

International Financial Reporting Standards

January 2014

BASIS FOR CONCLUSIONS

IFRS 14 *Regulatory Deferral Accounts*

BASES FOR CONCLUSIONS – AMENDMENTS

Annual Improvements to IFRSs 2010–2012 Cycle

Annual Improvements to IFRSs 2011–2013 Cycle

Defined Benefit Plans: Employee Contributions

IFRS 9 Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)

[Related to AASB 2014-1]

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International Financial Reporting Standard IFRS 14

Regulatory Deferral Accounts

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Basis for Conclusions on IFRS 14 *Regulatory Deferral Accounts*

This Basis for Conclusions accompanies, but is not part of, the Standard.

Introduction

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions in IFRS 14 *Regulatory Deferral Accounts*. Individual IASB members gave greater weight to some factors than to others.
- BC2 The IASB and the IFRS Interpretations Committee (the ‘Interpretations Committee’) received several requests for guidance on whether rate-regulated entities can or should recognise, in their IFRS financial statements, a regulatory deferral or variance account debit or credit balance as a result of price or rate regulation by regulatory bodies or governments. Some national accounting standard-setting bodies permit or require such balances to be recognised as assets and liabilities under some circumstances, depending on the type of rate regulation in force. In such cases, these regulatory deferral account balances are often referred to as ‘regulatory assets’ and ‘regulatory liabilities’. However, as explained in this Basis for Conclusions (see paragraphs BC11–BC12 and BC21), the term ‘regulatory deferral account balances’ has been chosen as a neutral descriptor for these items for the purpose of this Standard.
- BC3 US generally accepted accounting principles (US GAAP) have recognised the economic effect of certain types of rate regulation since at least 1962. In 1982, the US national standard-setter, the Financial Accounting Standards Board (FASB) issued SFAS 71 *Accounting for the Effects of Certain Types of Regulation*.¹ SFAS 71 formalised many of those principles. In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71. In the financial statements of rate-regulated entities that apply such guidance, regulatory deferral account balances are often incorporated into the carrying amount of items such as property, plant and equipment and intangible assets, or are recognised as separate items in the financial statements.
- BC4 In June 2005, the Interpretations Committee received a request about SFAS 71. The request asked whether an entity could apply SFAS 71 in accordance with the hierarchy in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting an accounting policy in the absence of specific guidance in IFRS.
- BC5 The Interpretations Committee previously discussed the possible recognition of regulatory deferral account debit balances as part of its project on service concessions. As a result of its consideration at that time, the Interpretations Committee concluded that “entities applying IFRS should recognise only assets that qualified for recognition in accordance with the IASB’s *Framework for the*

¹ The guidance in SFAS 71, together with subsequent amendments and related guidance, has now been incorporated into Topic 980 *Regulated Operations* in the FASB *Accounting Standards Codification*®.

*Preparation and Presentation of Financial Statements*² ... and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.” In other words, the Interpretations Committee thought that an entity should recognise ‘regulatory assets’ only to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRS.

- BC6 The Interpretations Committee concluded that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRS. Applying the guidance in SFAS 71 would result in the recognition of regulatory deferral account balances under certain circumstances that would not meet the recognition criteria of relevant Standards. Consequently, the requirements of SFAS 71 were not indicative of the requirements of IFRS. The Interpretations Committee decided not to add a project on regulatory assets to its agenda.
- BC7 In January 2008, the Interpretations Committee received a second request to consider whether rate-regulated entities could or should recognise a regulatory liability (or a regulatory asset) as a result of rate regulation by regulatory bodies or governments. The Interpretations Committee again decided not to add the issue to its agenda for several reasons. Importantly, it concluded that divergence did not seem to be significant in practice for entities that were applying IFRS. The established practice of almost all entities is to eliminate regulatory deferral account balances when IFRS is adopted and not to recognise such balances in IFRS financial statements. However, the Interpretations Committee also noted that rate regulation is widespread and significantly affects the economic environment of many entities.
- BC8 The IASB noted the ongoing requests for guidance on this issue. It also considered the comments that had been received on the Interpretations Committee’s tentative agenda decisions. Those comments pointed out that although divergence in IFRS practice did not exist, several jurisdictions whose local accounting principles permitted or required the recognition of regulatory deferral account balances would be adopting IFRS in the near future. This would increase pressure for definitive guidance on the recognition of regulatory deferral account balances as assets or liabilities.
- BC9 Consequently, in December 2008, the IASB added a project on rate-regulated activities to its agenda and subsequently, in July 2009, published an Exposure Draft *Rate-regulated Activities* (the ‘2009 ED’). The responses to the 2009 ED raised complex and fundamental issues at a conceptual level. In September 2010, the IASB decided that the complex technical issues could not be resolved quickly, and suspended the project until it had considered whether to include rate-regulated activities in its future agenda. The 2011 Agenda Consultation asked stakeholders to provide their views as to which projects the IASB should give priority.³ The responses to this consultation, received through comment

² In September 2010, the IASB replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for Financial Reporting*. The definitions of assets and liabilities and the criteria for recognising them in the statement of financial position were unchanged.

³ In July 2011, the IASB published a formal Request for Views document to provide a channel for formal public input on the broad aspects of our agenda-setting process.

letters and other outreach activities, persuaded the IASB to prioritise addressing the unresolved issues related to rate-regulated activities.

- BC10 As a result of its agenda-setting process, in September 2012 the IASB decided to add to its agenda a comprehensive project on rate-regulated activities to investigate these complex issues. In addition, the *Conceptual Framework for Financial Reporting* (the 'Conceptual Framework') is currently being reviewed and updated. The outcome of the Rate-regulated Activities project will be influenced by the outcome of the *Conceptual Framework* project. The initial objective is to develop a Discussion Paper for each of these projects, which the IASB hopes will provide a basis for developing guidance in the long term.⁴ It also decided, in December 2012, to develop an interim Standard on the accounting for regulatory deferral accounts that would apply until the completion of the comprehensive project. This Standard is the result of that decision.

Reasons for issuing this Standard

- BC11 Many rate-regulated entities think that recognising regulatory deferral account balances as assets and liabilities would provide more relevant information and would provide a more faithful representation of their rate-regulated activities than the established practice in IFRS currently. They suggest that rate regulation creates special conditions that support the recognition of regulatory deferral account balances, even when those balances consist of deferred costs that other Standards require to be recognised as an expense in the period in which they are incurred. The 2009 ED, which proposed that regulatory deferral account balances should be recognised when arising from activities that are subject to a specific type of rate regulation (referred to in the 2009 ED as "cost-of-service rate regulation"), raised expectations that the IASB had agreed that there was merit to the arguments used to support recognition of such balances as assets and liabilities.
- BC12 Consequently, some respondents have noted that, although the case has not been made conclusively for amending IFRS to permit or require the recognition of regulatory deferral account balances as assets and liabilities, neither has it been made conclusively for an approach that eliminates such balances and changes existing accounting policies. These policies are being widely applied in accordance with some national GAAPs, and are familiar to many users of financial statements in jurisdictions that currently permit or require the recognition of rate-regulated items.
- BC13 The IASB recognises that discontinuing the recognition of regulatory deferral account balances in advance of the conclusion of the comprehensive Rate-regulated Activities project could be a significant barrier to the adoption of IFRS for entities for which regulatory deferral account balances represent a significant proportion of net assets. This has led to an industry-specific 'carve-out' from the application of IFRS in at least one jurisdiction that has otherwise adopted IFRS, to allow rate-regulated entities to continue to use local GAAP (or, in some cases, US GAAP). In addition, there are examples of 'carve-ins'

⁴ The IASB published, in July 2013, the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*. The deadline for comments was 14 January 2014.

being created that introduce specific guidance for rate-regulated activities that overlies IFRS requirements as issued by the IASB. However, the interaction of such guidance when it is in conflict with the requirements of IFRS can create diversity of application in practice.

- BC14 During outreach, some respondents told the IASB that, in many jurisdictions, the accounting policies developed for regulatory deferral account balances are based on US GAAP or local GAAP that provides similar guidance. This is understood to provide a reasonable level of comparability for regulatory deferral account balances across jurisdictions. However, different approaches to accommodating existing practice for such balances have reduced comparability for users of financial statements in these jurisdictions, because the rest of the items in the financial statements are now accounted for using different accounting frameworks (for example, IFRS, US GAAP or local GAAP), depending on which approach has been adopted. In some cases, the development of these carve-in or carve-out options has been in direct response to the publication of the 2009 ED.
- BC15 The IASB acknowledges the difficult practice problems related to this issue. The IASB has, therefore, decided to issue this Standard, which allows entities that currently recognise regulatory deferral account balances in accordance with their previous GAAP to continue to do so when making the transition to IFRS. In accordance with paragraph 5, an entity is only eligible to apply this Standard if it:
- (a) is subject to oversight and/or approval from an authorised body (the rate regulator);
 - (b) recognised regulatory deferral account balances in its financial statements in accordance with its previous GAAP; and
 - (c) elected to apply the requirements of this Standard in its first IFRS financial statements.
- BC16 Consequently, an entity that does not recognise regulatory deferral account balances in accordance with its previous GAAP in the period immediately preceding its first IFRS financial statements is not eligible to apply this Standard in order to start recognising such balances. An entity would not, therefore, be eligible if, for example:
- (a) the entity did not have any relevant rate-regulated activities in the period before it made the transition to IFRS but then acquires or commences rate-regulated activities after the date that it adopts IFRS; or
 - (b) the entity is a newly formed business and adopts IFRS in its first IFRS financial statements.
- BC17 The IASB thinks that this restriction balances the needs of preparers and users in jurisdictions that currently recognise regulatory deferral account balances in accordance with previous GAAP, and those that already prepare IFRS financial statements and do not recognise such balances.
- BC18 A Standard that permits first-time adopters of IFRS to continue to apply their existing policies for the recognition, measurement, impairment and

derecognition of regulatory deferral account balances will help those entities avoid having to make a major change to their accounting policies for regulatory deferral account balances until the comprehensive Rate-regulated Activities project is completed. The related presentation and disclosure requirements should help to reduce the disruption to information available for trend analyses for these entities on transition to IFRS, until the IASB can consider these issues in its comprehensive project. This would enable rate-regulated entities to overcome the barrier noted in paragraph BC13 and, consequently, to make the transition to IFRS.

- BC19 Although comparability will be improved overall by having more entities applying IFRS, the IASB acknowledges that permitting only a limited population of entities to recognise regulatory deferral account balances will introduce some inconsistency and diversity into IFRS practice for the treatment of regulatory deferral account balances, when it does not currently exist. In order to improve comparability between IFRS preparers that are subject to rate regulation but that do not recognise regulatory deferral account balances and entities that are permitted to recognise such balances in accordance with this Standard, the IASB decided to require segregated presentation of these balances. The IASB thinks that the resulting presentation and disclosure requirements in this Standard will help to minimise the impact of introducing this inconsistency, and that the benefits to users and preparers of financial statements outweigh the costs.
- BC20 The IASB thinks that the following benefits of this Standard justify introducing this diversity:
- (a) it is likely to remove a major barrier to the adoption of IFRS for entities for which regulatory deferral account balances represent a significant proportion of net assets;
 - (b) it should reduce the risk of entities adopting locally developed carve-ins or carve-outs that would otherwise create greater diversity of accounting treatment and greater confusion for users of financial statements. Having more entities applying IFRS would ensure that their other activities are reported in accordance with IFRS, thereby increasing comparability for those other assets and liabilities; and
 - (c) it is likely to improve transparency and consistency in the way that regulatory deferral account balances and movements in those balances are presented, thereby highlighting the impact of recognising such items and improving comparability between those entities that recognise such balances in accordance with the Standard.
- BC21 However, the IASB noted that, by issuing this Standard, it is not anticipating the outcome of the comprehensive Rate-regulated Activities project referred to in paragraph BC10. Consequently, regulatory deferral account balances are not described as regulatory assets or regulatory liabilities in this Standard because the IASB has yet to decide whether they meet the definitions of assets or liabilities in the *Conceptual Framework*. The separation of these balances from the amounts that are recognised as assets and liabilities in accordance with other Standards is designed to maintain the integrity of the application of existing Standards.

Scope

- BC22 This Standard does not allow entities to recognise regulatory deferral account balances if those entities have a dominant position in a market and decide to self-regulate to avoid the potential government intervention that might occur if it were perceived to be abusing its dominant position. Instead, it requires there to be a formal rate regulator involved to ensure that the rate-regulatory mechanism in place is supported by statute or regulation and that the regulatory mechanism binds the entity.
- BC23 However, the IASB does not intend to exclude entities that are regulated by their own governing body in cases in which:
- (a) the governing body sets prices both in the interests of the customers and to ensure the financial viability of the entity within a specified framework; and
 - (b) the framework is subject to oversight and/or approval by an authorised body that is empowered by statute or regulation.
- BC24 This situation could arise, for example, when the entity conducts previously state-run activities and the government delegates regulatory powers to an entity (that may be state-controlled) within a statutory framework that is overseen by an authorised body of the government. Another example is a co-operative that may be subject to some form of regulatory oversight in order to obtain preferential loans, tax relief or other incentives to maintain the supply of goods or services that the government consider to be essential or near essential.
- BC25 This Standard does not address an entity's accounting for reporting to rate regulators (regulatory accounting). Rate regulators may require a regulated entity to maintain its accounts in a form that permits the rate regulator to obtain the information that is needed for regulatory purposes. Rate regulators' actions are based on many considerations. This Standard neither limits nor endorses a rate regulator's actions.
- BC26 Although rate regulators can affect the timing of the recovery of the costs or the reversal of over-recoveries through future increases and decreases in rates, they cannot change the characteristics of assets and liabilities that exist and that are accounted for in accordance with IFRS. The IASB has not, therefore, introduced any changes to the accounting for assets or liabilities that are already addressed in other Standards. Those items should be accounted for in accordance with those Standards, irrespective of whether the entity is subject to rate regulation or not.
- BC27 Consequently, the IASB decided that the scope of the Standard should be limited to specifying how an entity reports the differences that arise between the regulatory accounting requirements of rate regulators and the accounting that would otherwise be required in financial statements that are prepared in accordance with IFRS, in the absence of this Standard.

Recognition, measurement, impairment and derecognition

Temporary exemption from paragraph 11 of IAS 8

- BC28 As noted in paragraph BC7, the established practice in IFRS has been that rate-regulated entities do not recognise regulatory deferral accounts in IFRS financial statements. Some IASB members are concerned that entities that will recognise regulatory deferral account balances in accordance with this Standard could give the appearance of being compliant with IFRS while being inconsistent with the stated objectives of the IASB, ie to provide users of financial statements with financial information that is transparent, comparable and of high quality. The IASB did not consider the exemption from parts of IAS 8 lightly, but introduced this interim step to lower a significant barrier to adopting IFRS for some jurisdictions, pending the completion of the comprehensive Rate-regulated Activities project. This step is also intended to minimise disruption, both for users (for example, a lack of continuity of information available for trend analyses) and preparers (for example, extensive system changes) when entities in these jurisdictions make the transition to IFRS.
- BC29 The IASB has been told that the majority of the national standard-setting bodies that permit or require the recognition of regulatory deferral account balances in accordance with local GAAP do so using the requirements of US GAAP (Topic 980 *Regulated Operations* in the FASB *Accounting Standards Codification*[®]) or local requirements that are based on US GAAP. Consequently, the IASB does not expect there to be significant diversity in the accounting for regulatory deferral account balances in jurisdictions that currently apply regulatory accounting in financial statements.
- BC30 Paragraph 12 of IAS 8 could permit Topic 980 or similar local GAAP requirements to be applied in IFRS financial statements, but only to the extent that those national GAAPs do not conflict with the sources of guidance listed in paragraph 11 of IAS 8 (ie other Standards and the *Conceptual Framework*). As noted in paragraph BC6, the Interpretations Committee concluded that the recognition criteria in SFAS 71 (now incorporated into Topic 980) were not fully consistent with the recognition criteria in IFRS. This is because some regulatory deferral account balances are specifically prohibited from being recognised as assets and liabilities by other Standards. It is this conflict with the sources listed in paragraph 11 of IAS 8 that has prevented almost all existing IFRS preparers from recognising regulatory deferral account balances. Consequently, the IASB has decided that entities within the scope of this Standard should be granted a temporary exemption from paragraph 11 of IAS 8 in order to overcome the restriction on the use of the sources of accounting guidance referred to in paragraph 12 of IAS 8.
- BC31 When developing IFRS 4 *Insurance Contracts* and IFRS 6 *Exploration for and Evaluation of Mineral Resources*, the IASB considered whether they should require an entity to follow its national accounting requirements (ie national GAAP) when accounting for insurance contracts or the exploration for and evaluation of mineral resources respectively to prevent the selection of accounting policies that do not form a comprehensive basis of accounting. Consistent with its conclusions in those Standards, the IASB concluded that defining national GAAP

would have posed problems. Further definitional problems could have arisen because some entities do not apply the national GAAP of their own country. For example, some non-US entities with rate-regulated activities apply US GAAP (Topic 980). Moreover, it is unusual and, arguably, beyond the IASB's mandate to impose requirements set by another body.

- BC32 Consequently, the IASB decided that an entity could continue to follow the accounting policies that it was using when it first applied the IFRS requirements, provided that they satisfy the requirements of paragraphs 10 and 12 of IAS 8. This should help to ensure that those policies are generally accepted in the local jurisdiction, either because the local GAAP allows the use of another standard-setter's pronouncement or because of accepted industry practice. The IASB decided to adopt the same approach in this Standard that it adopted with IFRSs 4 and 6, for the same reasons.

Changes in accounting policies

- BC33 IAS 8 prohibits a change in accounting policies that is not required by a Standard, unless the change will result in information that is reliable and more relevant. Paragraph 15 of IAS 8 explains that this is because users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in financial position, financial performance and cash flows. Consistent with its conclusions in IFRSs 4 and 6, the IASB decided to permit changes in accounting policies for regulatory deferral account balances if they make the financial statements more relevant and no less reliable, or more reliable and no less relevant, judged in accordance with the criteria in IAS 8.
- BC34 As previously noted, the IASB has started the research phase of a comprehensive project to investigate how IFRS financial statements might reflect the effects of rate regulation (see paragraph BC10). Until that project is completed, the IASB wishes to minimise disruption to information used for trend analyses of IFRS financial statements and thus the limitation on changes in accounting policy is intended to be restrictive. The established practice in IFRS has been that almost all rate-regulated entities do not recognise regulatory deferral account balances in IFRS financial statements. Consequently, the IASB thinks that changing an accounting policy to start to recognise such balances, or to recognise a wider range of such balances by modifying a previous GAAP policy, when that changed policy might need to change again following the completion of the Rate-regulated Activities project, would not make the financial statements more reliable. The scope of this Standard and the restriction on changes in accounting policies in paragraphs 13–15, therefore, prohibit entities that currently do not recognise regulatory deferral account balances from starting to do so.
- BC35 The IASB wished to avoid imposing unnecessary changes of accounting policy as a result of applying this Standard. However, it did not want to prevent entities that currently recognise regulatory deferral account balances from ceasing to recognise them when adopting IFRS because this would be consistent with the established IFRS practice. The IASB thinks that this would result in an entity presenting more comparable information with existing IFRS preparers, which would bring the financial statements closer to the criteria in IAS 8. The IASB

has, therefore, decided that the continued recognition of regulatory deferral account balances in accordance with this Standard should be optional. An entity that is eligible to apply this Standard but that elects not to apply it and, consequently, ceases to recognise its regulatory deferral account balances, is not required to apply any of the disclosure requirements of this Standard. However, such entities, and other entities that are not eligible to apply this Standard, are not prohibited from providing supplementary disclosures, such as those set out in paragraphs 30–36.

- BC36 In addition, this Standard contains some specific accounting requirements for presentation that may require entities to change the presentation of regulatory deferral account balances that they recognise in accordance with their previous GAAP accounting policies. The IASB thinks that these changes, together with the specific disclosure requirements set out in this Standard, will improve comparability and understandability, and provide relevant information to users.

Interaction with other Standards

- BC37 Any specific exception, exemption or additional requirements related to the interaction of this Standard with other Standards is contained within this Standard. The IASB thinks that, except for IFRS 1, other Standards should not be subject to consequential amendments relating only to this Standard because its application is restricted to a limited population of entities. In addition, it is intended to be applicable only as a short-term interim solution until the comprehensive Rate-regulated Activities project is completed.
- BC38 As previously noted, in order to apply this Standard an eligible entity must elect to apply it in the entity's first IFRS financial statements. Consequently, a first-time adopter will initially apply this Standard at the same time as it applies IFRS 1. Paragraph D8B of IFRS 1 provides an exemption to allow first-time adopters to use, as the deemed cost at the date of transition to IFRS, the previous GAAP carrying amount of items of property, plant and equipment or intangible assets that are used, or were previously used, in operations subject to rate regulation. For the purposes of that exemption, paragraph D8B defined operations that are subject to rate regulation in the context of a cost-plus or cost-of-service type of rate regulation. The IASB has decided to make a consequential amendment to paragraph D8B of IFRS 1 to make the definition of rate regulation used in that paragraph consistent with the definition used in this Standard. This will ensure that a first-time adopter that applies this Standard is not prohibited from using the exemptions available to other first-time adopters in IFRS 1.

Recoverability

- BC39 Although the approval by the rate regulator may not guarantee that a regulatory deferral account balance will be recovered (or reversed) through future sales, it does provide a high degree of assurance that the anticipated economic benefits will flow to or from the entity. In some cases, an entity may incur costs several months or even years before the rate regulator formally approves them. The IASB concluded that, in such cases, judgement is required to determine whether the costs can be considered recoverable. Consequently, the IASB decided not to develop specific recognition or impairment requirements for these

circumstances, but instead decided that an entity should continue to apply its previous GAAP accounting policies for the recognition and measurement of such amounts.

