge ratio.	A hedging relationship would need to be assessed as reasonably effective.
Frequency of effectiveness assessment	Effectiveness assessment will be required, at a minimum, each reporting period or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.	Reassessment would be required only if circumstances suggest that the hedging relationship may no longer be reasonably effective.
Assumption of perfective effectiveness	Will be prohibited.	Would be prohibited.
Cash flow hedge accounting	The effective portion of the gain or loss on the hedging instrument will be recognised in AOCI; the effective portion will be the lower of the cumulative change in fair value of the hedging instrument and the cumulative change in fair (present) value of the hedged item.	The effective portion of the gain or loss on the hedging instrument would be recognised in AOCI; the ineffective portion would be the difference between the cumulative change in fair value of the hedging instrument and the cumulative change in expected future cash flows of the hedged item.

Differences between	IFRS 9 – General hedging model	FASB's proposed model
Forecast transaction that was the hedged item in a cash flow hedge that subsequently results in recognising a non-financial item (or a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied)	Upon recognition of the non-financial item, the amount of the gain or loss that was accumulated in AOCI as part of the cash flow hedge accounting will be removed from AOCI and added to the original carrying amount of the non-financial item. The same accounting will apply upon the recognition of the forecast transaction for a non-financial item becoming a firm commitment for which fair value hedge accounting is applied.	The amount of the gain or loss that was accumulated in AOCI as part of the cash flow hedge accounting would remain in AOCI and would be reclassified to earnings when the non-financial item affects earnings.
Mandatory rebalancing of a hedging relationship	An entity will be required to rebalance when the hedging relationship fails the effectiveness assessment but the entity's risk management objective remains the same. Rebalancing will be treated as a continuation of the hedging relationship.	Rebalancing would never be mandatory. Rebalancing would be treated as a new hedging relationship.
Voluntary discontinuation of hedge accounting	Will be prohibited.	Would be prohibited; however, an entity could effectively terminate a hedging derivative by meeting certain criteria.
Whether change in risk management objective triggers discontinuation of hedge accounting	Will trigger discontinuation.	Would not trigger discontinuation.
Accounting for the time value of a purchased option when the intrinsic value of the option is designated as a hedging instrument	Changes in fair value of the time value will be recognised in OCI based on the time value of a purchased option with critical terms that align with the hedged item. Amounts in equity will be reclassified to profit or loss, or recognised as basis adjustments, depending upon whether the hedged item is transaction-related or time period-related. This will apply to cash flow and fair value hedges.	The time value would be treated as a free-standing derivative. However, if the total changes in the option's cash flows are designated as the hedging instrument in a cash flow hedge, then the changes in fair value of the time value would be recognised in OCI. These amounts would be reclassified from AOCI to earnings during the term of the hedging relationship. This applies only to certain cash flow hedges.

Differences between	IFRS 9 – General hedging model	FASB's proposed model
Accounting for the forward element of a forward contract when the spot element of the forward contract is designated as a hedging instrument	Changes in fair value of the forward element may be recognised in OCI based on the forward element of a forward contract with critical terms that align with the hedged item. Amounts in equity will be reclassified to profit or loss, or recognised as basis adjustments, depending on whether the hedged item is transaction-related or time period-related. This will apply to cash flow and fair value hedges.	The forward element would be treated as a freestanding derivative. However, if total changes in the forward contract's cash flows are designated as the hedging instrument in a cash flow hedge, then the changes in fair value of the forward would be recognised in OCI. These amounts would be reclassified from AOCI to earnings during the term of the hedging relationship. This applies only to certain cash flow foreign currency hedges.
Accounting for the foreign currency basis spread when it is excluded from the designation of a financial instrument as the hedging instrument	Changes in fair value of the foreign currency basis spread may be recognised in OCI based on the foreign currency basis spread of a financial instrument with critical terms that align with the hedged item. Amounts in equity will be reclassified to profit or loss, or recognised as basis adjustments, depending on whether the hedged item is transaction-related or time period-related. This will apply to cash flow and fair value hedges.	Foreign currency basis spreads are not addressed; however, common practice is to treat them in the same manner as forward points.
Hedging gross positions	Will be permitted if certain criteria are met. The criteria do not include the criterion that the change in the fair value attributed to the hedged risk for each individual item in the group should be approximately proportional to the overall change in the fair value of the group for the hedged risk.	The individual items within the group should have similar risk characteristics, and the change in the fair value attributable to the hedged risk for each individual item in the group should be approximately proportional to the overall change in the fair value of the group for the hedged risk.
Hedging net positions	Will be permitted if certain criteria are met.	Would be prohibited.
Hedging nil net positions without a hedging derivative instrument	Will be permitted if certain criteria are met.	Would be prohibited.

Differences between	IFRS 9 – General hedging model	FASB's proposed model
Fair value option for own-use (normal purchase normal sale) contracts	Will be permitted if certain criteria are met.	Would be prohibited. However, use of the normal purchase normal sale exclusion would be elective.
Aggregated exposure as the hedged item	Will be permitted if certain criteria are met.	Would be prohibited.

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our *First Impressions* publications are prepared on the release of a new IFRS, interpretation or other significant amendment to the requirements of IFRS. They include a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to help assess the impact of implementation.

This edition of *First Impressions* considers the requirements of IFRS 9 *Financial Instruments* (2013), including the new general hedging model.

The text of this publication is referenced to IFRSs in issue at 30 November 2013; references in the left-hand margin identify the relevant paragraphs. (References in parentheses identify the paragraph that is amended in another standard by the preceding referenced paragraph in the new standard.)

In many cases, further analysis and interpretation may be needed in order for an entity to apply IFRS to its own facts, circumstances and individual transactions. Furthermore, some of the information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change as practice develops.

We will update and supplement the interpretation guidance and examples in this publication by adding additional interpretative guidance to *Insights to IFRS*, our practical guide to IFRS.

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User need	Publication series	Purpose
Application issues	Insights into IFRS	Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretative issues. The overview version provides a high-level briefing for audit committees and boards.
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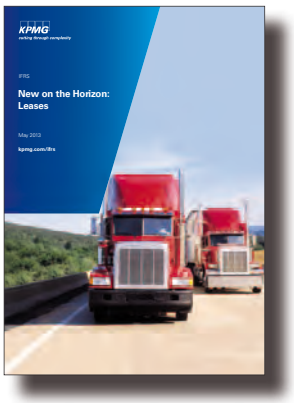

Our IFRS – leases hot topics page brings together our materials on the leases project, including our *New on the Horizon*, which provides detailed analysis on the leases exposure draft published in May 2013.

Our IFRS – revenue hot topics page brings together our materials on the revenue project, including our *IFRS Newsletter: Revenue*.

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