Presentation

Cost of self-constructed or internally generated assets

- BC40 The IASB noted that in some cases, a rate regulator requires, for rate-setting purposes, an entity to include, as part of the cost of property, plant and equipment or other assets, amounts that would not be included by non-rate-regulated entities. For example, a rate regulator might specify how to calculate the carrying value of an item of property, plant and equipment for rate-setting purposes (the rate-base or regulatory value), which might differ from the method required by IAS 16.
- BC41 The IASB acknowledges that at least two alternatives exist for accounting for these amounts: present them separately or include them within the amounts presented for property, plant and equipment or other assets. Proponents of the first alternative think that regulatory deferral account balances that would be recognised as a result of this Standard do not have the same characteristics as assets and liabilities that would be recognised in accordance with other Standards. Consequently, proponents of this alternative think that all amounts that qualify for recognition as regulatory deferral account balances should be presented separately from the assets and liabilities that are recognised in accordance with other Standards, instead of being included within the carrying amount of the item of property, plant and equipment or other asset.
- BC42 Proponents of the second alternative think that some regulatory deferral account balances that would be recognised as a result of this Standard are so closely related to other assets of the entity that accounting for them separately does not provide additional information to users. Proponents of this alternative think that when regulatory assets are complementary to other assets and have similar useful lives, there is no need to incur the costs of separate accounting. Instead, they think that the other assets should be measured at the amount allowed for rate-regulatory purposes. In accordance with this alternative, an entity includes the regulatory deferral account balances in the cost of the asset that is recognised in accordance with other Standards as a single asset. This approach is consistent with that applied in US GAAP (Topic 980).
- BC43 The IASB will consider this issue as part of the comprehensive Rate-regulated Activities project. For the purpose of this Standard, the IASB has decided to require the first alternative. This decision does not change the relief available to first-time adopters using the deemed cost exemption provided by paragraph D8B of IFRS 1 (see paragraph BC38). This is consistent with the IASB's decision not to introduce any changes to the accounting for assets and liabilities that are already addressed in other Standards (see paragraph BC26). Some IASB members think that this separate presentation is essential until the consideration of the more fundamental issues about accounting for rate-regulated activities is completed through the comprehensive project.

Separate presentation in the primary financial statements

- BC44 Many of the items included in regulatory deferral account balances would not otherwise be capitalised as assets (or liabilities) in the absence of the temporary exemption from paragraph 11 of IAS 8 that is contained in this Standard (see paragraph BC30). Consequently, and consistent with the IASB's decision discussed in paragraph BC43, the Standard requires the total of all regulatory deferral account debit balances and the total of all regulatory deferral account credit balances to be presented as separate line items in the statement of financial position. Similarly, the net movement between the opening and closing balances is presented separately within the statement(s) of profit or loss and other comprehensive income, split between amounts related to other comprehensive income and amounts related to profit or loss. Any movements not related to profit or loss or other comprehensive income, such as amounts acquired or disposed of, are disclosed in the reconciliation of opening and closing balances required by paragraph 33.
- BC45 In addition, the IASB concluded that presenting the regulatory impact separately would provide more useful information about the regulatory environment and would be consistent with the enhancing qualitative characteristic of comparability in paragraphs QC20–QC25 of the *Conceptual Framework*. In particular, it would enable users to more directly compare the property, plant and equipment or intangible assets of comparable rate-regulated entities (in addition to comparing them to those of non-rate-regulated entities), regardless of whether they recognise regulatory deferral account balances in their financial statements. This would also result in more consistent application of IFRS for all other transactions or activities, irrespective of whether an entity has rate-regulated activities and the type of rate-regulatory environment that the entity is subject to.
- BC46 The IASB concluded that the separate presentation of regulatory deferral account balances, especially those amounts that are often permitted by national GAAP practices to be included within the carrying amounts of property, plant and equipment and other assets, is an important improvement because it contributes to increased transparency in financial reporting. The IASB noted that a first-time adopter of IFRS may apply the deemed cost exemption in paragraph D8B of IFRS 1, which allows adopters to use their previous GAAP carrying amounts at the date of transition to IFRS. This exemption provides relief for first-time adopters that would otherwise be required to separate out the regulatory component of the carrying amount of sometimes very large and old items of property, plant and equipment or intangible assets at the date of transition to IFRS, which may be impracticable. The IASB has made a consequential amendment to the scope of the IFRS 1 exemption to make it consistent with the scope of this Standard. Consequently, entities that apply this Standard will only need to isolate the regulatory deferral account amounts for those items on a prospective basis from the date of transition to IFRS. The IASB also noted that the information required for separate presentation on an ongoing basis is normally available in any case, due to the information requirements of rate regulators.

Current/non-current allocation and offset

- BC47 Regulatory deferral account balances arise from specific individual costs (income) that the rate regulator requires or permits to be deferred to future periods. The rates charged for goods or services in the current period may be intended to recover a combination of past costs, current costs and, in some cases, anticipated future costs. Although the rate regulator may specify the period over which the recovery of the regulatory deferral account balances is intended, judgement may be needed to identify the costs that the revenue billed in a period recovers. This means that detailed scheduling of the timing of recovery or reversal of each regulatory deferral account debit or credit balance may be needed for the purpose of identifying which amounts should be classed as current or for determining which amounts would be recovered or reversed in the same period for the purposes of offsetting. Consequently, the IASB has decided that regulatory deferral account balances should not be presented as current or non-current and that debit and credit balances should not be offset in the statement of financial position. Instead, this Standard requires information about the period(s) over which regulatory deferral account balances are expected to be recovered or reversed to be disclosed. An entity is not, however, prohibited from identifying current and non-current amounts within the information disclosed if the relevant information is available.

Disclosure

- BC48 In December 2012, the IASB launched a survey on disclosures, which was directed at preparers, users and others interested in or affected by disclosure requirements. The results were discussed in a public discussion forum on *Disclosures in Financial Reporting* in January 2013. The survey and the discussion forum were aimed at assisting the IASB to gain a clearer picture on the perceived “disclosure problem” (ie identifying disclosure requirements that create a burden for preparers but do not provide users with sufficient relevant information). The views of most financial statement preparers that took part in these events identified the primary problem as the disclosure requirements being too extensive, with not enough being done to exclude immaterial information, which has been referred to as “disclosure overload”. Similarly, many users of financial statements felt that preparers could do more to improve the communication of relevant information within the financial statements, rather than leaving users to sift through large amounts of data.
- BC49 With this in mind, this Standard sets out a general objective for disclosure as well as a list of detailed items that might be useful in achieving that objective. The IASB has previously concluded that it is unnecessary, in general, to state explicitly that specified disclosures relate only to material items because all Standards are governed by the concept of materiality as described in IAS 1 *Presentation of Financial Statements* and in IAS 8. The IASB has decided, consistent with its previous conclusions, not to specifically refer to materiality in this Standard. However, this Standard contains other explicit guidance to clarify that preparers should use their judgement to decide which of the detailed items are necessary to achieve the objective and what level of detail to provide.

- BC50 The IASB thinks that an understanding of an entity's different types of rate-regulated activities is important for understanding the entity as a whole. In addition, an understanding of each class of regulatory deferral account is considered important because that can provide information about the nature of the rate regulation and the potential timing of related cash flows. Consequently, this Standard requires the disclosure of qualitative and quantitative information for each type of an entity's rate-regulated activities and each class of regulatory deferral account balance, because this will provide information that is more useful in assessing the impact of different rate-regulatory environments.
- BC51 The IASB thinks that most entities that already recognise regulatory deferral account balances in accordance with US GAAP, or similar requirements or practices in other jurisdictions, currently provide most of the information required to be disclosed by paragraph 33 of this Standard. However, the IASB observed that the information is often disclosed in various places throughout the financial statements in a way that can make it difficult for a user to appreciate the overall effect that rate regulation has had on the amounts recognised in the financial statements. Consequently, this Standard requires that entities meet the disclosure requirements by providing a table, containing aggregated information, and showing a reconciliation of the movements in the carrying amounts in the statement of financial position of the various categories of regulatory items. This table will be required unless another format is more appropriate. The IASB noted that such a table, presenting information in a structured manner, would assist financial statement users in understanding how the entity's reported financial position and comprehensive income have been affected by rate regulation.

Location of qualitative disclosures

- BC52 The IASB observed that many entities provide, often in the management commentary reports that accompany the financial statements, a qualitative description of the nature and extent of the effect of rate regulation on its activities. The IASB acknowledges that the nature and extent of rate regulation can have a significant impact on the amount and timing of revenue and cash flows of a rate-regulated entity. Hence, the IASB concluded that such disclosures should be part of the financial statements and they could be given either in the financial statements or incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms as the financial statements and at the same time. This approach is intended to reduce duplication of information and is consistent with some types of risk disclosure required by IFRS 7 *Financial Instruments: Disclosures*.

Effective date and transition

- BC53 This Standard will only be available to first-time adopters of IFRS and will need to be applied retrospectively at the date of transition to IFRS. The IASB usually intends to allow a minimum of one year between the date when wholly new Standards or major amendments to Standards are issued and the date when

implementation is required. Consequently, the IASB has set 1 January 2016 as the effective date for this Standard. Earlier application is permitted to make the benefits outlined in paragraph BC20 available at the earliest opportunity.

- BC54 The IASB concluded that no explicit relief from full retrospective application of the Standard is needed because existing recognition, measurement, impairment and derecognition policies are continued when this Standard is applied. First-time adopters of IFRS can use the deemed cost exemption for property, plant and equipment and intangible assets that is already available in IFRS 1 that allows first-time adopters to use their previous GAAP carrying amounts at the date of transition to IFRS. Consequently, they will only need to change their presentation policies for these items to isolate the regulatory deferral account amounts on a prospective basis from the date of transition to IFRS.

Summary of main changes from the Exposure Draft *Regulatory Deferral Accounts*

- BC55 The proposed definition of the rate regulator included the term “or contract” when establishing the authority of the rate regulator. Some respondents to the Exposure Draft *Regulatory Deferral Accounts*, which was published in April 2013 (the ‘2013 ED’), were concerned that this term resulted in the definition being too broad. Those respondents assumed that the intention of including the entity’s own governing body was to (appropriately) capture those cases in which an entity conducts previously state-run monopolistic activities and is consequently delegated regulatory powers by the government. However, the respondents were concerned that the scope could be applied, by analogy, to other commercial entities having monopolistic features. This concern was raised within the context of entities that, in the absence of an external regulator, self-regulate (for example, by formally agreeing this with investors through the articles of association or other contractual arrangement). Entities may do this to avoid potential government intervention if they might otherwise be perceived to be abusing their strong market position.
- BC56 Consequently, the IASB decided to refine the definition of the rate regulator to exclude self-regulation and instead require the rate regulator to be supported by statute or other formal regulations.
- BC57 In addition, the definitions of rate regulation and the rate regulator were further refined to clarify that the regulation can permit some flexibility in the prices to be charged, within a range of prices established or approved by the rate regulator.
- BC58 The scope criterion in paragraph 7(b) of the 2013 ED, which proposed that the price established by regulation (the rate) should be designed to recover the entity’s allowable costs of providing the regulated goods or services, has been removed. The IASB was persuaded by arguments from some respondents that this criterion was inconsistent with the underlying objective of the IASB to reduce barriers to the adoption of IFRS. In addition, retaining this criterion may be perceived as prejudging the outcome of the comprehensive project.
- BC59 The other main changes from the proposals in the 2013 ED are as follows:

- (a) application guidance has been added to:
- (i) clarify some group accounting issues. Paragraph 19 of IFRS 10 *Consolidated Financial Statements* requires that a “parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances”. Consequently, if a parent recognises regulatory deferral account balances in accordance with this Standard, it shall apply the same accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances arising from the rate-regulated activities of all of its subsidiaries, even if some of those subsidiaries do not recognise such balances in their own financial statements. A similar requirement applies to an investor applying the equity method to investments in associates and joint ventures.
 - (ii) introduce a limited exception to IFRS 3 *Business Combinations* to require the continuation of the acquirer’s previous GAAP accounting policies for the recognition and measurement of regulatory deferral account balances acquired or assumed in a business combination. The IASB noted that, if an acquirer does not recognise regulatory deferral account balances in accordance with this Standard, but subsequently acquires a subsidiary that does recognise such balances, the acquirer is not eligible to apply this Standard. Consequently, the acquirer is not eligible to recognise the acquiree’s regulatory deferral account balances within the consolidated financial statements.
 - (iii) clarify that an entity is not prohibited from recognising new regulatory deferral account balances for timing differences that are created as a consequence of a change in an accounting policy for other items required by IFRS. The IASB noted that the recognition of timing differences between its applied accounting policies and rate-regulatory requirements is a key element of what regulatory deferral account balances represent. When an entity adopts IFRS, the accounting policies that it uses in its opening IFRS statement of financial position may differ from those that it used at the same date when it used its previous GAAP. Such changes in accounting policies may create new timing differences that will be recorded by the entity in regulatory deferral accounts. For example, the rate regulator might allow pension costs to be reflected in rates when benefits or other costs are paid. The previous GAAP accounting policy for pension costs may have been consistent with this ‘as paid’ policy and thus no regulatory deferral account balance would have existed for those costs. However, IAS 19 *Employee Benefits* requires pension costs to be attributed to periods of service in accordance with the plan’s benefit formula, or in some cases on a straight-line basis. For defined benefit pension costs, this would create a new timing difference for which a regulatory deferral

account balance would be created. Some respondents were concerned that the prohibition to change accounting policies would prevent such newly created regulatory deferral account balances from being recognised. However, this was not the IASB's intention, because the recognition of such timing differences would be consistent with the recognition of other timing differences already recognised as regulatory deferral account balances.

- (b) the requirement to continue previous GAAP accounting policies for the recognition, measurement and impairment of regulatory deferral account balances has been extended to include derecognition.
- (c) the requirement to present the net movement in regulatory deferral account balances in the statement of profit or loss and other comprehensive income has been modified to require the net movement to be split between amounts related to items reported in profit or loss and those reported in other comprehensive income. The IASB was persuaded by those respondents that stated that the proposal to recognise all net movements in regulatory deferral account balances in a single line item in the profit or loss section of the statement of profit or loss and other comprehensive income could be confusing or misleading when a material portion of the movement related to items that are recognised in other comprehensive income.
- (d) the references to materiality as a factor to consider in deciding the level of detail to disclose has been deleted. The IASB noted that the consideration of materiality is already dealt with in IAS 1 and IAS 8. The IASB is currently assessing the adequacy of the guidance contained in those Standards as part of its Disclosure Initiative project.

- BC60 A few respondents to the 2013 ED asked for additional guidance for the application of IAS 34 *Interim Financial Reporting*. In particular, they requested that it should be made clear that separate line items for regulatory deferral account balances and movements therein should also be included in a condensed set of financial statements. However, the IASB did not agree that additional guidance is necessary. Paragraph 10 of IAS 34 requires that condensed financial statements "shall include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard." In addition, paragraphs 15–15A of IAS 34 require that an entity shall include an explanation of events and transactions that are significant to an understanding of the changes in the financial position and performance of the entity.
- BC61 The IASB concluded that the existing requirements, together with the detailed year-end information required in this Standard, are sufficient to provide users with the relevant information to understand the regulatory deferral account balances that are recognised.
- BC62 The Illustrative examples and the Basis for Conclusions on the 2013 ED contained some educational background information about rate regulation,

which was not related specifically to the contents of the proposed requirements. This background information has been deleted from this Standard.

Effects analysis

- BC63 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing new requirements and the likely ongoing costs and benefits of each new Standard. The costs and benefits are collectively referred to as 'effects'. The IASB gains insight on the likely effects of the proposals for new or revised Standards through its formal exposure of proposals, analysis and consultations with relevant parties.
- BC64 In evaluating the likely effects of permitting rate-regulated entities that are first-time adopters of IFRS to continue to recognise regulatory deferral account balances, the IASB has considered the following factors:
- (a) how the changes to the presentation of regulatory deferral account balances affect the financial statements of a rate-regulated entity;
 - (b) whether the changes improve the comparability of financial information between different reporting periods for a rate-regulated entity and between different rate-regulated entities in a particular reporting period;
 - (c) whether the changes improve the quality of financial information that is available to investors and its usefulness in assessing the future cash flows of a rate-regulated entity;
 - (d) whether users will benefit from better economic decision-making as a result of improved financial reporting;
 - (e) the likely effect on compliance costs for preparers, both on initial application and on an ongoing basis; and
 - (f) whether the likely costs of analysis for users are affected.

Financial statements of rate-regulated entities

- BC65 The scope of this Standard is limited to first-time adopters of IFRS that already recognise regulatory deferral account balances in their financial statements in accordance with their previous GAAP. Consequently, the financial statements of rate-regulated entities that already apply IFRS, or that do not otherwise recognise such balances, will not be affected by this Standard.
- BC66 This Standard permits rate-regulated entities within its scope to continue to apply their existing recognition, measurement, impairment and derecognition policies for regulatory deferral account balances. Consequently, the application of this Standard should have little or no impact on the net assets or the net profit reported in the financial statements.
- BC67 However, the presentation of some regulatory deferral account balances will be changed to isolate the impact of their recognition and present this impact as separate line items within the statement of financial position and the statement of profit or loss and other comprehensive income. In particular, some regulatory deferral account balances that would be presented within the carrying amount of items of property, plant and equipment, intangible assets

and inventories in accordance with previous GAAP will, in future, be presented separately from those classes of asset in accordance with this Standard.

Comparability

- BC68 The IASB acknowledges that the requirements of this Standard will reduce comparability in some ways, but thinks that this reduction will be outweighed by other improvements in comparability that will result from applying the requirements in this Standard.
- BC69 As noted in paragraph BC19, permitting only a limited population of entities to recognise regulatory deferral account balances will introduce some inconsistency and diversity into IFRS practice, when it does not currently exist. However, this is mitigated by the requirements to isolate the regulatory deferral account balances, and the movements in those balances, into separate line items in the financial statements.
- BC70 The IASB is aware that many rate-regulated entities view the inability to recognise regulatory deferral account balances in IFRS financial statements as a major barrier to the adoption of IFRS. Although many of these entities are understood to use similar policies for the recognition and measurement of these balances, they use different frameworks of accounting for the preparation and presentation of the financial statements as a whole. The IASB thinks that reducing the barriers for these entities to adopt IFRS will improve the comparability of the financial statements of rate-regulated entities across jurisdictions.
- BC71 In addition, the IASB thinks that the requirements to isolate the regulatory deferral account balances, and the movements in those balances, from other items in the financial statements will increase the transparency of these items. This will provide greater comparability across those entities within the scope of this Standard. This will, as a result, assist users of financial statements to understand more clearly the impact of recognising regulatory deferral account balances, and will allow direct comparisons not only against those entities that will be permitted to recognise these balances, but also against entities that do not recognise them.

Usefulness in assessing the future cash flows of an entity

- BC72 Rate regulation imposes a framework for establishing prices that can be charged to customers for goods or services. Consequently, a rate-regulated entity is usually unable to react quickly in order to change its selling price in response to changes in its operating or other costs. Many of those who support the recognition of regulatory deferral account balances in financial statements argue that these balances provide some indication of the impact of these time delays on the cash flows that will be generated through future sales that will be made at a higher or lower price. The disclosures required by this Standard should provide more information about the amount and expected timing of the recovery or reversal of the regulatory deferral account balances recognised.

Better economic decision-making

- BC73 The IASB has been told by many users in jurisdictions that currently permit or require regulatory deferral account balances to be recognised in financial statements that the information about those balances is useful in making economic decisions. At the same time, many other users of IFRS financial statements have noted that the inclusion of such balances could be confusing because it is not clear whether they meet the definitions of assets and liabilities. As a result, these users think that it is unclear what these balances represent.
- BC74 The IASB thinks that this Standard will allow entities within its scope to continue to provide information that some users find useful, but that the presentation requirements will provide clarity to avoid confusion for those who are not familiar with the recognition of regulatory deferral account balances.
- BC75 In particular, the IASB thinks that the improvements in comparability noted in paragraphs BC69–BC71 will provide users of financial statements with more information to help them better understand the impact of rate regulation on those rate-regulated entities that will be able to continue to recognise regulatory deferral account balances in accordance with this Standard.

Effect on compliance costs for preparers

- BC76 This Standard will not change the recognition or measurement policies of entities within its scope, and thus will not result in any cost change in this respect. However, the IASB acknowledges that the separate presentation of regulatory deferral account balances is likely to result in changes to most existing presentation policies. Existing policies of entities within the scope of this Standard usually require or permit certain regulatory deferral account balances to be included within the carrying amount of items of property, plant and equipment and other assets. The separate presentation required by this Standard may add some cost on an ongoing basis, because preparers would need to track some of the differences between the regulatory amounts and those reported in the financial statements in more detail than is currently required.
- BC77 However, the cost on the initial application of this Standard would largely be mitigated by the exemption that is already contained in paragraph D8B of IFRS 1. This exemption applies to first-time adopters of IFRS that hold items of property, plant and equipment or intangible assets that are, or were previously, used in operations subject to rate regulation. It allows those first-time adopters to use the previous GAAP carrying amount of such an item at the date of transition to IFRS as deemed cost. Consequently, the additional administrative burden of tracking changes need only apply on a prospective basis for differences arising after the date of transition.
- BC78 In addition, the IASB understands that in many regulatory regimes, the regulatory accounting requirements require that regulatory deferral account balances are recorded in separate accounts within the entity's financial record-keeping system, at least until such time that the regulator issues a formal rate decision. Consequently, the IASB thinks that the incremental costs of retaining this separation beyond the time normally required by the regulator should not be significant.

How the costs of analysis for users are affected

BC79 The likely effect of these requirements on the costs of analysis for users of financial statements is expected to be outweighed by the benefits of improved reporting. Some users have commented that information related to the impact that rate regulation has on the amount, timing and certainty of returns and cash flows is important. The IASB think that the segregated presentation and related disclosures required by this Standard will highlight more clearly this impact. As noted in paragraph BC66, the requirements should have little or no impact on the net assets or the net profit reported in the financial statements of those entities within the scope of this Standard. Consequently, there is expected to be little disruption to the information available for trend analyses. Although the changes to the presentation of the amounts may cause some initial costs to be incurred, the IASB thinks that the added transparency introduced by this Standard will provide users with clearer and more comparable information.

Dissenting opinions

Dissent of Messrs Edelmann, Gomes and Zhang

DO1 Messrs Edelmann, Gomes and Zhang voted against the publication of IFRS 14.

Reduced comparability and inconsistency with existing IFRS practice

DO2 The established practice in IFRS has been that rate-regulated entities do not recognise regulatory deferral account balances in IFRS financial statements. Consequently, almost all rate-regulated entities around the world that previously recognised regulatory deferral account balances in their financial statements in accordance with their previous GAAP did not continue to recognise such balances but instead, derecognised them when they first adopted IFRS. In the view of Messrs Edelmann, Gomes and Zhang, to now permit an unknown population of rate-regulated entities to recognise these balances when adopting IFRS will introduce inconsistent accounting treatment into IFRS reporting and will reduce existing comparability.

DO3 In addition, Messrs Edelmann, Gomes and Zhang disagree with permitting first-time adopters of IFRS to continue to measure the regulatory deferral account balances that are recognised in the statement of financial position using their previous GAAP accounting policies. They believe that further inconsistency might be introduced by entities continuing to apply existing practices that might not be comparable with other entities that have different existing practices. In their view, isolating the impact of recognising regulatory deferral account balances by presenting them separately is not sufficient to eliminate the effect of this inconsistency. Messrs Edelmann, Gomes and Zhang are also concerned that entities might encounter operational difficulties in applying other general Standards to regulatory deferral account balances because there is uncertainty as to whether these balances are assets and liabilities, and there is no single clear and consistent recognition and measurement policy for them. This in turn might create additional diversity and further reduce comparability in practice.

Creating uncertainty for potential future adopters of IFRS

DO4 Messrs Edelmann, Gomes and Zhang acknowledge that this Standard is intended to be a practical and short-term interim solution to address a significant barrier to the adoption of IFRS in some jurisdictions. They note that a major argument for this Standard is to avoid rate-regulated entities having to make a major change to their accounting policies when making the transition to IFRS (ie derecognise their regulatory deferral account balances in accordance with the current established practice in IFRS of almost all rate-regulated entities) until guidance can be developed through the comprehensive project on rate-regulated activities (see paragraph BC18). However, they also note that this argument is not new, and nor is it specific to this particular subject. Despite this argument, when developing major projects, the IASB does not usually introduce interim Standards to be applied only by first-time adopters of IFRS. In particular, the IASB did not decide to introduce an interim Standard when it worked on the

Exposure Draft *Rate-regulated Activities*, published in July 2009 (the ‘2009 ED’), which, at that time, would have equally avoided the issue for many entities in jurisdictions that have since adopted IFRS.

- DO5 In addition, Messrs Edelmann, Gomes and Zhang note that the majority of IFRS Advisory Council members, at their meeting in October 2012, did not support the development of an interim Standard that would permit the continuation of existing previous GAAP policies. Many of those members warned against setting a precedent of implementing a policy of adopting an interim solution whenever a major standard-setting project is activated. Messrs Edelmann, Gomes and Zhang are concerned that developing an interim solution in this situation might create uncertainty as to what the IASB’s approach might be when major projects are being researched in the future.

Recognition is contrary to the *Conceptual Framework for Financial Reporting*

- DO6 Messrs Gomes and Zhang also disagree with permitting regulatory deferral account balances to be recognised in the statement of financial position because they do not think that all such balances meet the definitions of assets and liabilities in the IASB’s *Conceptual Framework*. This is one of the issues that the comprehensive Rate-regulated Activities project is looking to resolve. Consequently, the IASB has stated that IFRS 14 does not anticipate the outcome of the comprehensive project, and uses the neutral term ‘regulatory deferral account balances’ instead of ‘regulatory assets’ and ‘regulatory liabilities’ (see paragraph BC21). However, Messrs Gomes and Zhang believe that permitting them to be included in the statement of financial position is equivalent to recognising them as assets and liabilities, which, in their view, is contrary to the current accounting principles in the *Conceptual Framework* and the application of existing Standards.
- DO7 In addition, Messrs Gomes and Zhang are concerned that allowing regulatory deferral account balances to be recognised in the financial statements is contrary to the IASB’s objectives of requiring high-quality, transparent and comparable information in financial statements by requiring similar transactions and events to be accounted for and reported in a similar way. The IASB acknowledges that rate regulators have different objectives for regulatory reporting than the IASB has for financial reporting. In the view of Messrs Gomes and Zhang, allowing regulatory deferral account balances to be recognised will effectively allow the objectives of the rate regulator(s) to take precedence over the objectives of general purpose financial reporting, as expressed in the *Conceptual Framework*. In particular, they believe that allowing regulatory deferral account balances to be recognised effectively allows the objectives of the rate regulator(s) for setting rates and smoothing out the volatility, which results from real economic events, to be reflected in the financial statements. Messrs Gomes and Zhang think that this is inconsistent with paragraph OB17 of the *Conceptual Framework*, which notes the importance of depicting the effects of transactions and other events and circumstances on a reporting entity’s economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

International Financial Reporting Standard

Annual Improvements to IFRSs 2010–2012 Cycle

December 2013

BASES FOR CONCLUSIONS – AMENDMENTS

[IFRS 2, 3, 8, 9 (October 2010) & 13 and IAS 16, 24, 38 & 39]

[Related to AASB 2014-1]

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Amendment to the Basis for Conclusions on IFRS 2 *Share-based Payment*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC334–BC370 and their related headings are added.

Definition of vesting condition (2013 amendments)

- BC334 The Board decided to clarify the definition of ‘vesting conditions’ in IFRS 2 to ensure the consistent classification of conditions attached to a share-based payment. Previously, this Standard did not separately define ‘performance condition’ or ‘service condition’, but instead described both concepts within the definition of vesting conditions.
- BC335 The Board decided to separate the definitions of performance condition and service condition from the definition of vesting condition to make the description of each condition clearer.
- BC336 In response to the comments received on the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* (Proposed amendments to International Financial Reporting Standards) (the ‘ED’), published in May 2012, the Board addressed the following concerns that had been raised about the definitions of performance condition, service condition and market condition:
- (a) whether a performance target can be set by reference to the price (or value) of another entity (or entities) that is (are) within the group;
 - (b) whether a performance target that refers to a longer period than the required service period may constitute a performance condition;
 - (c) whether the specified period of service that the counterparty is required to complete can be either implicit or explicit;
 - (d) whether a performance target needs to be influenced by an employee;
 - (e) whether a share market index target may constitute a performance condition or a non-vesting condition;
 - (f) whether the definition of performance condition should indicate that it includes a market condition;
 - (g) whether a definition of non-vesting condition is needed; and
 - (h) whether the employee’s failure to complete a required service period due to termination of employment is considered to be a failure to satisfy a service condition.

Whether a performance target can be set by reference to the price (or value) of another entity (or entities) that is (are) within the group

- BC337 The Board decided to clarify that within the context of a share-based payment transaction that involves entities in the same group, a performance target can be defined by the price (or value) of the equity instruments of another entity in that

group. This amendment is consistent with the guidance in paragraphs 3A and 43A–43D of IFRS 2. Paragraph 3A, which provides guidance about the scope of IFRS 2, states that “a share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services”.

- BC338 The Board decided to make a similar amendment to the definition of market condition to indicate that a market condition can be based on the market price of the entity’s equity instruments or the equity instruments of another entity in the same group.

Whether a performance target that refers to a longer period than the required service period may constitute a performance condition

- BC339 The Board observed that IFRS 2 was not clear about the duration of a performance target relative to the duration of the related service condition. Some understood IFRS 2 to require that the duration of the performance has to be wholly within the period of the related service requirement; others understood that a performance target could be achieved over a period that extends beyond the period for which the employee is required to provide a service.
- BC340 During its deliberations prior to the issue of the ED, the Board decided to clarify that the duration of the performance condition needed to be wholly within the period of the related service requirement. This meant that the period of achieving the performance target could not start before, or end after, the service period. This requirement was reflected in the ED.
- BC341 Some respondents to the ED disagreed with the requirement that the duration of the performance condition needed to be wholly within the period of the related service, because they asserted that it was common for a performance target to start before the service period. For example, a performance target could be set as a measure of the growth in earnings per share (the ‘EPS target’) between the most recently published financial statements on the grant date and the most recently published financial statements before the vesting date.
- BC342 Other respondents noted that if the beginning of the period for achieving the performance target was restricted, then a relatively minor difference in the way that the awards are structured could lead to a different classification of the performance target (ie as either a non-vesting condition or a performance (vesting) condition), which could consequently lead to differences in the way in which the award would be accounted for in accordance with the guidance in IFRS 2.
- BC343 In response to the comments received on the ED, the Board decided to revise the proposed definition of performance condition. In this revision, the Board decided to ease the restriction on when the period for a performance target could start. It therefore decided to clarify that the start of the period of achieving the performance target could be before the service period, provided that the commencement date of the performance target is not substantially before the commencement of the service period.

- BC344 However, the Board decided to retain the proposal in the ED that the period over which the performance target is achieved should not extend beyond the service period. It thought that this decision was consistent with the definition of a performance condition, which was previously included within the definition of a vesting condition. The definition of a performance condition requires the counterparty to complete a specified period of service and to meet the performance target(s) while the counterparty is rendering the service required. The definition of performance condition reflects the principle in paragraph 7 of IFRS 2, which states that “An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received”.
- BC345 The Board also decided to add the words “ie a **service condition**” to criterion (a) of the definition of performance condition in order to create a cross-reference to the definition of service condition.

Whether the specified period of service that the counterparty is required to complete can be either implicit or explicit

- BC346 In the definition of performance condition, the Board decided to highlight a feature that distinguishes a performance condition from a non-vesting condition in accordance with paragraph BC171A of IFRS 2; namely, that a performance condition has an explicit or implicit service requirement and a non-vesting condition does not. This is so that, in order to constitute a performance condition, a performance target needs to be accompanied by a service requirement, which can be implicit or explicit. The Board observed that if the share-based payment arrangement does not contain an explicit requirement to provide services, the arrangement may still contain an implicit service condition.

Whether a performance target needs to be influenced by an employee

- BC347 During its deliberations the Board observed that for a target to constitute a performance condition it needs to be both ‘within the influence’ of the employee and in the interest of the entity. Consequently, the Board proposed that the definition of performance condition should make clear that a performance target is defined by reference to the entity’s own operations (or activities) or the price (or value) of its equity instruments (including shares and share options).
- BC348 In response to the ED, some respondents indicated that the reason why the performance target needed to be within the influence of the employee was unclear and found it to be contradictory to the proposed definition of performance condition. This is because in the proposed definition, the performance target was defined by reference to the performance of the entity, that is, by reference to the entity’s own operations (or activities) or the price (or value) of its equity instruments. Some other respondents also raised some difficulties that they expected to encounter when applying the proposed guidance. In this respect, the respondents stated that determining whether a performance target is within the influence of the employee would be difficult to

apply in the case of a group of entities; for example, the profit or share price of a group of companies could be seen to be 'remote from the influence of' an employee of a particular subsidiary of the group.

- BC349 The Board observed that requiring a performance target to be within the influence of the employee could be misinterpreted as meaning that the Board's intention was to challenge management to explain how the performance of the employee affects the performance target. The Board confirmed that it was not its intention to do so. It observed that the link between the employee's service/performance against a given performance target is management's responsibility. It noted that each employee has, in varying degrees, an influence over an entity's (or group's) overall performance, that is, over an entity's (or group's) own operations (or activities) or the price (or value) of its equity instruments. Consequently, the Board decided to omit the requirement that the target "needs to be within the influence of the employee" to avoid further confusion.
- BC350 In its review of the definition of performance condition the Board also considered what, if any, level of correlation is required between an employee's responsibility and the performance target. Potential diversity in practice had emerged because some were of the view that if share based payment awards are granted to employees conditional on the entity-wide profit, it is not clear that the profit target constitutes a performance condition on the basis that the employee might have so little influence on the entity-wide profit that it is not clear whether the target is able to sufficiently incentivise an individual employee's actions. Others held the view that because the entity is in business in order to make a profit, it is reasonable to assume that all employees contribute directly or indirectly to the entity-wide profit, ie that the whole body of employees contribute towards the entity-wide profit.
- BC351 In the ED the Board observed that it is reasonable to assume that the performance target that is set by management for an employee's share-based payment appropriately incentivises the employee to provide an increased quality and/or quantity of service to benefit the entity. Consequently, the Board decided that the definition of performance condition should make clear that a performance target may relate either to the performance of the entity as a whole or to some part of it, such as a division or an individual employee.
- BC352 Respondents to the ED questioned whether it was the Board's intention to require an entity to demonstrate, or provide evidence of, the correlation between an employee's responsibility and the performance target in order for that target to be a performance condition. During its deliberations, the Board confirmed that it was not its intention to require an entity to prove this correlation.

Whether a share market index target may constitute a performance condition or a non-vesting condition

- BC353 The Board analysed the case in which a share-based payment is conditional on a share market index target and whether it would be considered a performance condition or a non-vesting condition. For example, a grant might be conditional

on a stock exchange index (of which the entity's shares are a part) reaching a specified target and the employee remaining in service up to the date that the target is met.

- BC354 The Board observed that some might argue that the share market index target with the implicit service requirement constitutes a performance condition, because an employee is required to provide service to the entity, and that the time estimated to affect the share market index target implicitly determines how long the entity receives the required service. Others might argue that the share market index target is a non-vesting condition because it is not related to the performance of the entity (ie instead it is related to, or based on, not only the entity's share price but also the share price of other unrelated entities).
- BC355 In the ED the Board observed that the share market index target would be considered a non-vesting condition because it is not related to the performance of the entity or of another entity in the same group, even if the shares of the entity or of another entity in the same group form part of that index. The Board also observed that a share market index target may be predominantly affected by many external variables or factors involved in its determination, including macroeconomic factors such as the risk-free interest rate or foreign exchange rates and, consequently, it is remote from the influence of the employee.
- BC356 Respondents to the ED agreed that it would be reasonable to assume that the share market index target is a non-vesting condition but some thought that it should not be based on the level of influence exercised by an employee over the performance target or on whether the target is affected by external variables or factors. This is because, in their view, the level of influence and the effect of external variables are subjective reasons that are difficult to measure.
- BC357 The Board decided to reaffirm its position that a share market index is a non-vesting condition but, on the basis of the comments received, it is clarifying that the reason why it is a non-vesting condition is because a share market index not only reflects the performance of an entity but, in addition, also reflects the performance of other entities outside the group.
- BC358 The Board also considered a similar case in which the entity's share price makes up a substantial part of the share market index. The Board determined that even in such a case the condition should still be considered a non-vesting condition because it reflects the performance of other entities that are outside the group.

Whether the definition of performance condition should indicate that it includes a market condition

- BC359 A respondent to the ED noted that the final sentence of the definition of vesting conditions, which states that "a performance condition might include a market condition", is contradictory. This is because a market condition:
- (a) is a target that is related to the market price of the entity's equity instruments; and
 - (b) includes no explicit requirement for the counterparty to complete a specified period of service.

BC360 The Board observed that, on the basis of the definition of performance condition, a performance target that is related to the market price of an entity's equity instruments and to the completion of a specified period of service is considered a market (performance) condition. Consequently, the Board disagreed that an inconsistency existed in the definitions of performance condition and market condition. To avoid confusion in the definitions of performance condition and market condition, the Board decided to:

- (a) delete the last sentence in the definition of vesting condition (ie "a performance condition might include a market condition"); and
- (b) indicate within the definition of performance condition that performance conditions are either market conditions or non-market conditions.

BC361 The Board decided to confirm that a market condition is a type of performance condition. The Board considered that a condition that is not subject to a service requirement is not a performance condition, and instead, is considered a non-vesting condition. In making this clarification, the Board did not change the measurement requirements in IFRS 2 for a market condition.

Whether a definition of 'non-vesting condition' is needed

BC362 Respondents to the ED thought that clarity could be further improved in IFRS 2 by defining a 'non-vesting condition'.

BC363 The Board noted that there is no formal definition of non-vesting condition in IFRS 2, but Implementation Guidance on the split between vesting and non-vesting conditions is provided in a flowchart in paragraph IG24 of IFRS 2.

BC364 The Board determined that the creation of a stand-alone definition of non-vesting condition would not be the best alternative for providing clarity on this issue. This is because the Board observed that the concept of a non-vesting condition can be inferred from paragraphs BC170–BC184 of IFRS 2, which clarify the definition of vesting conditions. In accordance with this guidance it can be inferred that a non-vesting condition is any condition that does not determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement. In other words, a non-vesting condition is any condition that is not a vesting condition. On the basis of its analysis the Board decided to not add a definition of non-vesting condition.

Whether the employee's failure to complete a required service period due to termination of employment is considered to be a failure to satisfy a service condition

BC365 When considering a possible revision of the definition of service condition, the Board observed that in IFRS 2 there is no specific guidance on how to account for a share-based payment award when the entity terminates an employee's employment.

BC366 The Board noted, however, that paragraph 19 of this Standard regards the employee's failure to complete a specified service period as a failure to satisfy a service condition. In the ED the Board proposed to clarify within the definition

of service condition that if the employee fails to complete a specified service period, the employee thereby fails to satisfy a service condition, regardless of the reason for that failure. The Board also noted that the accounting consequence is that the compensation expense would be reversed if an employee fails to complete a specified service period.

- BC367 Some respondents to the ED thought that more clarity could be provided in the proposed guidance. This is because they noted that in some circumstances in which an employee is unable to perform the service condition by completing the stipulated service period (such as when the employee is ill or dies in service), it would normally be expected that part of the award would vest and that the related compensation expense should not be reversed. They noted that, to the extent that a portion of the award vests, that portion should be recognised as an expense.
- BC368 In response to the comments received, the Board noted that the objective of the proposed amendment to the definition of service condition is to clarify that the termination of an employee's employment is a situation in which the employee fails to complete a specified service period and, consequently, is considered a situation in which the service condition is not met.
- BC369 The Board observed that in circumstances in which equity instruments do not vest because of failure to satisfy a vesting condition, paragraph 19 of IFRS 2 states that "on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of a failure to satisfy a vesting condition". The Board observed that in circumstances in which the equity instruments either partly or fully vest on cessation of employment, paragraph 23 of IFRS 2 states that "the entity shall make no subsequent adjustment to total equity after vesting date". The Board also noted that, in accordance with paragraph 28, "if a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period". Noting the guidance already provided in IFRS 2, the Board concluded that further guidance was not necessary.

Transition provisions

- BC370 The Board considered the transition provisions and effective date of the amendment to IFRS 2. The Board noted that the changes to the definitions of vesting conditions and market condition and the addition of performance condition and service condition might result in changes to the grant-date fair value of share-based payment transactions for which the grant date was in previous periods. To avoid the use of hindsight, it decided that an entity would apply the amendments to IFRS 2 prospectively to share-based payment transactions for which the grant date is on or after 1 July 2014. Earlier application should be permitted.

Amendment to the Basis for Conclusions on IFRS 3 *Business Combinations*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC360A–BC360J and their related headings are added.

Clarification on the accounting for contingent consideration in a business combination

- BC360A The IASB clarified the accounting for contingent consideration arising from business combinations.

Classification of contingent consideration in a business combination

- BC360B The IASB noted that the classification requirements in paragraph 40 of IFRS 3 were unclear as to when, if ever, “other applicable IFRSs” would need to be used to determine the classification of contingent consideration as a financial liability or as an equity instrument. Consequently, the IASB deleted the reference to “other applicable IFRSs” in paragraph 40.

Subsequent measurement of contingent consideration in a business combination

- BC360C The IASB also noted that the requirements for subsequent measurement in paragraph 58 require contingent consideration, other than that which meets the definition of equity in accordance with IAS 32 *Financial Instruments: Presentation*, to be subsequently measured at fair value. However, paragraph 58 then refers to IFRS 9 *Financial Instruments* (or IAS 39, if IFRS 9 has not yet been applied), IAS 37 or other IFRSs as appropriate, which may not require subsequent measurement at fair value.

Subsequent measurement of contingent consideration that is a financial instrument

- BC360D The IASB noted that the requirements for subsequent measurement in paragraph 58 for contingent consideration that is a financial instrument within the scope of IFRS 9 (or IAS 39) were inconsistent with the accounting requirements of IFRS 9 (or IAS 39). Because paragraph 58 referred to IFRS 9 (or IAS 39), which allows amortised cost measurement in some circumstances, contingent consideration that is a financial liability might be classified as being measured at amortised cost. This would conflict with the requirement in paragraph 58 that such contingent consideration should be subsequently measured at fair value. Consequently, the IASB amended the classification requirements of IFRS 9 (and IAS 39) to ensure that the subsequent measurement requirement for contingent consideration that is a financial liability is fair value. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.
- BC360E In redeliberating this issue, the IASB decided that it would not be possible for contingent consideration that is a financial asset that meets the requirements in

IFRS 9 to be subsequently measured at amortised cost (because the contractual terms of contingent consideration that is a financial asset would not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding). Consequently, the IASB decided that the proposed amendments to paragraph 4.1.2 of IFRS 9 in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* were not needed.

- BC360F The IASB also decided that changes in fair value of any contingent consideration that is a financial asset or a financial liability should be recognised in profit or loss. Consequently, the IASB decided to amend paragraph 5.7.5 of IFRS 9 to ensure that any change in the fair value of investments in equity instruments that are contingent consideration in a business combination should be presented in profit or loss. The IASB noted that it was unlikely that contingent consideration that is an asset would meet the definition of equity. However, it decided to amend the paragraph to ensure that all contingent consideration that is made up of financial instruments is accounted for consistently.

Subsequent measurement of contingent consideration that is a non-financial asset or a non-financial liability

- BC360G The IASB also noted that the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is a non-financial asset or a non-financial liability may conflict with the measurement requirements in other applicable Standards. The conflict arises because paragraph 58 refers to changes in the fair value of contingent consideration but paragraph 58(b) refers to Standards that do not require fair value as a measurement basis, for example, IAS 37. Consequently, the IASB deleted the reference to “IAS 37 or other IFRSs as appropriate” from paragraph 58(b). This, therefore, maintains fair value as the subsequent measurement basis for all non equity contingent consideration to which IFRS 3 applies. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.
- BC360H The IASB also decided that the full change in the fair value of any contingent consideration that is a non-financial asset or a non-financial liability should be recognised in profit or loss.

Other considerations given to subsequent measurement of contingent consideration

- BC360I The IASB considered alternatives for the subsequent measurement requirements for contingent consideration. It considered whether all references to other Standards, including references to IFRS 9 (or IAS 39), should be removed and instead all necessary guidance for the subsequent measurement of contingent consideration should be included in IFRS 3. It decided, however, to amend IFRS 9 (and IAS 39) as a consequential amendment derived from the amendment to IFRS 3 and to retain the link to IFRS 9 (or IAS 39) so that the general guidance in IFRS 9 (or IAS 39) applies to contingent consideration that is within the scope of IFRS 9 (or IAS 39). The IASB also considered whether some liability contingent consideration should be measured at fair value with some fair value changes being presented in other comprehensive income. It decided that it was preferable that the guidance was consistent for all liability contingent

consideration and, consequently, it decided that all liability contingent consideration should be subsequently measured at fair value with any resulting gain or loss, including gain or loss attributable to changes in own credit risk, being recognised in profit or loss.

Disclosure

- BC360J Some stakeholders had asked whether the IASB had intended the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* to apply to contingent consideration, noting that there are disclosure requirements for contingent consideration in IFRS 3. The IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7. Consequently, the IASB decided not to make any changes to the scope of IFRS 7 to exclude such financial instruments.

Paragraph BC434A is amended and paragraph BC434D and its related heading are added. New text is underlined and deleted text is struck through.

Transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (as revised in 2008)

- BC434A In *Improvements to IFRSs* issued in May 2010, the Board addressed a perceived conflict in the guidance on accounting for contingent consideration in a business combination. The perceived conflict related to the transition guidance for contingent consideration arising from business combinations that had been accounted for in accordance with IFRS 3 (as issued in 2004). Before their deletion in January 2008, paragraph 3(c) of IFRS 7 *Financial Instruments: Disclosures*, paragraph 4(c) of IAS 32 *Financial Instruments: Presentation* and paragraph 2(f) of IAS 39 *Financial Instruments: Recognition and Measurement* excluded contingent consideration arrangements from the scope of those IFRSs. To allow the acquirer to account for contingent consideration as required by IFRS 3 (revised 2008), the Board deleted those scope exceptions in the second phase of its project on business combinations.

...

Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations

- BC434D *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, clarifies the accounting for contingent consideration that arises from business combinations. The IASB considered whether the transition provisions of paragraph 19 in IAS 8 should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Retrospective application might therefore require the determination of fair value for contingent consideration, which might not have been previously measured at fair value following initial recognition. It may be impracticable for

an entity to determine the fair value of such contingent consideration without using hindsight. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. The IASB also decided on a 1 July 2014 mandatory effective date for the amendments to IFRS 3 and the consequential amendments to IAS 37 as well as to IFRS 9 and IAS 39, depending on the financial instruments Standard that is applied by the entity at the time that this amendment becomes effective.

The following footnote is added after "... in accordance with that IFRS)" in paragraph BC437(c).

Annual Improvements to IFRSs 2010–2012 Cycle, issued in December 2013, amended IFRS 3, IFRS 9, IAS 37 and IAS 39 to clarify that contingent consideration in a business combination that is classified as an asset or a liability shall be subsequently measured at fair value with changes in fair value recognised in profit or loss.

Amendment to the Basis for Conclusions on IFRS 8 *Operating Segments*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC30A–BC30B and BC35B and their related headings are added.

Aggregation of operating segments

BC30A The Board received a request to consider including a disclosure in paragraph 22 that would require a description of the operating segments that have been aggregated and the economic indicators that have been assessed to decide whether operating segments have ‘similar economic characteristics’ in accordance with paragraph 12. The Board observed that:

- (a) paragraph 12 does not elaborate upon the meaning of “similar economic characteristics” except to say that operating segments that share similar economic characteristics would be expected to exhibit a similar long term financial performance. In addition, determining whether operating segments have similar economic characteristics requires the use of judgement.
- (b) paragraph 22(a) currently contains a requirement to disclose the factors used to identify the entity’s reportable segments, including the basis of organisation, and suggests, as an example, disclosing whether operating segments have been aggregated. However, there is no explicit, or indeed apparent, requirement in paragraph 22(a) to disclose the aggregation of operating segments.

BC30B The Board noted that the disclosure is complementary to the information required by paragraph 22(a). The Board thinks that including a disclosure requirement in paragraph 22 would provide users of financial statements with an understanding of the judgements made by management on how (and the reasons why) operating segments have been aggregated. The judgements made by management may relate to the application of any of the criteria in paragraph 12, which states that two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of IFRS 8, the segments have similar economic characteristics and the segments are similarly based on the factors listed in paragraph 12(a)–(e). Consequently, the Board added paragraph 22(aa) to complement the disclosure required in paragraph 22(a). The requirements in paragraph 22(b) remain the same and its wording has not been modified.

...

Reconciliation of segment assets

BC35B The Board received a request to clarify in paragraph 28(c) that a reconciliation of the total of the reportable segments’ assets to the entity’s assets should only be disclosed if that amount is regularly provided to the chief operating decision maker. This clarification would make this paragraph consistent with

paragraphs 23 and 28(d). The Board agreed with the request and decided to modify paragraph 28(c) to achieve this.

Amendment to the Basis for Conclusions on IFRS 13 *Fair Value Measurement*

Paragraph BC138A and its related heading are added.

Short-term receivables and payables

BC138A After issuing IFRS 13, the IASB was made aware that an amendment to IFRS 9 and IAS 39, which resulted in the deletion of paragraphs B5.4.12 and AG79 respectively, might be perceived as removing the ability to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial. The IASB did not intend to change the measurement requirements for those short-term receivables and payables, noting that paragraph 8 of IAS 8 already permits entities not to apply accounting policies set out in accordance with IFRSs when the effect of applying them is immaterial.

Consequential amendments to other IFRSs resulting from the amendment to IFRS 13

Amendment to the Basis for Conclusions on IFRS 9 *Financial Instruments* (issued in October 2010)

The footnote to the heading above paragraph BCZ5.1 is amended. New text is underlined.

IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.13 of IFRS 9 have been deleted. Annual Improvements to IFRSs 2010–2012 Cycle, issued in December 2013, added paragraph BC138A to the Basis for Conclusions on IFRS 13 to clarify the IASB’s reason for deleting paragraph B5.4.12.

Amendment to the Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

The footnote to paragraph BC95 is amended. New text is underlined.

IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence in Appendix A of IAS 39 paragraphs AG69–AG75, AG76A–AG79 and AG82 have been deleted and paragraphs AG76, AG80 and AG81 have been amended. Annual Improvements to IFRSs 2010–2012 Cycle, issued in December 2013, added paragraph BC138A to the Basis for Conclusions on IFRS 13 to clarify the IASB’s reason for deleting paragraph AG79.

Amendment to the Basis for Conclusions on IAS 16 *Property, Plant and Equipment*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC25A–BC25J and their related heading are added.

Revaluation method—proportionate restatement of accumulated depreciation when an item of property, plant and equipment is revalued

- BC25A The IFRS Interpretations Committee reported to the Board that practice differed in calculating the accumulated depreciation for an item of property, plant and equipment that is measured using the revaluation method in cases in which the residual value, the useful life or the depreciation method has been re-estimated before a revaluation.
- BC25B Paragraph 35(a) required that, in instances in which the gross carrying amount is revalued, the revalued accumulated depreciation is restated proportionately with the change in the gross carrying amount.
- BC25C The submission noted that applying the same proportionate factor to restate the accumulated depreciation as for the change in the gross carrying amount has caused problems in practice if the residual value, the useful life or the depreciation method has been re-estimated before the revaluation. The submission used an example in which both the gross carrying amount and the carrying amount were revalued.
- BC25D In such cases, divergent views existed as to how to calculate the accumulated depreciation when the item of property, plant and equipment is revalued:
- (a) some think that the restatement of the accumulated depreciation is not always proportionate to the change in the gross carrying amount and that paragraph 35(a) should be amended accordingly.
 - (b) others are of the opinion that the accumulated depreciation and the gross carrying amount should always be restated proportionately when applying paragraph 35(a). The difference between the amount required for a proportionate restatement of the depreciation and the actual restatement of the depreciation required for the gross carrying amount to result in a carrying amount equal to the revalued amount being treated as an accounting error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- BC25E The definition of ‘carrying amount’ in paragraph 6 is “the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment loss”. The Board noted that, when revaluing an item of property, plant and equipment, the definition implies that the accumulated depreciation is calculated as the difference between the gross carrying amount and the carrying amount, after taking into account accumulated impairment losses.

- BC25F The Board agrees with the proponents of the view presented in paragraph BC25D(a) that the restatement of the accumulated depreciation is not always proportionate to the change in the gross carrying amount. The Board noted that the accumulated depreciation would not be able to be restated proportionately to the gross carrying amount in situations in which both the gross carrying amount and the carrying amount are revalued non-proportionately to each other. It was noted that this was the case regardless of whether there had been a re-estimation of residual value, the useful life or the depreciation method in a prior period.
- BC25G For example, when the revalued amounts for the gross carrying amount and the carrying amount both reflect non-proportionate observable data, it is demonstrated that accumulated depreciation cannot be proportionately restated to the gross carrying amount in order for the carrying amount to equal the gross carrying amount less any accumulated depreciation and accumulated impairment losses. In that respect, the Board thinks that the requirements in paragraph 35(a) may be perceived as being inconsistent with the definition of carrying amount.
- BC25H In addition, the Board noted that the second sentence in paragraph 35(a) reinforced that inconsistency because it states that proportionate restatement is often used when an asset is revalued by means of applying an index to determine its replacement cost. It reinforced the inconsistency because the determination of the accumulated depreciation does not depend on the selection of the valuation technique used for the revaluation under the revaluation model for property, plant and equipment.
- BC25I Consequently, the Board decided to:
- (a) amend paragraph 35(a) to state that the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount;
 - (b) amend paragraph 35(a) to state that the accumulated depreciation is calculated as the difference between the gross carrying amount and the carrying amount after taking into account accumulated impairment losses; and
 - (c) delete the references to valuation methods in paragraph 35(a)–(b).
- The Board also decided to amend paragraph 35(b) to be consistent with the wording used in those amendments.
- BC25J The Board decided to include wording in paragraph 35(a) to require an entity to take into account accumulated impairment losses when adjusting the depreciation on revaluation. This was to ensure that when future revaluation increases occur, the correct split, in accordance with paragraph 39 of IAS 16 and paragraph 119 of IAS 36 *Impairment of Assets*, is made between profit or loss and other comprehensive income when reversing prior accumulated impairment losses.

The footnote to the heading above paragraph BC35A is amended. Deleted text is struck through.

Paragraphs BC35A–BC35F were added as a consequence of amendments to IAS 16 by *Improvements to IFRSs* issued in May 2008. At the same time, the Board also amended paragraph 6 by replacing the term ‘net selling price’ in the definition of ‘recoverable amount’ with ‘fair value less costs to sell’ for consistency with the wording used in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36 *Impairment of Assets*.

Paragraph BC36A is added.

Transitional provisions

...

BC36A *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended paragraph 35. The Board also decided that the amendment should be required to be applied to all revaluations occurring in annual periods beginning on or after the date of initial application of the amendments and in the immediately preceding annual period. The Board was concerned that the costs of full retrospective application might outweigh the benefits.

Amendment to the Basis for Conclusions on IAS 24 *Related Party Disclosures*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC50–BC52 and their related heading are added.

Key management personnel

- BC50 The Board was asked to address the identification and disclosure of related party transactions that arise when a management entity provides key management personnel services to a reporting entity. The Board understood that divergence existed because some reporting entities do not identify this as a related party transaction. Of those who do identify this as a related party transaction, some reporting entities would disclose the compensation paid by the management entity to those employees or directors of the management entity that act as key management personnel of the reporting entity. Other reporting entities would disclose the service fee that is paid or payable to the management entity, which is incurred by the reporting entity.
- BC51 The Board noted that IAS 24 is unclear as to what information to disclose for key management personnel when those persons are not employees of the reporting entity. To address the diversity in disclosures that has arisen from IAS 24 being unclear, the Board decided to amend the definition of 'related party'. The amendment clarified that a management entity that provides key management services to a reporting entity is deemed to be a related party of the reporting entity. In discussing these proposals, the Board acknowledged that the relationship between the management entity and the reporting entity is not symmetrical. The reporting entity is not a related party of the management entity solely as a consequence of being a customer of the management entity. The reporting entity cannot affect the management entity's activities, financial position or profit except through some other relationship. Consequently, the reporting entity is required to disclose the amount incurred for the service fee paid or payable to the management entity that employs, or has as directors, the persons that provide the key management personnel services. As a result of identifying the management entity as a related party of the reporting entity, the Board noted that the reporting entity is also required to disclose other transactions with the management entity, for example, loans, under the existing disclosure requirements of IAS 24 with respect to related parties.
- BC52 The Board was informed of concerns that it is impracticable to access the detailed information that is required in paragraph 17 when compensation is paid to a separate management entity as fees. The Board therefore decided to provide relief so that the reporting entity is not required to disclose the components of compensation to key management personnel that is paid through another entity. Instead, amounts incurred in respect of key management personnel compensation or key management personnel services, paid or payable to another entity, shall be disclosed in accordance with paragraph 18A.

Amendment to the Basis for Conclusions on IAS 38 *Intangible Assets*

This Basis for Conclusions accompanies, but is not part of, the amendment.

Paragraphs BC77A–BC77E and BC100A and their related heading are added.

Revaluation method—proportionate restatement of accumulated amortisation when an intangible asset is revalued

- BC77A The IFRS Interpretations Committee reported to the Board that practice differed in calculating the accumulated depreciation for an item of property, plant and equipment that is measured using the revaluation method in cases in which the residual value, the useful life or the depreciation method has been re-estimated before a revaluation.
- BC77B The reasons for making the change are further explained in paragraphs BC25A–BC25G of IAS 16.
- BC77C The Board noted that the issue in paragraphs BC25A–BC25G of IAS 16 regarding accumulated depreciation upon revaluation could also occur when revaluing an intangible asset under IAS 38, because both IAS 16 and IAS 38 have the same requirements for accumulated depreciation/amortisation when revaluing items of property, plant and equipment/intangible assets. Differences in the revaluation models for items of property, plant and equipment and intangible assets do not result in different models for restating accumulated depreciation/amortisation. For example, IAS 38 requires that the fair value of an intangible asset is measured by reference to an active market. Otherwise, the revaluation model cannot be applied. However, IAS 38 requires fair value measurement by reference to an active market only for the carrying amount of an intangible asset in contrast to its gross carrying amount.
- BC77D Consequently, the Board decided to amend paragraph 80(a) to state that:
- (a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount; and
 - (b) the accumulated amortisation is calculated as the difference between the gross carrying amount and the carrying amount after taking into account accumulated impairment losses.
- The Board also decided to amend paragraph 80(b) to be consistent with the wording used in those amendments.
- BC77E The Board decided to include wording in paragraph 80(a) to require an entity to take into account accumulated impairment losses when adjusting the amortisation on revaluation. This was to ensure that when future revaluation increases occur, the correct split according to paragraph 85 of IAS 38 and paragraph 119 of IAS 36 is made between profit or loss and other comprehensive income when reversing prior accumulated impairment losses.
- ...

Revaluation method—proportionate restatement of accumulated amortisation when an intangible asset is revalued

- BC100A *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended paragraph 80. The Board also decided that the amendment should be required to be applied to all revaluations occurring in annual periods beginning on or after the date of initial application of the amendment and in the immediately preceding annual period. The Board was concerned that the costs of full retrospective application might outweigh the benefits.

International Financial Reporting Standard

Annual Improvements to IFRSs 2011–2013 Cycle

December 2013

BASES FOR CONCLUSIONS – AMENDMENTS

[IFRS 1, 3 & 13 and IAS 40]

[Related to AASB 2014-1]

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Amendment to the Basis for Conclusions on IFRS 1 *First-time Adoption of International Financial Reporting Standards*

A footnote is added to paragraph BC11 and paragraph BC11A is added. New text is underlined.

Current version of IFRSs

BC11 Paragraphs 7–9 of the IFRS require a first-time adopter to apply the current version of IFRSs, without considering superseded or amended versions.¹ This:

(a) ...

BC11A Paragraph 7 requires an entity to use the IFRSs that are effective at the end of its first IFRS reporting period. Paragraph 8 allows a first-time adopter to apply a new IFRS that is not yet mandatory if that IFRS permits early application. Notwithstanding the advantages, set out in paragraph BC11, of applying a more recent version of an IFRS, paragraphs 7–8 permit an entity to use either the IFRS that is currently mandatory or the new IFRS that is not yet mandatory, if that new IFRS permits early application. Paragraph 7 requires an entity to apply the same version of the IFRS throughout the periods covered by the entity's first IFRS financial statements. Consequently, if a first-time adopter chooses to early apply a new IFRS, that new IFRS will be applied throughout all the periods presented in its first IFRS financial statements on a retrospective basis, unless IFRS 1 provides an exemption or an exception that permits or requires otherwise.

¹ Annual Improvements Cycle 2011–2013 clarified that this paragraph does not require an entity to use a more recent version of an IFRS. It only explains the advantages of applying a more recent version of an IFRS. See paragraph BC11A for further details.

Amendment to the Basis for Conclusions on IFRS 3 *Business Combinations*

After paragraph BC61 a subheading and paragraphs BC61A–BC61E are added. After paragraph BC434D a heading and paragraph BC434E are added.

Joint ventures and combinations of entities under common control

...

Annual Improvements Cycle 2011–2013

- BC61A The IASB observed that there was uncertainty about whether paragraph 2(a) of IFRS 3, which excludes the formation of joint ventures from the scope of IFRS 3, should have been amended to refer to joint arrangements when IFRS 11 was issued. IFRS 11 had changed the use of the term ‘joint venture’ from having a general meaning that included ‘jointly controlled operations’, ‘jointly controlled assets’ and ‘jointly controlled entities’, to meaning a specific type of joint arrangement, which does not include ‘joint operations’. The IASB did not change the wording of the scope exclusion in paragraph 2(a) of IFRS 3 for ‘the formation of a joint venture’ when it replaced IAS 31 with IFRS 11 *Joint Arrangements*, although it had not intended to change the scope of IFRS 3.
- BC61B There was also uncertainty about whether the scope exclusion in paragraph 2(a) of IFRS 3 addresses:
- (a) the accounting by the joint arrangements themselves in their financial statements only; or also
 - (b) the accounting by the parties to the joint arrangement for their interests in the joint arrangement.
- BC61C The IASB noted that paragraph 2(a) of IFRS 3 should exclude formations of every type of joint arrangement (ie joint ventures and joint operations) from the scope of IFRS 3. It also noted that paragraph 2(a) of IFRS 3 excludes, from the scope of IFRS 3, only the accounting by the joint arrangements themselves in their financial statements.
- BC61D The IASB concluded that paragraph 2(a) of IFRS 3 should be amended to address all types of joint arrangements and to remove uncertainty about the financial statements to which it applies.
- BC61E Consequently, the IASB amended paragraph 2(a) of IFRS 3 to:
- (a) exclude the formation of all types of joint arrangements from the scope of IFRS 3 by replacing ‘joint venture’ with ‘joint arrangement’; and
 - (b) clarify that the only scope exclusion needed from the scope of IFRS 3 is the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

...

Scope exceptions for joint ventures

BC434E *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 2(a) and added paragraph 64I to clarify the scope exception in paragraph 2(a) of IFRS 3. It took into consideration the transition provisions and effective date of the amendment to IFRS 3. In order to be consistent with the prospective initial application of IFRS 3, the IASB decided that an entity shall apply the amendment to IFRS 3 prospectively for annual periods beginning on or after 1 July 2014.

Amendment to the Basis for Conclusions on IFRS 13 *Fair Value Measurement*

After paragraph BC119 a subheading and paragraphs BC119A–BC119B are added.
Paragraph BC230A is added.

Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk

...

Scope of paragraph 52

- BC119A After issuing IFRS 13, the IASB was made aware that it was not clear whether the scope of the exception for measuring the fair value of a group of financial assets and financial liabilities on a net basis (the 'portfolio exception') includes all contracts that are within the scope of IAS 39 or IFRS 9. The exception is set out in paragraph 48 and the scope of the exception is set out in paragraph 52. In particular, the IASB was asked whether the scope of the portfolio exception included contracts that are accounted for as if they were financial instruments, but that do not meet the definitions of financial assets or financial liabilities in IAS 32. Examples of such a situation would be some contracts to buy or sell a non-financial item that can be settled net in cash by another financial instrument or by exchanging financial instruments as if the contracts were financial instruments within the scope of, and accounted for in accordance with, IAS 39 or IFRS 9.
- BC119B The IASB did not intend to exclude from the scope of the portfolio exception any contracts that are within the scope of IAS 39 or IFRS 9. Consequently, the IASB amended paragraph 52 of this Standard to clarify that the portfolio exception applies to all contracts within the scope of, and accounted for in accordance with, IAS 39 or IFRS 9, regardless of whether they meet the definitions of financial assets or financial liabilities as defined in IAS 32.

...

Effective date and transition

...

- BC230A *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 52 and added paragraph C4 to clarify the scope of the portfolio exception. It considered the transition provisions and effective date of the amendments to IFRS 13. It decided that an entity should apply that amendment for annual periods beginning on or after 1 July 2014. In order to be consistent with the prospective initial application of IFRS 13, the IASB decided that an entity would apply the amendment to IFRS 13 prospectively from the beginning of the annual period in which IFRS 13 was initially applied.

Amendment to the Basis for Conclusions on IAS 40 *Investment Property*

After paragraph BC17 a heading and paragraphs BC18–BC22 are added.

Classification of property as investment property or owner-occupied property

Acquisition of investment property: interrelationship with IFRS 3

- BC18 The IFRS Interpretations Committee (the 'Interpretations Committee') reported to the Board that practice differed in delineating the scope of IFRS 3 *Business Combinations* and IAS 40:
- (a) some considered both Standards as mutually exclusive if investment property with associated insignificant ancillary services, as specified in paragraph 11 of IAS 40, is acquired. They view property, together with any associated insignificant ancillary services, as being a single 'unit of account' and they consider this unit of account to be one asset called 'investment property'.
 - (b) others did not view IFRS 3 and IAS 40 as being mutually exclusive if investment property with associated insignificant ancillary services, as specified in paragraph 11 of IAS 40, is acquired; nor did they view the definitions of a business as defined in Appendix A of IFRS 3 and investment property as defined in paragraph 5 of IAS 40 as being interrelated. They think that an entity that acquires investment property has to determine whether it meets both definitions.
- BC19 The Board noted that paragraphs 7–14 of IAS 40 have been developed to differentiate investment property from owner-occupied property and to define the scope of IAS 40 to distinguish it from the scope of IAS 16 *Property, Plant and Equipment*. In addition, neither IFRS 3 nor IAS 40 contains a limitation in its scope that restricts its application when the other Standard applies, ie there is nothing within the scope of each Standard to suggest that they are mutually exclusive. The Board also noted that the wording of IAS 40 is not sufficiently clear about the interrelationship between the two Standards.
- BC20 The Board agreed with the proponents of the view presented in paragraph BC18(b) that IFRS 3 and IAS 40 are not mutually exclusive. It amended IAS 40 to state explicitly that judgement is also needed to determine whether the transaction is the acquisition of an asset or a group of assets or is a business combination within the scope of IFRS 3. That judgement is not based on paragraphs 7–14 of IAS 40 but is instead based on the guidance in IFRS 3. Only the judgement needed to distinguish investment property from owner-occupied property is based on those paragraphs.
- BC21 Consequently, the Board clarified the interrelationship between the two Standards by adding paragraph 14A and a heading before paragraph 6 to IAS 40.

Effective date and transition

- BC22 *Annual Improvements Cycle 2011–2013* issued in December 2013 added headings before paragraph 6 and after paragraph 84 and added paragraphs 14A, 84A and 85D to clarify the interrelationship between IFRS 3 and IAS 40. It considered the provisions for transition and the effective date of the amendment to IAS 40. The Board noted that applying IFRS 3 to transactions that have previously been accounted for as the acquisition of an asset or a group of assets might involve the use of hindsight when determining the fair values, at acquisition date, of the identifiable assets acquired and of the liabilities assumed as part of the business combination transaction. However, it also noted that the amendment is only a clarification of the interrelationship between IFRS 3 and IAS 40. Consequently, it decided that an entity would apply the amendments to IAS 40 prospectively for annual periods beginning on or after 1 July 2014, but an entity may choose to apply the amendment to individual transactions that occurred prior to the beginning of the first annual period occurring on or after the effective date only if the information needed is available to the entity.

International Financial Reporting Standard

Defined Benefit Plans: Employee Contributions

November 2013

BASIS FOR CONCLUSIONS – AMENDMENTS

[IAS 19]

[Related to AASB 2014-1]

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Amendments to the Basis for Conclusions on IAS 19 *Employee Benefits*

The following footnote is added to the end of paragraph BC143(b) and after "... on the net benefit)" in paragraph BC150(a).

Defined Benefit Plans: Employee Contributions, issued in November 2013, clarified the requirements that relate to how contributions from employees or third parties that are linked to service should be attributed to periods of service. In addition, it permits a practical expedient if the amount of the contributions is independent of the number of years of service. See paragraphs BC150A–BC150K.

A heading and paragraphs BC150A–BC150K are added.

Contributions from employees or third parties: amendments issued in 2013

- BC150A In 2012, the IFRS Interpretations Committee (the 'Interpretations Committee') received two submissions that requested clarification of the accounting requirements set out in paragraph 93 of IAS 19 for contributions from employees or third parties.
- BC150B The Interpretations Committee considered whether some types of contributions from employees or third parties to a defined benefit plan should reduce the cost of short-term employee benefits instead of reducing the cost of post-employment benefits. The Interpretations Committee observed that the wording in paragraph 93 of IAS 19 appeared to suggest that all employee contributions that are linked to service should be attributed to periods of service as a reduction of service cost (ie as a negative benefit). However, employee contributions that are linked solely to the employee's service rendered in the same period in which those contributions are payable (for example, contributions that are a fixed percentage of salary throughout the period of the employment) might also be considered to be a reduction of the cost of short-term employee benefits (ie a reduction in salary). Consequently, the Interpretations Committee recommended to the IASB that it should amend IAS 19 regarding the accounting for such contributions.
- BC150C In the IASB's view, contributions from employees or third parties that are required by the terms of a defined benefit plan should form part of the post-employment benefit rather than the short-term employee benefit. Consequently, such contributions should be attributed to periods of service as a reduction of service cost (ie as a negative benefit). However, the IASB acknowledged the general concern about the complexity of the required calculations that could result from the requirement to attribute the net benefit to periods of service. The IASB thus concluded that the costs of applying the

attribution requirements to some simple types of contributory plans outweighed the benefits and so the IASB decided to add a practical expedient to paragraph 93.

- BC150D Consequently, in March 2013, the IASB published the Exposure Draft ED/2013/4 *Defined Benefit Plans: Employee Contributions* ('ED/2013/4'), which proposed amendments to paragraph 93 of IAS 19. In ED/2013/4 the IASB proposed that some contributions from employees or third parties may be excluded from being attributed to periods of service as a negative benefit. Instead, those contributions could be recognised as a reduction in the service cost in the period in which they are payable if, and only if, they are linked solely to the employee's service rendered in that period. An example of such a situation would be contributions based on an employee's salary at a fixed percentage that does not depend on the number of years of service by the employee to the employer. On the other hand, if an employee is required to contribute a higher percentage of salary in later years of service, then the contributions are not linked solely to the employee's service that is rendered in the period in which the contributions are payable.
- BC150E When developing ED/2013/4, the IASB observed that paragraph 93 first states that contributions from employees or third parties in respect of service are attributed to periods of service as a negative benefit in accordance with paragraph 70, and then states that the net benefit is attributed in accordance with paragraph 70. The references to both the negative benefit and net benefit might cause confusion as to whether the back-end loading test in paragraph 70 is required to be performed on the net benefit, or on the gross benefit and the negative benefit separately. The IASB observed that performing the test on the net benefit would add complexity and that the outcome of that test would differ from the outcome of performing the test on the gross benefit and the negative benefit separately. Consequently, the IASB proposed to specify in paragraph 93 that the contributions from employees or third parties that are not solely linked to current-year service should be attributed to periods of service using the same method of attribution as the gross benefit in accordance with paragraph 70.
- BC150F A total of 63 respondents commented on ED/2013/4. The majority of respondents supported the proposed amendments, but about half of them requested either further clarification of the scope of the practical expedient or the addition of application guidance or examples.
- BC150G Some respondents requested clarification of whether they could apply the proposed practical expedient if the amount of the contributions depended on the employee's age instead of the number of years of service (age-based contributions). The IASB observed that examples illustrating the proposed practical expedient in ED/2013/4 implied two criteria—one is whether contributions are a fixed percentage of salary and the other is whether the contributions are independent of the number of years of service.
- BC150H The IASB considered whether contributions should have to meet either or both of the criteria to qualify for the practical expedient. In some circumstances, age-based contributions could approximate contributions that depend on the number of years of service, because both of the contribution formulas depend on

time. However, age-based contributions are independent of the number of years of service. For example, the terms of a plan require employee contributions of four per cent of salary for the first ten years and then six per cent thereafter. The increase to six per cent is not only related to the service in the current year, but is also related to the first ten years of service, which is a prerequisite for the change in the contribution percentage. If the terms of the plan required employee contributions of four per cent of salary if the employee was 30 years old or younger and six per cent if the employee was more than 30 years old, then an employee would be required to contribute either four per cent or six per cent regardless of the length of their service. In other words, the contributions paid for each year are not dependent on prior service.

- BC150I Consequently, the IASB decided that the practical expedient should be permitted if the amount of the contributions is independent of the number of years of service. This principle would also help to clarify whether the practical expedient would apply to other types of contribution arrangements, including contributions that are a fixed amount (as opposed to a fixed percentage) regardless of the number of years of service.
- BC150J One respondent to ED/2013/4 was concerned that some might interpret the requirements to attribute contributions from employees or third parties to periods of service to mean that the accumulated value of contributions should be deducted from both the defined benefit obligation and the plan assets. The IASB noted that the plan assets and the defined benefit obligation would increase by the amount of the contributions paid. This is because the contributions that are paid increase the employer's obligation to the employees even if those contributions are attributed to other periods of service to reflect the net cost to the employer.
- BC150K When developing the amendments, the IASB observed that paragraph 94 sets out requirements for the accounting for changes in employee or third-party contributions. The IASB noted that the requirements in that paragraph apply to contributions that are attributed to periods of service using the same attribution method that is required by paragraph 70 for the gross benefit. Consequently, the IASB decided to amend paragraph 94 to clarify the scope of the requirements in that paragraph.

A heading and paragraphs BC271A–BC271B are added.

Transition provisions for *Defined Benefit Plans: Employee Contributions*

- BC271A In ED/2013/4, the IASB proposed retrospective application and to permit earlier application of the amendments. The majority of the respondents supported those proposals. Some respondents questioned whether retrospective application was practicable because some calculations might require information that is not readily available. The IASB observed that in current practice, contributions from employees or third parties are generally reduced from service cost without being attributed to periods of service. The proposed amendments are intended to provide relief so that entities can deduct

contributions from service cost in the period in which the service is rendered, which was common practice prior to the 2011 amendments to IAS 19. The impact of retrospective application would therefore be minimal in those cases. Consequently, the IASB decided to retain the requirement for retrospective application.

- BC271B The amendments to IAS 19 published in 2011 are effective for annual periods beginning on or after 1 January 2013. In the IASB's view, the objective of the amendments published in 2013 is to provide relief in the accounting for contributions from employees or third parties and, therefore, the effective date should be set as early as possible, while allowing jurisdictions to have sufficient time to prepare for the new requirements. Consequently, the IASB decided that the effective date of the amendments should be 1 July 2014, with earlier application permitted.

International Financial Reporting Standard

Financial Instruments

November 2013

BASES FOR CONCLUSIONS – AMENDMENTS

[IFRS 1, 2, 3, 4, 5, 7, 9 (Nov 2009), 9 (Oct 2010) & 9 (Nov 2013), IAS 1, 17, 20, 27, 28, 32, 36, 39, 40 & 41, IFRIC 2, 4, 5, 10, 12, 16, 17 & 19 and SIC 27]

[Related to AASB 2013-9 & AASB 2014-1]

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Basis for Conclusions on IFRS 9 *Financial Instruments*

This Basis for Conclusions accompanies, but is not part of, IFRS 9.

The IASB expects that IFRS 9 will replace IAS 39 *Financial Instruments: Recognition and Measurement*. When revised in 2003, IAS 39 was accompanied by a Basis for Conclusions summarising the considerations of the IASB, as constituted at the time, in reaching some of its conclusions in that Standard. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard. For convenience the IASB has incorporated into its Basis for Conclusions on IFRS 9 material from the Basis for Conclusions on IAS 39 that discusses matters that the IASB has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to the Standard have been updated accordingly and minor, necessary editorial changes have been made. After 2003 some IASB members dissented from the issue of IAS 39 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 9. Those dissenting opinions are set out after the Basis for Conclusions on IAS 39.

Paragraphs describing the IASB's considerations in reaching its conclusions on IFRS 9 are numbered with the prefix BC.

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

This publication amends some existing paragraphs and adds others. Only the paragraphs that have been amended are included, or those that are there for ease of reference. No mark-up has been used; instead the amended paragraph should be replaced in full.

The Introduction is amended.

Introduction

- BCIN.1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) when developing IFRS 9 *Financial Instruments*. Individual IASB members gave greater weight to some factors than to others.
- BCIN.2 The IASB has long acknowledged the need to improve the requirements for financial reporting of financial instruments to enhance the relevance and understandability of information about financial instruments for users of financial statements. That need became more urgent in the light of the financial crisis, so the IASB decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* in its entirety as expeditiously as possible. To make progress quickly the IASB divided the project into several phases. In adopting this approach, the IASB acknowledged the difficulties that might be created by differences in timing between this project and others, in particular phase II of the project on insurance contracts (see paragraphs BC7.2(b), BC7.4 and BC7.30–BC7.34 for issues relating to insurance contracts).

Classification and measurement

- BCIN.3 IFRS 9 is a new Standard that deals with the accounting for financial instruments. When developing IFRS 9, the IASB considered the responses to its Exposure Draft *Financial Instruments: Classification and Measurement*, published in July 2009.
- BCIN.4 That Exposure Draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the IASB should finalise its proposals on the classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the IASB had more fully considered and debated the issues relating to financial liabilities. Those respondents pointed out that the IASB had accelerated its project on financial instruments because of the global financial crisis, which had placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the IASB should consider issues related to financial liabilities more closely before finalising the requirements for classification and measurement of financial liabilities.
- BCIN.5 The IASB noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with the classification and measurement of financial assets. In the IASB's view, requirements for classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and the requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the IASB noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement of financial assets in accordance with IAS 39.
- BCIN.6 Thus, financial liabilities, including derivative liabilities, remained within the scope of IAS 39. Taking that course enabled the IASB to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.
- BCIN.7 Immediately after issuing IFRS 9, the IASB began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The IASB obtained information and views from its Financial Instruments Working Group (FIWG) and from users of financial statements, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the IASB received were that the requirements in IAS 39 for classifying and measuring financial liabilities were generally working well but that the effects of the changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the IASB decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46–BC4.53).
- BCIN.8 By taking that course, the issue of credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010, the IASB published the Exposure Draft

Fair Value Option for Financial Liabilities, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The IASB considered the responses to that Exposure Draft and finalised the requirements that were then added to IFRS 9 in October 2010.

- BCIN.9 The IASB is committed to completing its project on financial instruments expeditiously. The IASB is also committed to increasing comparability between IFRS requirements for financial instruments and the related requirements of US generally accepted accounting principles (GAAP).

Hedge accounting

- BCIN.10 In December 2010 the IASB published the Exposure Draft *Hedge Accounting*. That Exposure Draft contained an objective for hedge accounting that aimed to align accounting more closely with risk management and to provide useful information about the purpose and effect of hedging instruments. It also proposed requirements for:
- (a) what financial instruments qualify for designation as hedging instruments;
 - (b) what items (existing or expected) qualify for designation as hedged items;
 - (c) an objective-based hedge effectiveness assessment;
 - (d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*); and
 - (e) hedge accounting presentation and disclosures.
- BCIN.11 After the publication of the Exposure Draft, the IASB began an extensive outreach programme to gather feedback on the hedge accounting proposals. The IASB obtained information and views from users of financial statements, preparers, treasurers, risk management experts, auditors, standard-setters and regulators from a range of industries across different geographical regions.
- BCIN.12 The views from participants in the IASB's outreach activities were largely consistent with the views in the comment letters to the Exposure Draft. The IASB received strong support for the objective of aligning accounting more closely with risk management. However, many asked the IASB for added clarification on some of the fundamental changes proposed in the Exposure Draft.
- BCIN.13 The IASB considered the responses in the comment letters to that Exposure Draft and the information received during its outreach activities when it finalised the requirements for hedge accounting that were then added to IFRS 9 in November 2013.

Paragraphs BC6.1–BC6.545 are added.

Hedge accounting (Chapter 6)

Analysis of the effects of the requirements added to, and amendments of, IFRS 9 in November 2013

Introduction

- BC6.1 Before the IASB issues new requirements, or makes amendments to existing IFRSs, the IASB considers the costs and benefits of the new pronouncements. This includes assessing the effects on the costs for both preparers and users of financial statements. The IASB also considers the comparative advantage that preparers have in developing information that would otherwise cost users of financial statements to develop. One of the main objectives of developing a single set of high quality global accounting standards is to improve the allocation of capital. The IASB therefore takes into account the benefits of economic decision-making resulting from improved financial reporting. The IASB gains insight on the likely effects of the proposals for new or revised Standards through its formal exposure of proposals and through its analysis and consultations with relevant parties through outreach activities.
- BC6.2 Throughout the Hedge Accounting project, the IASB performed outreach and consultation with interested parties, with the largest outreach meeting being attended by over 200 participants. The IASB also had extensive discussions with regulators and audit firms worldwide. The analysis in paragraphs BC6.6–BC6.75 is based on the feedback received through this process. Overall, the IASB held over 145 outreach meetings in all the major jurisdictions and also evaluated 247 comment letters received in response to the Exposure Draft *Financial Instruments: Hedge Accounting* (the ‘Exposure Draft’). The IASB also considered comments received on the draft Standard posted on its website in September 2012.
- BC6.3 The evaluation of costs and benefits are necessarily qualitative, rather than quantitative. This is because quantifying costs and, particularly, benefits, is inherently difficult. Although other standard-setters undertake similar types of analyses, there is a lack of sufficiently well-established and reliable techniques for quantifying this analysis. Consequently, the IASB sees this Effects Analysis as being part of an evolving process. In addition the assessment undertaken is that of the likely effects of the new requirements, as the actual effects will not be known until after the new requirements have been applied. These are subsequently analysed through the post-implementation review process.
- BC6.4 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely, associated ongoing costs and benefits of each new Standard—these costs and benefits are collectively referred to as ‘effects’.

BC6.5 Paragraphs BC6.6–BC6.75 describe the IASB’s analysis of the likely effects that will result from the hedge accounting requirements to be included in IFRS 9 *Financial Instruments*. In evaluating the likely effects of the proposals, the IASB has considered how:

- (a) activities would be reported in the financial statements of those applying IFRS;
- (b) comparability of financial information would be improved both between different reporting periods for the same entity and between different entities in a particular reporting period;
- (c) more useful financial reporting would result in better economic decision-making;
- (d) the compliance costs for preparers would likely be affected; and
- (e) the likely costs of analysis for users of financial statements would likely be affected.

Overview

BC6.6 Financial reporting should provide transparent information to enable better economic decision-making. Hedge accounting relates to the reporting of risk management activities that entities enter into, to manage their exposures to the risks identified as relevant, from a business perspective.

BC6.7 Over the last decades, the extent and complexity of hedging activities have increased substantially. This has been caused not only by entities’ increasing willingness and ability to manage their exposures, but also by the increased availability of financial instruments to manage those exposures.

BC6.8 The hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* were complex and rule-based. They involved trying to fit transactions that were originated for risk management purposes into an accounting framework that was largely divorced from the purpose of the transactions. This was pointed out by respondents to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (published in 2008) and the sentiment has been confirmed in the outreach and feedback received by the IASB while developing the new hedge accounting requirements.

BC6.9 This also caused difficulties for users of financial statements when trying to understand the information reported in financial statements. Some users of financial statements regarded hedge accounting as being incomprehensible and often removed its effects from their various analyses. Users frequently argued that they had to request additional information (often on a non-GAAP basis) to be able to perform their analyses (for example, making forecasts), because the way in which the hedging activities were accounted for and the disclosures that were provided were often considered not to portray risk management in a useful way. The disclosures under IAS 39 were perceived as too accounting-centric and lacking transparency. This led to entities presenting non-GAAP information in various ways, with various levels of detail across different documents that range from the Management Discussion and Analysis to investor presentations.

- BC6.10 The complexity of the hedge accounting model in IAS 39 and the resulting increased importance of non-GAAP information led preparers and users of financial statements to ask the IASB to develop a model that, instead of reporting the results of an accounting-centric exercise, would report the performance of an entity's hedging activities in the financial statements on a basis that was consistent with that entity's risk management activities.
- BC6.11 The IASB believes that the new hedge accounting requirements address this issue. Under the new model, it is possible for the financial statements of an entity to reflect its risk management activities rather than simply complying with a rule-based approach, such as the approach in IAS 39.
- BC6.12 Overall, the IASB's assessment is that these new requirements will bring significant and sustained improvements to the reporting of hedging activities. In addition, entities will be able to use information that they have prepared for the purpose of undertaking their hedging activities as the basis for demonstrating compliance with the hedge accounting requirements.
- BC6.13 The hedge accounting requirements included in IFRS 9 reflect a substantial change from many aspects of hedge accounting in IAS 39. These amendments to hedge accounting will affect a variety of entities, including both financial and non-financial institutions. The new model will benefit from a more principle-based approach, including the revised eligibility criteria both for hedged items and hedging instruments, and a new objective-based hedge effectiveness assessment. In addition a targeted solution has been introduced for hedges of credit risk using credit derivatives. Entities dealing with hedging of non-financial items are likely to have significant benefits, albeit with some costs to be incurred when implementing the new model. Banks and other financial institutions will also benefit from the general hedge accounting model.
- BC6.14 Areas in which it is expected that the new requirements will produce the greatest impact include: hedge effectiveness testing; eligibility of risk components of non-financial instruments; disclosures; accounting for the costs of hedging; aggregated exposures; groups and net positions; the rebalancing and discontinuation of hedging relationships; and hedges of credit risk using credit derivatives.
- BC6.15 The IASB expects that most costs for preparers will be incurred at the transition date and will relate to the links that needs to be created between the accounting and the risk management functions. Under the current model for hedge accounting such links have generally been weak or non-existent, reflecting the accounting-centric character of that model. Additional costs will be incurred in explaining to the users of financial statements the impact of the hedging activities. This cost will, however, be mitigated by the fact that, given the greater alignment with risk management, some of the information, although not used for accounting purposes, is already being produced for risk management purposes or is being produced for the reporting of alternative performance measures (the latter often being presented on a non-GAAP basis). In particular, the costs for the hedge effectiveness test for many hedging relationships, especially simple ones, should be reduced on an ongoing basis.

The IASB's assessment is that the significant improvements in terms of comparability and transparency will outweigh those costs.

How activities would be reported in the financial statements of those applying IFRS

- BC6.16 The analysis in paragraphs BC6.17–BC6.75 focuses on the key differences between the existing model in IAS 39 and the new hedge accounting model in this Standard and how the new model will impact financial reporting. In particular, an analysis of some of the key changes introduced by the IFRS 9 hedge accounting model that will change entities' ability to apply hedge accounting is included in paragraphs BC6.20–BC6.32.

Objective of the Standard

- BC6.17 During its outreach activities the IASB learnt that both preparers and users of financial statements were frustrated about the lack of connection between actual risk management and the hedge accounting requirements. In particular, preparers found it difficult to reflect their risk management and users of financial statements found it difficult to understand the reflection of risk management on the basis of the hedge accounting requirements in IAS 39. In view of the criticisms received, the IASB, instead of merely considering improvements to the existing model, decided to rethink the entire paradigm of hedge accounting.
- BC6.18 The IASB decided that the "objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments".¹ This is a principle-based rather than a rule-based approach that focuses on an entity's risk management. Almost all respondents to the Exposure Draft as well as participants in the IASB's outreach activities supported the objective of improving information about risk management through hedge accounting as proposed by the IASB.
- BC6.19 Consequently, subject to qualifying criteria, the model developed by the IASB uses the risk management activities of an entity as the foundation for deciding what qualifies (or what does not qualify) for hedge accounting. The aim of the model is to faithfully represent, in the financial statements, the impact of the risk management activities of an entity.

Qualifying hedging instruments

- BC6.20 IAS 39 imposed restrictions on what could and what could not be considered as hedging instruments. Respondents to the Exposure Draft questioned the logic behind the arbitrary disallowance of certain types of financial instruments as hedging instruments in IAS 39 even when such financial instruments provided an effective offset for risks managed under common risk management strategies. The key restriction in IAS 39 was the disallowance of designating non-derivative instruments as hedging instruments for hedges of risks other than foreign currency risk.

¹ See paragraph 6.1.1.

- BC6.21 The IASB decided to expand the types of eligible financial instruments under the new hedge accounting model, to allow non-derivative financial assets and liabilities at fair value through profit or loss to be designated as hedging instruments, ie to acknowledge their effect also for accounting purposes.
- BC6.22 The other key change brought in by the new hedge accounting model is the removal of the distinction between combinations of stand-alone written and purchased options and those combined in one contract. The IASB decided that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance and risk management objectives rather than its legal form alone. Consequently, the IASB decided that a stand-alone written option would be eligible for designation as a hedging instrument if it is jointly designated with other hedging instruments so that, in combination, they do not result in a net written option.

Qualifying hedged items

- BC6.23 A key change brought about by the Standard is the ability to hedge a risk component of a non-financial item. The IASB decided to align the treatment of financial and non-financial items to also allow the hedging of risk components in non-financial items, when they are separately identifiable and reliably measurable. This, as noted by many respondents, represents a key aspect of the new hedge accounting model as it allows the accounting to reflect the commercial reality in hedges of non-financial items because, in practice, components of non-financial items are often hedged because hedging the entire item is commercially not viable (because of, for example, a lack of availability of cost effective hedging instruments) or not desired (because, for example, the entity regards accepting the risk as more economical than transferring it to others using hedges). This change will enable such hedges to be reflected in the designation used for hedge accounting, thereby enabling preparers to better reflect, and users of financial statements to better understand, the actual risk management activity and the effectiveness of hedging strategies.
- BC6.24 Under IAS 39 hedged items that together constitute an overall net position of assets and liabilities could only be designated in a hedging relationship with the gross position (a group) being the hedged item if certain restrictive criteria were met. These restrictions made achieving hedge accounting for items managed as part of a net position under IAS 39 difficult in practice and made it necessary to designate gross positions rather than the net position that is being economically hedged. This created a disconnect between the accounting and the actual risk management activity.
- BC6.25 Consequently, the IASB decided that groups of items (including net positions) would be eligible for hedge accounting. In the case of foreign currency exposures this would mean that all of the actual cash flows included within the group of cash flows being hedged could be designated in line with actual risk management. However, the IASB also decided that for cash flow hedges such net position hedging would not be available for risks other than foreign currency exposures. However, the IASB noted that this did not prevent entities from getting hedge accounting through gross designations that are determined by the net exposure that is monitored for risk management purposes.

- BC6.26 In the area of 'risk components', respondents believed that it should be possible to designate a risk component that assumes cash flows that would exceed the actual cash flows of the hedged item, as it reflects risk management in situations in which the hedged item has a negative spread to the benchmark rate. For example, being able to designate a full LIBOR component in a financial instrument that yields LIBOR less a spread (colloquially referred to as 'sub-LIBOR'). Such respondents believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component, as they hedged their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.
- BC6.27 In its deliberations, the focus was primarily on the sub-LIBOR scenario although the issue is not unique to that situation (see paragraphs BC6.217–BC6.229). In that context, the IASB noted that, for risk management purposes, an entity normally does not try to hedge the entire interest rate of a financial instrument but rather the change in the variability of the cash flows attributable to LIBOR. Such a strategy protects an entity's exposure to benchmark interest rate risk and, importantly, the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes. This is, of course, only feasible if LIBOR does not fall below the absolute value of the negative spread. However, if LIBOR does fall below the absolute value of that negative spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates. Consequently, in contrast to exposures with full LIBOR variability, hedging sub-LIBOR exposures means that the entity remains exposed to cash flow variability in some situations. The IASB noted that allowing a designation that ignores this fact would not faithfully represent the economic phenomenon.
- BC6.28 Consequently, in the Standard the IASB retained the restriction in IAS 39 for the designation of risk components when the designated risk component exceeds the total cash flows of the hedged item. However, hedge accounting would still be available in such situations if all the cash flows hedged for a particular risk are designated as the hedged item.

Qualifying criteria for hedge accounting

- BC6.29 As with the other aspects of the current hedge accounting model in IAS 39, the IASB received information during outreach and comments from respondents to the Exposure Draft about the hedge effectiveness requirements in IAS 39. The feedback received clearly showed that participants believed that the hedge effectiveness assessment in IAS 39 was formulaic, onerous and difficult to apply. As a consequence, there was often little or no link between the analysis undertaken by risk managers who hedge the risk and the analysis required to apply hedge accounting, and as a result between the hedge accounting and risk management operations. This was reflected, for example, in the fact that hedge accounting could be required to be discontinued in situations in which the hedging relationship was regarded as satisfactory and could be continued from a risk management perspective and for which the entity could achieve hedge accounting again—but only as a new hedging relationship. Also, given the

specified bright lines for effectiveness and the accounting consequences of deviating from the same, it made hedge accounting difficult to understand and apply.

- BC6.30 To address these concerns, the IASB decided to require an objective-based model for testing hedge effectiveness instead of the bright line test (80–125 per cent) in IAS 39. Instead of setting quantitative thresholds or bright lines, this approach focuses on the achievement of economic offset, a concept used by risk managers when designing and implementing hedging strategies. It also has the benefit of removing the burden of working out hedge effectiveness purely for accounting purposes and instead leverages the assessment done by risk management to ensure compliance with the hedge effectiveness requirements in the Standard. The principles and the concepts behind this change received widespread support.
- BC6.31 In addition, IAS 39 did not allow adjustments in the hedging relationship subsequent to designation, except for rollover strategies documented at contract inception, to be treated as adjustments to a continuing hedging relationship. Consequently, IAS 39 treated such adjustments to an existing hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The IASB, in its deliberations, noted that this was inconsistent with risk management practices and did not represent the economic phenomenon in practice. There are instances when, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. The IASB concluded that, in situations in which the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. This will have the effect of enabling changes in risk management to be properly portrayed in hedge accounting.
- BC6.32 Under IAS 39 an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria. Also, the entity had a free choice to discontinue hedge accounting by simply revoking the designation of the hedging relationship, irrespective of the reason behind it. The IASB noted that entities often voluntarily discontinued hedge accounting because of how the effectiveness assessment in IAS 39 worked. The IASB noted that, in some situations, the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the IASB's view, this created a disconnect between the hedge accounting model in IAS 39 and hedging from a risk management perspective. In the light of this, the IASB decided that the ability of an entity to voluntarily revoke a hedge designation, even when all qualifying criteria are met, would no longer be available. However, if the risk management objective for the hedging relationship changes then hedge accounting needs to be discontinued. This will improve the link with risk management by ensuring that once hedge accounting commences it will continue as long as the hedge still qualifies for hedge accounting.

Mechanics of hedge accounting

- BC6.33 The IASB considered the fact that the mechanics for hedge accounting in IAS 39 were well established and understood by most interested parties, and therefore decided to retain those hedge accounting mechanics in the new model. The IASB did, however, note that many users of financial statements were confused by the accounting distinction made between cash flow hedges and fair value hedges and how that distinction related to risk and the strategies for managing such risks. Consequently, the IASB decided to include new disclosure requirements in IFRS 7, whereby all disclosures for hedge accounting are presented in a single section in the financial statements with the objective of alleviating this confusion.
- BC6.34 Under IAS 39 entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. This meant that the time value that was not designated was required to be presented similarly to financial instruments held for trading. This created a disconnect between the accounting treatment and the risk management view, whereby entities typically consider the time value of an option at contract inception (the premium paid) as a cost of hedging akin to a cost of buying protection (like insurance).
- BC6.35 The IASB agreed that the time value of an option could be viewed as a premium paid for protection against risk and, consequently, decided to align the accounting for the time value with the risk management perspective. The IASB took the view that, like the distinction between the different types of costs related to insuring risk, the time value of options should be similarly distinguished. For transaction related hedged items the cumulative change in the fair value of the option's time value should be accumulated in other comprehensive income and should be reclassified in a similar way to that for cash flow hedges. In contrast, for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the IASB considered that the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis.
- BC6.36 The effect of this change is that the time value paid is treated like a cost of hedging rather than as held for trading with the resulting volatility recognised in profit or loss. This enables the costs of such a hedging strategy to be presented in a manner that reflects the inter-relation with the hedging relationship in which the option's intrinsic value is designated, and is consistent with risk management. It also removes a potential disincentive against the use of options as hedging instruments and improves transparency of the costs of hedging.
- BC6.37 The IASB made similar changes to the accounting for the forward element of forward contracts and the foreign currency basis spread of hedging instruments.

Accounting for macro hedging

- BC6.38 In practice, risk management often consider exposures on an aggregated basis over time. Over time, exposures are either added or removed from the hedged portfolio resulting in what are generally called hedges of 'open positions'.

Hedges of open positions introduce significant complexity in the accounting model as the continuous changes in the hedged item need to be monitored and tracked for accounting purposes. The continuous changes in the hedged item also mean there is no direct one-to-one relationship with particular hedges.

- BC6.39 The IASB decided not to specifically address open portfolios or the accounting for 'macro hedging' as part of the new hedge accounting model. The IASB noted that under IAS 39 entities often already account for 'macro' activities by applying the general hedge accounting model. The IASB received feedback from financial institutions, as well as from entities outside the financial sector, that addressing situations in which entities use a dynamic risk management strategy was important. Given the nature and complexity of the topic, the IASB has decided to separately deliberate the accounting for macro hedging with the objective of issuing a Discussion Paper.
- BC6.40 IFRS 9 (like IAS 39) does not allow cash flow hedges of interest rate risk to be designated on a net position basis but instead on the basis of gross designations. However, so called 'proxy hedging' (when, for example, the designation for hedge accounting purposes is on a gross position basis even though actual risk management typically manages on a net position basis) is still an eligible way to designate a hedged item as long as the designation reflects risk management in that it is related to the same type of risk that is being managed and the financial instruments used for that purpose. Thus, while the separate project continues to explore a more comprehensive model to address the accounting for macro hedging activities, the ability to apply hedge accounting is not expected to change as a result of applying IFRS 9.
- BC6.41 In addition, entities can elect to continue to apply the IAS 39 hedge accounting requirements until completion of the project on accounting for macro hedging.

Hedges of credit risk

- BC6.42 Financial institutions use credit derivatives to manage their credit risk exposures arising from their lending activities and also, on occasion, to reduce their regulatory capital requirements. However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. This is currently a significant issue, particularly for financial institutions because, by using derivatives to manage credit risk, an activity designed to reduce risk, volatility in profit or loss is increased, thereby creating the perception of increased risk.
- BC6.43 Many respondents were of the view that the IASB should address the accounting for hedges of credit risk using credit derivatives. Most of them also believed that this is an important issue in practice that the IASB should address.
- BC6.44 The IASB decided to use a targeted fair value option to reflect the management of credit risk. The IASB decided to allow the designation of financial instruments, both recognised and unrecognised, to be at fair value through profit or loss if the credit risk of those financial instruments is managed using a credit derivative that is also measured at fair value through profit or loss. This eliminates the accounting mismatch that would otherwise arise from measuring credit derivatives at fair value and hedged items (such as loans) at amortised

cost. It also enables entities to appropriately reflect this risk management activity in their financial statements. By allowing entities to make this election also for a proportion of a financial instrument and after its initial recognition, and to subsequently discontinue the fair value measurement for the hedged credit exposure, this approach enables entities to reflect their risk management activity more effectively than using the fair value option (which is available only on initial recognition for the financial instrument in its entirety, and is irrevocable). This becomes important because entities often do not hedge items for their entire life. This targeted fair value option is also available for credit exposures that are outside the scope of this Standard, such as most loan commitments.

Comparability of financial information

- BC6.45 The IASB decided that by its very essence, hedge accounting should continue to be voluntary. As a result, there will never be full comparability because, for example, despite identical risk management activity one entity may choose to apply hedge accounting whereas the other may not. However, by improving the link to risk management, which in itself makes hedge accounting less burdensome to apply and facilitates a more useful reflection of risk management activities, increased use of hedge accounting should occur thus improving comparability.
- BC6.46 With this in mind the IASB discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship. The IASB decided not to allow the discontinuation of hedge accounting when an entity's risk management objective is unchanged. This will assist in improving comparability.
- BC6.47 One of the key contributors to comparability is disclosure. The IASB decided to retain the scope of the hedge accounting disclosures because it provides, to users of financial statements, information on exposures that an entity hedges and for which hedge accounting is applied. For this population of hedging relationships, disclosure is required that will enable users of financial statements to better understand risk management (its effects on cash flows) and the effect of hedge accounting on financial statements. In addition, the IASB decided that all hedge accounting disclosures (ie irrespective of the type of hedge and the type of information required) should be presented in one location within an entity's financial statements. Hedge accounting has been difficult for users of financial statements to understand, which in turn has made risk management difficult to understand. These enhanced disclosures will assist in improving the ability of users of financial statements to compare entities' risk management activities.

Better economic decision making as a result of improved financial reporting

- BC6.48 One of the fundamental changes introduced by the Standard is that the entire paradigm of hedge accounting has been changed to align more closely with the risk management activities of an entity. The IASB is of the view that this fundamental shift in focus—whereby the accounting and risk management

objectives are brought in congruence—will result in better economic decision making through improved financial reporting. One such example is the accounting for options.

- BC6.49 In the IASB's outreach some entities said that the accounting consequences of using options (non-linear instruments) were a consideration in their risk management activities. This was because the undesignated time value of the option was accounted for as at fair value through profit or loss, thereby resulting in significant profit or loss volatility. The IASB has addressed this issue and has better aligned the reported results with the risk management perspective. Time value is now considered to be a cost of hedging rather than a trading position. Similarly, the IASB addressed the accounting for the forward element of forward contracts and the foreign currency basis spread in instruments that hedge foreign currency risk and decided on a treatment similar to that of the time value of options. The latter issue was, for example, of particular concern to entities that raised funds in a currency other than their functional currency.
- BC6.50 The IASB expects that these amendments will significantly reduce the accounting considerations affecting risk management decisions and also provide users of financial statements with more useful information about hedging activities, including the cost of such activities, resulting in better economic decision making.
- BC6.51 As discussed previously (see paragraphs BC6.20–BC6.21) the IASB decided to expand the types of eligible financial instruments under the new hedge accounting model to allow non-derivative financial assets and liabilities at fair value through profit or loss as eligible hedging instruments. The IASB noted the comments received from respondents that such a treatment enables an entity to better capture its risk management activities in its financial statements. In the IASB's view this will significantly contribute to better economic decision making by capturing established risk management strategies in reported results through hedge accounting. It is particularly relevant for jurisdictions in which the use of derivatives is restricted.
- BC6.52 Aligning the treatment of risk components for financial and non-financial items represents a fundamental change in the hedge accounting model, as this will allow entities to better represent their hedging and risk management activities for non-financial items in their financial statements. Entities will be able to more readily designate hedges in a manner that is consistent with risk management and to recognise hedge effectiveness on this basis. The IASB believes that this will significantly improve the usefulness of reported information for entities hedging non-financial items, which will enable preparers to better reflect their performance and result in better economic decision making.
- BC6.53 The removal of the bright-line hedge effectiveness requirements will avoid discontinuation of hedging relationships in the financial statements under circumstances in which the hedge is still economically effective. Instead of a percentage-based test that does not meaningfully capture the characteristics of a hedging relationship in all situations, the effectiveness of hedging relationships will be evaluated on the basis of the features that drive their economic success.

The new model will ensure that when the economics of a transaction demand that a hedge be rebalanced, such rebalancing does not lead to the hedging relationship being portrayed as discontinued. The IASB believes that such amendments will enable the economic success of an entity's hedging programme to be reflected in the financial statements, thereby leading to better decision making by both management and users of financial statements, because they will be in a better position to make informed judgements about an entity's hedging operations.

- BC6.54 The IASB's decision to require the continuation of hedge accounting when a derivative is novated to effect clearing with a central clearing party also improves the usefulness of information for users of financial instruments. This is achieved by preventing the discontinuation of hedge accounting and the ineffectiveness that would arise from a new hedging relationship being designated as a replacement.
- BC6.55 Risk management also takes into consideration the risk positions that have been created by aggregating exposures that include derivative financial instruments. IAS 39 only allowed derivatives to be designated as hedging instruments, but not to be part of hedged items. Consequently, positions that are a combination of an exposure and a derivative (aggregated exposures) failed to qualify as hedged items. Under the new model an aggregated exposure (comprising a derivative and non-derivative) is an eligible hedged item. Similarly, by modifying the requirements for hedges of groups of items, the accounting for such hedges can now be better represented in the financial statements. Again, the IASB believes that, aligning the accounting model with risk management will result in better information for economic decision making.
- BC6.56 This Standard also makes changes to aspects of the accounting for financial instruments outside hedge accounting that allow risk management to be more faithfully represented in the financial statements. One area is the accounting for contracts to buy or sell non-financial items, so called 'own use contracts'. Currently, those contracts are not treated as derivatives in particular circumstances (they are executory contracts that are off the statement of financial position). This can create an artificial perspective when they are measured as part of a portfolio that includes other items that are recognised in the statement of financial position and measured at fair value through profit or loss. By allowing entities to elect to measure own use contracts at fair value through profit or loss, entities are better able to provide information about their risk management activities in the financial statements. The IASB believes that these changes, along with those concerning the management of credit risk, will provide better information for economic decision making.

Compliance costs for preparers

- BC6.57 As with all new requirements, the IASB acknowledges that different areas of the requirements will have different effects and hence different types of costs and benefits will arise when considering both preparers and users of financial statements. Given that the new model is based on an entity's risk management practices, it is reasonable to conclude that one of the key drivers of the costs

incurred and the benefits obtained, in complying with the new requirements, will be the level of development and the sophistication of the entities' risk management functions.

BC6.58 Entities will incur a one-time cost on initial application to address:

- (a) development of new processes, systems and controls to integrate information produced for risk management purposes into their accounting processes;
- (b) creating accounting capabilities for some new eligible accounting treatments (if they are intended to be used—for example, the new accounting for costs of hedging);
- (c) updating of the documentation for existing hedging relationships on transition to the new requirements;
- (d) education of accounting functions to enable them to assess whether the information prepared for risk management purposes would suffice to comply with the new hedge accounting requirements; and
- (e) the need to explain to users of financial statements the difference between the information produced for risk management purposes and the hedge accounting disclosures.

BC6.59 The IASB believes that the costs of the transition, as well as the ongoing costs of applying the new hedge accounting requirements, will very much depend on the individual circumstances of each entity—for example, what type of hedging instruments and hedged items it has, what types of hedges it uses, and how it has implemented hedge accounting in terms of processes and systems. It is therefore difficult to generalise the likely impact of costs on preparers. Broadly, the IASB expects:

- (a) entities with more sophisticated risk management functions, that produce reliable information for the entity's own management, will have costs of initial application in establishing better links between those functions and their accounting function, but the ongoing costs of application should then be lower because of the new hedge effectiveness test.
- (b) entities that have embedded hedge accounting in their accounting systems may have to adjust their systems, depending on the particular implementation of IAS 39 and what additional new accounting treatments the entity wants to use. Entities using bespoke or self-developed solutions are affected differently from those using standard software. In all cases, the costs are one-off transition costs.
- (c) entities that use a master documentation approach, whereby the documentation of individual hedging relationships includes references to master documents that set out risk management strategies or effectiveness testing methods, will have lower costs of making the transition than entities that include that information in full in the documentation of each individual hedging relationship. Those costs are also one-off transition costs.

- (d) the new disclosure requirements will result in the need to capture more data than under the current hedge accounting disclosures in IAS 39. Costs arise on transition when the capability to provide those disclosures is created but will also include ongoing costs. However, if entities embed this in their systems that they use for preparing their financial statements the ongoing costs can be significantly reduced.
- BC6.60 Overall, given the fact that the new model developed by the IASB is more aligned with the day-to-day risk management activities of an entity, the IASB believes that the following benefits will outweigh the costs of initial implementation and on-going application:
- (a) better consistency between accounting and risk management;
 - (b) better operational efficiency;
 - (c) less need for non-GAAP information to explain to users of financial statements the impact of hedging for which hedge accounting was not achieved;
 - (d) reduction in the costs of workarounds to deal with the restrictions in IAS 39; and
 - (e) standardised and more transparent information, resulting in a better understanding of the company's hedging performance.
- BC6.61 In addition to those costs set out in paragraph BC6.59, the IASB notes that one of the key costs of compliance with the hedge accounting requirements of IAS 39 is the infrastructure and resources required to maintain the hedge documentation and effectiveness testing. Under the new model, linking the hedge documentation requirements with that of risk management systems will, in the IASB's view, bring in efficiencies and cost savings as entities integrate such systems. In addition, the new model includes an objective-based effectiveness assessment, which is linked to the way that the hedging relationship is designed and monitored for risk management purposes. This will substantially reduce the costs of ongoing compliance compared with IAS 39.
- BC6.62 This will be further reinforced by the fact that the IASB, after due consideration, decided to keep the mechanics of hedge accounting for fair value, cash flow and net investment hedges the same. This will avoid any major costs involved with changing accounting systems both on initial application and on an ongoing basis.
- BC6.63 One of the costs involved with the application of any new Standard is the cost of developing ways to implement it. One of the main requests that respondents made to the IASB was to provide examples that would illustrate the various aspects of the new proposals. In response, the IASB has provided detailed guidance whenever possible (for example, detail about the accounting mechanics for aggregated exposures). The IASB believes that this will help in reducing both the initial and ongoing cost of compliance.
- BC6.64 The IASB always intended to retain the 'macro fair value hedge accounting model' in IAS 39 pending completion of the project on the accounting for macro hedging. In addition, as noted in paragraphs BC6.39–BC6.40, the IASB is of the

view that those using the general requirements in IAS 39 to achieve hedge accounting for their macro hedging activities should be able to continue to do so under the IFRS 9 model. Thus, the ability to apply hedge accounting to macro hedging activities should not be adversely affected by the introduction of IFRS 9. However, the IASB acknowledged that some entities may want to migrate from accounting for their macro hedging activities using IAS 39 directly to any new model for accounting for macro hedging. Consequently, the IASB decided to provide an option to preparers to continue to apply hedge accounting under IAS 39 without requiring them to move to the new hedge accounting model in IFRS 9. This means that those who do not want to change their accounting for macro hedging need not do so until completion of the project on the accounting for macro hedging. This will, however, mean that all of their hedge accounting will continue to be in accordance with IAS 39 (ie the election is made for hedge accounting as a whole).

- BC6.65 However, the IASB is of the view that the migration from the accounting for macro hedging using the cash flow hedge accounting requirements in IAS 39 to the accounting using IFRS 9 will not be unduly burdensome for preparers. This is because the new hedge accounting model does not change how risk components of financial items can be designated as hedged items. In addition, while there are changes to the hedge effectiveness requirements, these have introduced simplifications compared with IAS 39. Entities would need to update their documentation of their hedging relationships to reflect the new effectiveness assessment. However, if hedge accounting was applied under IAS 39, the sources of ineffectiveness should be known, and it should be possible to update documentation efficiently by using a master document approach for similar hedges. This can be achieved by one central document being included by a cross reference in the documentation of specific hedging relationships that includes the identification of the specific hedging instruments and hedged items.

Costs of analysis for users of financial statements

- BC6.66 Given that the mechanics for hedge accounting were well established and understood by most interested parties, the IASB decided to retain the mechanics of hedge accounting that were in IAS 39 for fair value, cash flow and net investment hedges. Consequently, from the perspective of users of financial statements, the costs in educating themselves about these proposals will be reduced.
- BC6.67 The IASB also decided that it would require comprehensive information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the financial statements and so that all hedge accounting disclosures are presented in a single note in the financial statements. This will enable users to access a set of information that is more relevant to their needs and will therefore reduce the need to rely on information prepared on a non-GAAP basis. In addition, they will also benefit from more meaningful information that is more closely linked to the decision making for risk management purposes.

- BC6.68 Finally, the IASB expects that users of financial statements will obtain a higher level of transparency from the financial statements of entities applying hedge accounting. This will allow them to better form their own view of the entity's risk management and its effect on reported results. The opportunity for more extensive analyses would, of course, entail costs of performing those analyses, as with any use of financial reporting information.

Conclusion

- BC6.69 The IASB expects that preparers will be able to better reflect their risk management activities using hedge accounting under the new model. This should facilitate an increased use of hedge accounting by preparers. In addition, because risk management can be better reflected, and as a result of enhanced disclosures, more relevant and transparent information will be provided to users of financial statements.

The effects of own credit

- BC6.70 For financial liabilities designated under the fair value option, IFRS 9 (2010) requires an entity to present in other comprehensive income changes in the fair value of a financial liability that are attributable to changes in its credit risk.
- BC6.71 This requirement addresses the concern raised by many, including users of financial statements, that reflecting these fair value changes in profit or loss is counter-intuitive. In particular, the requirement addresses the concern that a gain is recognised in profit or loss as the credit risk on a financial liability increases (ie its credit quality deteriorates). This issue is often referred to as the 'own credit' issue.
- BC6.72 This Standard allows entities to apply these requirements for the presentation of own credit earlier by permitting them to apply this change in isolation. IFRS 9 (2010) enabled entities to apply the change to the presentation of such fair value gains and losses only if all the requirements in IFRS 9 for the classification and measurement of financial assets and liabilities were applied. The IASB had also indicated that when the impairment requirements are added to IFRS 9, any entities that would then newly apply IFRS 9 would be required to apply the classification and measurement requirements and the impairment requirements as a whole. This meant that in order to apply the requirements for the presentation of the effects of own credit, an entity would have also needed to change to the new impairment model.
- BC6.73 This Standard changes this requirement and enables an entity to elect to apply only the changes related to the presentation of own credit without applying any of the other requirements of IFRS 9. The effect of this change is to allow entities to present the effects of own credit in OCI, improving their financial reporting, without also needing to make other changes to their accounting for financial instruments. This will make the own credit requirements available on a more timely basis, particularly because an entity will be able to make this change before undertaking the changes that would be required in order to implement an expected credit loss impairment model.

Mandatory effective date

- BC6.74 This Standard also removes the mandatory effective date of 1 January 2015 for IFRS 9. This change means that entities are still able to elect to apply IFRS 9 but the IASB has not yet determined the date at which the application of IFRS 9 will become mandatory.
- BC6.75 By maintaining a mandatory effective date of 1 January 2015 entities would have needed to prepare to transition to IFRS 9 on the basis of an incomplete model for accounting for financial instruments. By removing the mandatory effective date, entities will be able to plan for the transition to IFRS 9 when the final requirements are complete. It also enables the IASB to determine the most appropriate mandatory effective date for IFRS 9, taking into account the timing of the completion of redeliberations and considering the lead time required to implement the requirements once finalised.

The objective of hedge accounting

- BC6.76 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRSs. For example, the hedge accounting guidance in IAS 39 permitted:
- (a) the recognition of items that would otherwise have not been recognised (for example, a firm commitment);
 - (b) the measurement of an item on a basis that is different from the measurement basis that is normally required (for example, adjusting the measurement of a hedged item in a fair value hedge); and
 - (c) the deferral of the changes in the fair value of a hedging instrument for a cash flow hedge in other comprehensive income. Such changes in fair value would otherwise have been recognised in profit or loss (for example, the hedging of a highly probable forecast transaction).
- BC6.77 The IASB noted that, although hedge accounting was an exception from normal accounting requirements, in many situations the information that resulted from applying those normal requirements without using hedge accounting either did not provide useful information or omitted important information. Hence, the IASB concluded that hedge accounting should be retained.
- BC6.78 In the IASB's view, a consistent hedge accounting model requires an objective that describes *when* and *how* an entity should:
- (a) override the general recognition and measurement requirements in IFRSs (ie when and how an entity should apply hedge accounting); and
 - (b) recognise effectiveness and/or ineffectiveness of a hedging relationship (ie when and how gains and losses should be recognised).
- BC6.79 The IASB considered two possible objectives of hedge accounting—that hedge accounting should:
- (a) provide a link between an entity's risk management and its financial reporting. Hedge accounting would convey the context of hedging instruments, which would allow insights into their purpose and effect.

- (b) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items and manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

- BC6.80 However, the IASB rejected both objectives for hedge accounting. The IASB thought that an objective that linked an entity's risk management and financial reporting was too broad: it was not clear enough what risk management activity was being referred to. Conversely, the IASB thought that an objective that focused on the accounting anomalies was too narrow: it focused on the mechanics of hedge accounting rather than on why hedge accounting was being done.
- BC6.81 Consequently, the IASB decided to propose in the Exposure Draft an objective that combined elements of both objectives. The IASB considered that the proposed objective of hedge accounting reflected a broad articulation of a principle-based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provided for a focus on the statement of financial position and the statement of comprehensive income, thereby reflecting the effects of the individual assets and liabilities associated with the risk management activities on those statements. This reflected the IASB's intention: that entities should provide useful information about the purpose and effect of hedging instruments for which hedge accounting is applied.
- BC6.82 The IASB also noted that, notwithstanding that an entity's risk management activities were central to the objective of hedge accounting, an entity would only achieve hedge accounting if it met all the qualifying criteria.
- BC6.83 Almost all respondents to the Exposure Draft as well as participants in the IASB's outreach activities supported the objective of hedge accounting proposed in the Exposure Draft.

Open portfolios

- BC6.84 Closed hedged portfolios are hedged portfolios in which items cannot be added, removed or replaced without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies at inception the hedged items that form that particular hedging relationship.
- BC6.85 In practice, risk management often assesses risk exposures on a continuous basis and at a portfolio level. Risk management strategies tend to have a time horizon (for example, two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to such hedged portfolios and other exposures are removed from them. These are referred to as open portfolios.
- BC6.86 Hedges of open portfolios introduce complexity to the accounting for such hedges. Changes could be addressed by treating them like a series of closed portfolios with a short life (ie by periodic discontinuations of the hedging relationships for the previous closed portfolios of items and designations of new hedging relationships for the revised closed portfolios of items). However, this

gives rise to complexities related to tracking, amortisation of hedge adjustments and the reclassification of gains or losses deferred in accumulated other comprehensive income. Furthermore, it may be impractical to align such an accounting treatment with the way in which the exposures are viewed from a risk management perspective, which may update hedge portfolios more frequently (for example, daily).

- BC6.87 The IASB decided not to specifically address open portfolios or ‘macro’ hedging (ie hedging at the level that aggregates portfolios) as part of the Exposure Draft. The IASB considered hedge accounting only in the context of groups of items that constitute a gross or net position for which the items that make up that position are included in a specified overall group of items (see paragraphs BC6.427–BC6.467).
- BC6.88 Consequently, for fair value hedge accounting for a portfolio hedge of interest rate risk the Exposure Draft did not propose replacing the requirements in IAS 39.
- BC6.89 The IASB received feedback from financial institutions as well as from entities outside the financial sector that addressing situations in which entities use a dynamic risk management strategy was important. Financial institutions also noted that this was important because some of their risk exposures might only qualify for hedge accounting in an open portfolio context (for example, non-interest bearing demand deposits).
- BC6.90 The IASB noted that this is a complex topic that warrants thorough research and feedback from interested parties. Accordingly, the IASB decided to separately deliberate on the accounting for macro hedging as part of its active agenda with the objective of issuing a Discussion Paper. The IASB noted that this would enable IFRS 9 to be completed more quickly and would enable the new ‘general’ hedge accounting requirements to be available as part of IFRS 9. The IASB also noted that during the project on accounting for macro hedging the status quo of ‘macro hedge accounting’ under previous IFRSs would broadly be maintained so that entities would not be worse off in the meantime.
- BC6.91 The IASB noted that broadly maintaining the status quo of ‘macro hedge accounting’ meant that:
- (a) an entity could continue to apply IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraph BC6.88), which includes the application of the specific ‘macro hedge accounting’ requirements in IAS 39; but
 - (b) all cash flow hedges would be within the scope of the hedge accounting model of IFRS 9—including those that are colloquially referred to as ‘macro cash flow hedges’ under IAS 39 today.
- BC6.92 The IASB noted that this approach appropriately reflected the interaction between the IAS 39 hedge accounting requirements and the new hedge accounting model it had developed for IFRS 9 for the following reasons:
- (a) the new hedge accounting model does apply to situations in which entities manage risk in a ‘macro’ context, for example, for risk exposures that result from large groups of items that are managed on an

aggregated level, including open portfolios. It also applies to all types of hedges and risks. But entities must use the designations that are available under the new hedge accounting model (and can only apply hedge accounting if they meet the qualifying criteria).

- (b) the new hedge accounting model does not however provide specific 'customised' solutions that would be an exception to (instead of an application of) the model designed to make the implementation of hedge accounting in those situations easier. For example, it does not provide an exception to allow a net position cash flow hedge for interest rate risk or to allow non-interest bearing demand deposits to be designated as hedged items.
- (c) the specific fair value hedge accounting for a portfolio hedge of interest rate risk is an exception to the hedge accounting model in IAS 39 and is strictly limited to that particular type of hedge. This exception does not fit into the new hedge accounting model. The IASB decided that in order to retain this exception pending the completion of the project on accounting for macro hedging, a scope exception that allows the continued application of IAS 39 for this particular type of hedge is appropriate.
- (d) in contrast, cash flow hedge accounting in a 'macro' context was an application of the (general) hedge accounting model under IAS 39. Consequently, it is consistent with that approach to include 'macro cash flow hedge accounting' as an application of the new hedge accounting model.

BC6.93 However, the IASB received feedback that some entities were unsure whether and how 'macro cash flow hedge accounting' could also be applied under the hedge accounting requirements of IFRS 9. In response, the IASB considered whether it could address those concerns by carrying forward the Implementation Guidance that accompanied IAS 39 and that illustrated 'macro cash flow hedge accounting'. The IASB noted that to do so would be inconsistent with its decision not to carry forward any of the hedge accounting Implementation Guidance that accompanied IAS 39. The IASB also noted that making an exception by carrying forward some parts of the Implementation Guidance but not others could have unintended consequences because it would inevitably create the perception that the IASB had endorsed some parts while it had rejected others.

BC6.94 The IASB also noted that carrying forward Implementation Guidance could not be justified as a means to address any concerns about whether a particular accounting practice complies with the hedge accounting requirements. Implementation Guidance only accompanies, but is not part of, a Standard, which means that it does not override the requirements of a Standard.

BC6.95 Consequently, the IASB decided to retain its original approach of not carrying forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39. However, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected that guidance.

- BC6.96 The IASB also received feedback that some entities were concerned that ‘proxy hedging’ would not be possible under the hedge accounting model in IFRS 9—a concern that was highlighted by the ‘macro cash flow hedge accounting’ related Implementation Guidance that accompanied IAS 39 not being carried forward. ‘Proxy hedging’ is a colloquial reference to the use of designations of hedging relationships that do not exactly represent an entity’s actual risk management. Examples include using a designation of a gross amount of an exposure (gross designation) when risks are actually managed on a net position basis, and using designations of variable-rate debt instruments in cash flow hedges when risk management is based on managing the interest rate risk of prepayable fixed-rate debt instruments or deposits (such as core deposits). Similarly, ‘proxy hedging’ can involve designating fixed-rate debt instruments in fair value hedges when risk management is based on managing the interest rate risk of variable-rate debt instruments.
- BC6.97 The IASB noted that its rationale for not including a scope exception from the IFRS 9 hedge accounting requirements for ‘macro cash flow hedge accounting’ reflected that designations of hedging relationships that represent ‘proxy hedging’ are possible. The IASB was aware that many financial institutions use ‘proxy hedging’ as described in paragraph BC6.96.
- BC6.98 The IASB considered that in those situations the designation for hedge accounting purposes was inevitably not the same as the entity’s risk management view of its hedging, but that 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. For example, like IAS 39, IFRS 9 also does not allow cash flow hedges of interest rate risk to be designated on a net position basis but entities must instead designate gross positions. This requires so called ‘proxy hedging’ because the designation for hedge accounting purposes is on a gross position basis even though risk management typically manages on a net position basis. This ‘proxy hedging’ also includes approaches that for risk management purposes determine the net interest rate risk position on the basis of fixed-rate items. A cash flow hedge designation can still reflect those approaches in that the net interest rate risk position can be viewed as having a dual character: the hedges bridge, for example, the economic mismatch between fixed-rate assets and variable-rate funding (existing variable-rate funding as well as funding to be obtained in the future to continue to fund the assets as existing funding matures). Such an economic mismatch can be regarded as fair value interest rate risk when looking at the assets and as cash flow interest rate risk when looking at the funding. The net position hedging combines the two aspects because both affect the net interest margin. Hence, both fair value and cash flow interest rate risk are inherent aspects of the hedged exposure. However, hedge accounting requires the designation of the hedging relationship as either a fair value hedge or as a cash flow hedge. The IASB noted that in that sense, even if a fair value hedge designation better represented a risk management perspective that considers the fixed-rate assets as the primary or leading aspect, a cash flow hedge designation would still reflect the risk management because of the dual character of the risk position. Consequently,

the IASB regarded 'proxy hedging' as an eligible way of designating the hedged item under IFRS 9 as long as that still reflected risk management, which was the case in this situation.

- BC6.99 The IASB noted that in such situations entities have to select some items that give rise to interest rate risk and that qualify for designation as a hedged item and designate them as a gross exposure in order to achieve hedge accounting. The IASB acknowledged that in those circumstances there is typically no obvious link between any particular designated hedged item and the designated hedging instrument, and that entities select items for designation that are most suitable for hedge accounting purposes. This means that different entities can have different ways of selecting those items depending on their situation (for example, whether designating an interest rate risk exposure related to a financial asset or a financial liability).
- BC6.100 The IASB also noted that designations of hedging relationships that reflect 'proxy hedging' were not unique to hedging of interest rate risk by banks in, for example, a 'macro' context. Notwithstanding the objective of the project to represent, in the financial statements, the effect of an entity's risk management activities, the IASB considered that this would in many situations not be possible as a simple, exact '1:1 copy' of the actual risk management perspective. In the IASB's view this was already apparent from other aspects of the hedge accounting model of IFRS 9, for example:
- (a) the mere fact that the IASB had limited net position cash flow hedges to foreign currency risk meant that for all other types of hedged risks an entity would have to designate gross amounts (gross designation). But this did not mean that cash flow hedge accounting was prohibited for all other risks that are managed on a net position basis.
 - (b) an entity that actually hedges on a risk component basis in accordance with its risk management view might not meet the criteria for designating the hedged item as a risk component. But this did not mean that the entity was prohibited from applying hedge accounting altogether. Instead, it was only prohibited from using that particular designation of a risk component. Consequently, the entity could designate the item in its entirety as the hedged item and apply hedge accounting (if it met the qualifying criteria on the basis of that designation).
 - (c) for many entities the actual risk management is based on a 'flow perspective' for cash flow hedges, which only considers mismatches in the variable cash flows of the hedging instrument and the hedged item as a source of hedge ineffectiveness. However, the measurement of hedge effectiveness for hedge accounting purposes does not allow an entity to assume perfect hedge effectiveness in those circumstances (or limiting the analysis to only the variable cash flows of the hedging instrument). However, this did not mean that hedge accounting was prohibited. Instead, it meant that the entity had to measure hedge ineffectiveness as required for accounting purposes.

- (d) the presentation of hedges of net positions requires the use of a separate line item in the income statement instead of directly adjusting the line items affected by the hedged items (for example, grossing up revenue and cost of sales). In contrast, entities' actual risk management often considers the respective line items as hedged at the respective rates that were locked in by the hedges. This difference between the risk management and accounting views did not mean that an entity was prohibited from using hedge accounting. Instead, it meant that the entity had to follow the presentation requirements for accounting purposes if it wanted to apply hedge accounting.

- BC6.101 Consequently, the IASB did not agree that designations of hedging relationships under IFRS 9 could not represent 'proxy hedging'. The IASB also decided to provide further guidance on how 'proxy hedging' is related to the discontinuation of hedge accounting (see paragraph BC6.331).
- BC6.102 However, the IASB also received feedback from some entities that they did not want to have to apply the hedge accounting requirements of IFRS 9 before the IASB's project on accounting for macro hedging was completed. Those entities cited concerns about remaining uncertainty as to whether IAS 39-compliant practices of designating hedging relationships for portfolio hedging or macro hedging activities would still be available, the costs of assessing whether those practices are IFRS 9-compliant and the risk of having to change those practices twice. Some entities questioned whether it was appropriate to require entities to re-examine and potentially make changes to their hedge accounting while the project on accounting for macro hedging was ongoing.
- BC6.103 The IASB considered whether it should provide a scope exception to the hedge accounting requirements of IFRS 9 to address those concerns over the interaction with macro hedging activities. This scope exception would be separate from that for fair value hedge accounting for a portfolio hedge of interest rate risk, which complements the hedge accounting requirements of IFRS 9 and which the IASB had already proposed in the Exposure Draft (see paragraph BC6.88). In this case the IASB considered whether there was a need to allow entities to continue to apply IAS 39 to cash flow hedges in the context of macro hedging activities. In the IASB's view it was not necessary from a technical perspective to make any changes in addition to the clarifications that it had already provided (see paragraphs BC6.93–BC6.101). However, the IASB acknowledged that it had not yet completed its project on accounting for macro hedging and that providing a choice to continue to apply the hedge accounting requirements in IAS 39 would allow entities to wait for the complete picture related to the accounting for hedging activities before applying a new hedge accounting model.
- BC6.104 Consequently, the IASB considered whether it could provide a specific scope exception that would confine the continued application of IAS 39 to situations in which entities seek to apply 'macro cash flow hedge accounting'. However, the IASB determined that such a specific scope would be difficult to describe, resulting in added complexity and the risk that interpretation questions would arise. The IASB therefore decided to provide entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9

(including the scope exception for fair value hedge accounting for a portfolio hedge of interest rate risk) and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting until its project on the accounting for macro hedging is completed. The IASB noted that an entity could subsequently decide to change its accounting policy and commence applying the hedge accounting requirements of IFRS 9 at the beginning of any reporting period (subject to the other transition requirements of IFRS 9). The IASB also emphasised that, once IFRS 9 as amended in November 2013 is applied, the new disclosure requirements related to hedge accounting are part of IFRS 7 and would consequently apply to all entities using hedge accounting under IFRSs (even if electing to continue to apply IAS 39 for hedge accounting).

Hedge accounting for equity investments designated as at fair value through other comprehensive income

- BC6.105 In accordance with IFRS 9 an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in other comprehensive income. Amounts recognised in other comprehensive income for such equity instruments are not reclassified to profit or loss. However, IAS 39 defined a hedging relationship as a relationship in which the exposure to be hedged could affect profit or loss. Consequently, an entity could not apply hedge accounting if the hedged exposure affected other comprehensive income without reclassification out of other comprehensive income to profit or loss because only such a reclassification would mean that the hedged exposure could ultimately affect profit or loss.
- BC6.106 For its Exposure Draft, the IASB considered whether it should amend the definition of a fair value hedge to state that the hedged exposure could affect either profit or loss or other comprehensive income, instead of only profit or loss. However, the IASB had concerns about the mechanics of matching the changes in the fair value of the hedging instrument with the changes in the value of the hedged item attributable to the hedged risk. Furthermore, the IASB was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the IASB considered alternative approaches.
- BC6.107 The IASB considered whether the hedge ineffectiveness should remain in other comprehensive income when the changes in the value of the hedged item attributable to the hedged risk are bigger than the changes in the fair value of the hedging instrument. This approach would:
- (a) be consistent with the IASB's decision on classification and measurement (the first phase of the IFRS 9 project), whereby changes in the fair value of the equity investment designated as at fair value through other comprehensive income should not be reclassified to profit or loss; but
 - (b) contradict the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss.
- BC6.108 Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:

- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but
- (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income.

- BC6.109 Consequently, in its Exposure Draft the IASB proposed prohibiting hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it could not be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the IASB did not want to add another exception (ie contradicting the principle in IFRS 9 of not reclassifying between other comprehensive income and profit or loss, or contradicting the principle of recognising hedge ineffectiveness in profit or loss) to the existing exception of accounting for investments in equity instruments (ie the option to account for those investments at fair value through other comprehensive income).
- BC6.110 However, the IASB noted that dividends from such investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from such investments could be an eligible hedged item (if all qualifying criteria for hedge accounting are met).
- BC6.111 Almost all respondents to the Exposure Draft disagreed with the IASB's proposal to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. Those respondents argued that hedge accounting should be available for equity investments at fair value through other comprehensive income so that hedge accounting can be more closely aligned with risk management activities. In particular, respondents commented that it was a common risk management strategy for an entity to hedge the foreign exchange risk exposure of equity investments (irrespective of the accounting designation at fair value through profit or loss or other comprehensive income). In addition, an entity might also hedge the equity price risk even though it does not intend to sell the equity investment because it might still want to protect itself against equity volatility.
- BC6.112 In the light of those concerns, the IASB reconsidered whether it should allow investments in equity instruments designated as at fair value through other comprehensive income to be designated as a hedged item in a fair value hedge. Some respondents argued that the inconsistencies that the IASB had discussed in its original deliberations (see paragraphs BC6.107–BC6.108) could be overcome by using a differentiating approach, whereby if fair value changes of the hedging instrument exceeded those of the hedged item hedge ineffectiveness would be presented in profit or loss and otherwise in other comprehensive income. However, the IASB noted that the cumulative ineffectiveness presented in profit or loss or other comprehensive income over the total period of the hedging relationship might still contradict the principle of not recycling to profit or loss changes in the fair value of equity investments at fair value through other comprehensive income. Hence, the IASB rejected that approach.

- BC6.113 The IASB noted that recognising hedge ineffectiveness always in profit or loss would be inconsistent with the irrevocable election of presenting in other comprehensive income fair value changes of investments in equity instruments (see paragraph BC6.108). The IASB considered that that outcome would defeat its aim to reduce complexity in accounting for financial instruments.
- BC6.114 The IASB considered that an approach that would recognise hedge ineffectiveness always in other comprehensive income (without recycling) could facilitate hedge accounting in situations in which an entity's risk management involves hedging risks of equity investments designated as at fair value through other comprehensive income without contradicting the classification and measurement requirements of IFRS 9. The IASB noted that, as a consequence, hedge ineffectiveness would not always be presented in profit or loss but would always follow the presentation of the value changes of the hedged item.
- BC6.115 The IASB considered that, on balance, the advantages of the approach that always recognises hedge ineffectiveness in other comprehensive income (without recycling) for those investments in equity instruments would outweigh any disadvantages and, overall, that this alternative was superior to the other alternatives that the IASB had contemplated. Hence, the IASB decided to include this approach in the final requirements.
- BC6.116 The IASB also considered whether hedge accounting should be more generally available for exposures that only affect other comprehensive income (but not profit or loss). However, the IASB was concerned that such a broad scope might result in items qualifying for hedge accounting that might not be suitable hedged items and hence have unintended consequences. Consequently, the IASB decided against making hedge accounting more generally available to such exposures.

Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

- BC6.117 IAS 39 required the separation of derivatives embedded in hybrid financial assets and liabilities that are not closely related to the host contract (bifurcation). In accordance with IAS 39, the separated derivative was eligible for designation as a hedging instrument. In accordance with IFRS 9, hybrid financial assets are measured in their entirety (ie including any embedded derivative) at either amortised cost or fair value through profit or loss. No separation of any embedded derivative is permitted.
- BC6.118 In the light of the decision that it made on IFRS 9, the IASB considered whether derivatives embedded in financial assets should be eligible for designation as hedging instruments. The IASB considered two alternatives:
- (a) an entity could choose to separate embedded derivatives solely for the purpose of designating the derivative component as a hedging instrument; or

- (b) an entity could designate a risk component of the hybrid financial asset, equivalent to the embedded derivative, as the hedging instrument.

BC6.119 The IASB rejected both alternatives. Consequently, the IASB proposed not to allow derivative features embedded in financial assets to be eligible hedging instruments (even though they can be an integral part of a hybrid financial asset that is measured at fair value through profit or loss and designated as the hedging instrument in its entirety—see paragraph BC6.129). The reasons for the IASB's decision are summarised in paragraphs BC6.120–BC6.121.

BC6.120 Permitting an entity to separate embedded derivatives for the purpose of hedge accounting would retain the IAS 39 requirements in terms of their eligibility as hedging instruments. However, the IASB noted that the underlying rationale for separating embedded derivatives in IAS 39 was not to reflect risk management activities, but instead to prevent an entity from circumventing the requirements for the recognition and measurement of derivatives. The IASB also noted that the designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 was not very common in practice. Hence, the IASB considered that reintroducing the separation of embedded derivatives for hybrid financial assets does not target hedge accounting considerations, would consequently not be an appropriate means to address any hedge accounting concerns and in addition would reintroduce complexity for situations that are not common in practice.

BC6.121 Alternatively, permitting an entity to designate, as the hedging instrument, a risk component of a hybrid financial asset would allow that entity to show more accurately the results of its risk management activities. However, such an approach would be a significant expansion of the scope of the Hedge Accounting project because the IASB would need to address the question of how to disaggregate a hedging instrument into components. In order to be consistent, a similar question would need to be addressed for non-financial items (for example, non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with currency or commodity risk elements). The IASB did not want to expand the scope of the hedge accounting project beyond financial instruments because the outcome of exploring this alternative would be highly uncertain, could possibly necessitate a review of other Standards and could significantly delay the project.

BC6.122 The IASB therefore retained its original decision when deliberating its Exposure Draft.

Non-derivative financial instruments

BC6.123 Hedge accounting shows how the changes in the fair value or cash flows of a hedging instrument offset the changes in the fair value or cash flows of a designated hedged item attributable to the hedged risk if it reflects an entity's risk management strategy.

BC6.124 IAS 39 permitted non-derivative financial assets and non-derivative financial liabilities (for example, monetary items denominated in a foreign currency) to be designated as hedging instruments only for a hedge of foreign currency risk. Designating a non-derivative financial asset or liability denominated in a foreign

currency as a hedge of foreign currency risk in accordance with IAS 39 was equivalent to designating a risk component of a hedging instrument in a hedging relationship. This foreign currency risk component is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because the foreign currency risk component is determined in accordance with foreign currency translation requirements in IAS 21, it is already available for incorporation by reference in the financial instruments Standard. Consequently, permitting the use of a foreign currency risk component for hedge accounting purposes did not require separate, additional requirements for risk components within the hedge accounting model.

- BC6.125 Not allowing the disaggregation of a non-derivative financial instrument used as a hedge into risk components, other than foreign currency risk, has implications for the likelihood of achieving hedge accounting for those instruments. This is because the effects of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness assessment. Consequently, depending on the size of the components that are not related to the risk being hedged, in most scenarios it will be difficult to demonstrate that there is an economic relationship between the hedged item and the hedging instrument that gives rise to an expectation that their values 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.
- BC6.126 In the light of this consequence, the IASB considered whether it should permit non-derivative financial instruments to be eligible for designation as hedging instruments for risk components other than foreign currency risk. The IASB noted that permitting this would require developing an approach for disaggregating non-derivative hedging instruments into components. For reasons similar to those set out in paragraph BC6.121 the IASB decided not to explore such an approach.
- BC6.127 The IASB also considered two alternatives to the requirements of IAS 39 (those requirements that limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk). The IASB considered whether for hedges of all types of risk (ie not limited to hedges of foreign currency risk) it should extend the eligibility as hedging instruments to non-derivative financial instruments:
- (a) that are classified as at fair value through profit or loss; or (alternatively to those)
 - (b) that are part of other categories of IFRS 9.
- BC6.128 The IASB noted that extending the eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems because to apply hedge accounting would require changing the measurement of non-derivative financial instruments measured at amortised cost when they are designated as hedging instruments. The IASB considered that the only way to mitigate this issue was to allow for the designation of components of the non-derivative financial instrument. This

would limit the change in measurement to a component of the instrument attributable to the hedged risk. However, the IASB had already rejected that idea in its deliberations (see paragraph BC6.126).

- BC6.129 However, the IASB noted that extending the eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety (rather than only some risk components of them), would not give rise to the need to change the measurement or the recognition of gains and losses of the financial instrument. The IASB also noted that extending the eligibility to these financial instruments would align the new hedge accounting model more closely with the classification model of IFRS 9 and make it better able to address hedging strategies that could evolve in the future. Consequently, the IASB proposed in its Exposure Draft that non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments if they are designated in their entirety (in addition to hedges of foreign currency risk for which the hedging instrument can be designated on a risk component basis—see paragraph BC6.124).
- BC6.130 Generally, respondents to the Exposure Draft agreed that distinguishing between derivative and non-derivative financial instruments was not appropriate for the purpose of determining their eligibility as hedging instruments. Many respondents believed that extending the eligibility criteria to non-derivative financial instruments at fair value through profit or loss would allow better representation of an entity's risk management activities in the financial statements. The feedback highlighted that this was particularly relevant in countries that have legal and regulatory restrictions on the use and availability of derivative financial instruments.
- BC6.131 Some respondents argued that there was no conceptual basis to restrict the eligibility of non-derivative financial instruments to those that are measured at fair value through profit or loss. In their view all non-derivative financial instruments should be eligible as hedging instruments.
- BC6.132 Other respondents thought that the proposals were not restrictive enough, particularly in relation to non-derivative financial instruments that are measured at fair value through profit or loss as a result of applying the fair value option. Those respondents thought that the IASB should specifically restrict the use of non-derivative financial instruments designated under the fair value option because these have usually been elected to be measured at fair value to eliminate an accounting mismatch and hence should not qualify for hedge accounting. Some respondents also questioned whether a financial liability that is measured at fair value, with changes in the fair value attributable to changes in the liability's credit risk presented in other comprehensive income, would be an eligible hedging instrument under the proposals in the Exposure Draft.
- BC6.133 The IASB noted that in its deliberations leading to the Exposure Draft it had already considered whether non-derivative financial instruments measured at amortised cost should also be eligible for designation as hedging instruments. The IASB remained concerned that designating as hedging instruments those non-derivative financial instruments that were not already accounted for at fair

value through profit or loss would result in hedge accounting that would change the measurement or recognition of gains and losses of items that would otherwise result from applying IFRS 9. For example, the IASB noted that it would have to determine how to account for the difference between the fair value and the amortised cost of the non-derivative financial instrument upon designation as a hedging instrument. Furthermore, upon discontinuation of the hedging relationship, the measurement of the non-derivative financial instrument would revert to amortised cost resulting in a difference between its carrying amount as of the date of discontinuation (the fair value as at the discontinuation date which becomes the new deemed cost) and its maturity amount. The IASB considered that addressing those aspects would inappropriately increase complexity.

- BC6.134 The IASB was also concerned that allowing non-derivative financial instruments that are not already accounted for at fair value through profit or loss to be designated as hedging instruments would mean that the hedge accounting model would not only change the measurement basis of the hedged item, as the existing hedge accounting model already does, but also the measurement basis of hedging instruments. Hence, it could, for example, result in situations in which a natural hedge (ie an accounting match) is already achieved on an amortised cost basis between two non-derivative financial instruments, but hedge accounting could still be used to change the measurement basis of both those instruments to fair value (one as a hedged item and the other as the hedging instrument).
- BC6.135 Consequently, the IASB decided that non-derivative financial instruments should be eligible hedging instruments only if they are already accounted for at fair value through profit or loss.
- BC6.136 The IASB also discussed whether or not those non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of applying the fair value option should be eligible for designation as a hedging instrument. The IASB considered that any designation as a hedging instrument should not contradict the entity's election of the fair value option (ie recreate the accounting mismatch that the election of the fair value option addressed). For example, if a non-derivative financial instrument that has previously been designated under the fair value option is included in a cash flow hedge relationship, the accounting for the non-derivative financial instrument under the fair value option would have to be overridden. This is because all (or part) of the changes in the fair value of that hedging instrument are recognised in other comprehensive income. However, recognising the changes in fair value in other comprehensive income re-introduces the accounting mismatch that the application of the fair value option eliminated in the first instance. The IASB noted that similar considerations apply to fair value hedges and hedges of net investments in foreign operations.
- BC6.137 Consequently, the IASB considered whether it should introduce a general prohibition against designating, as hedging instruments, non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option. However, such a prohibition would not necessarily be appropriate. The IASB noted that one of the items underlying

the fair value option might be sold or terminated at a later stage (ie the circumstances that made the fair value option available might be subject to change or later disappear). However, because the fair value option is irrevocable it would mean a non-derivative financial instrument for which the fair value option was initially elected could never qualify as a hedging instrument even if there was no longer a conflict between the purpose of the fair value option and the purpose of hedge accounting. A general prohibition would not allow the use of hedge accounting at a later stage even when hedge accounting might then mitigate an accounting mismatch (without recreating another one).

- BC6.138 The IASB noted that when a non-derivative financial instrument is accounted for at fair value through profit or loss as a result of electing the fair value option, the appropriateness of its use as a hedging instrument depends on the relevant facts and circumstances underlying the fair value option designation. The IASB considered that if an entity designates as a hedging instrument a financial instrument for which it originally elected the fair value option, and this results in the mitigation of an accounting mismatch (without recreating another one), using hedge accounting was appropriate. However, the IASB emphasised that if applying hedge accounting recreates, in the financial statements, the accounting mismatches that electing the fair value option sought to eliminate, then designating the financial instrument for which the fair value option was elected as a hedging instrument would contradict the basis (qualifying criterion) on which the fair value option was elected. Hence, in those situations there would be a conflict between the purpose of the fair value option and the purpose of hedge accounting as they could not be achieved at the same time but instead would, overall, result in another accounting mismatch. Consequently, the IASB emphasised that designating the non-derivative financial instrument as a hedging instrument in those situations would call into question the legitimacy of electing the fair value option and would be inappropriate. The IASB considered that, to this effect, the requirements of the fair value option were sufficient and hence no additional guidance was necessary.
- BC6.139 As a result, the IASB decided not to introduce a general prohibition against the eligibility of designating as hedging instruments non-derivative financial instruments accounted for at fair value through profit or loss as a result of electing the fair value option.
- BC6.140 The IASB also considered whether it needed to provide more guidance on when a non-derivative financial liability designated as at fair value through profit or loss under the fair value option would qualify as a hedging instrument. The IASB noted that IFRS 9 refers to liabilities for which the fair value option is elected as “liabilities designated at fair value through profit or loss”, irrespective of whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or (if that presentation would enlarge an accounting mismatch) in profit or loss. However, for the eligibility as a hedging instrument, the IASB considered that it would make a difference whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or profit or loss. The IASB noted that if a financial liability whose credit risk related fair value changes are presented in other comprehensive income was

an eligible hedging instrument there would be two alternatives for what could be designated as part of the hedging relationship:

- (a) only the part of the liability that is measured at fair value through profit or loss, in which case the hedging relationship would exclude credit risk and hence any related hedge ineffectiveness would not be recognised; or
- (b) the entire fair value change of the liability, in which case the presentation in other comprehensive income of the changes in fair value related to changes in the credit risk of the liability would have to be overridden (ie using reclassification to profit or loss) to comply with the hedge accounting requirements.

BC6.141 Consequently, the IASB decided to clarify its proposal by adding an explicit statement that a financial liability is not eligible for designation as a hedging instrument if under the fair value option the amount of change in the fair value attributable to changes in the liability's own credit risk is presented in other comprehensive income.

Internal derivatives as hedging instruments

BC6.142 An entity may follow different risk management models depending on the structure of its operations and the nature of the hedges. Some use a centralised treasury or similar function that is responsible for identifying the exposures and managing the risks borne by various entities within the group. Others use a decentralised risk management approach and manage risks individually for entities in the group. Some also use a combination of those two approaches.

BC6.143 Internal derivatives are typically used to aggregate risk exposures of a group (often on a net basis) to allow the entity to manage the resulting consolidated exposure. However, IAS 39 was primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align accounting with risk management, the IASB considered whether internal derivatives should be eligible for designation as hedging instruments. However, the IASB noted that the ineligibility of internal derivatives as hedging instruments was not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge was how to make hedge accounting operational for groups of items and net positions.

BC6.144 The IASB noted that, for financial reporting purposes, the mitigation or transformation of risk is generally only relevant if it results in a transfer of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity does not change the risk exposure from the perspective of that reporting entity as a whole. This is consistent with the principles of consolidated financial statements.

BC6.145 For example, a subsidiary might transfer cash flow interest rate risk from variable-rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (instead of hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's consolidated perspective, the cash flow interest rate risk has not changed but

merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).

BC6.146 Consequently, in the deliberations leading to the Exposure Draft, the IASB decided that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting entity (for example, intragroup derivatives in the consolidated financial statements) because they do not represent an instrument that the reporting entity uses to transfer the risk to an external party (ie outside the reporting entity). This meant that the related requirements in IAS 39 would be retained.

BC6.147 The IASB retained its original decision when redeliberating its Exposure Draft.

Intragroup monetary items as hedging instruments

BC6.148 In accordance with IAS 39, the difference arising from the translation of intragroup monetary items in the consolidated financial statements in accordance with IAS 21 was eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.

BC6.149 The IASB noted that, when translating an intragroup monetary item, IAS 21 requires the recognition of a gain or loss in the consolidated statement of profit or loss and other comprehensive income. Consequently, in the IASB's view, considering intragroup monetary items for eligibility as hedging instruments would require a review of the requirements in IAS 21 at the same time as considering any hedge accounting requirements. The IASB noted that at that time there was no active project on foreign currency translation. Hence, it decided that it should not address this issue as part of its project on hedge accounting. Consequently, in the deliberations leading to the Exposure Draft, the IASB decided not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).

BC6.150 The IASB retained its original decision when redeliberating its Exposure Draft.

Written options

BC6.151 In its Exposure Draft, the IASB retained the restriction in IAS 39 that a written option does not qualify as a hedging instrument except when it is used to hedge a purchased option or unless it is combined with a purchased option as one derivative instrument (for example, a collar) and that derivative instrument is not a net written option.

BC6.152 However, respondents to the Exposure Draft commented that a stand-alone written option should not be excluded from being eligible for designation as a hedging instrument if it is jointly designated with other instruments such that in combination they do not result in a net written option. Those respondents highlighted that entities sometimes enter into two separate option contracts because of, for example, legal or regulatory considerations, and that the two separate option contracts achieve, in effect, the same economic outcome as one contract (for example, a collar contract).

BC6.153 The IASB considered that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance rather than its legal form. Consequently, the IASB decided to amend the requirements such

that a written option and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument, provided that the combination is not a net written option. The IASB also noted that by aligning the accounting for combinations of written and purchased options with that for derivative instruments that combine written and purchased options (for example, a collar contract), the assessment of what is, in effect, a net written option would be the same, ie it would follow the established practice under IAS 39. That practice considers the following cumulative factors to ascertain that an interest rate collar or other derivative instrument that includes a written option is not a net written option:

- (a) no net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- (b) except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Hedged items

Qualifying items

Financial instruments held within a business model whose objective is to collect or pay contractual cash flows

- BC6.154 Against the background of potential interaction with the classification of financial instruments in accordance with IFRS 9, the IASB, in its deliberations leading to the Exposure Draft, considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows. The IASB focused on fair value hedges of interest rate risk because other risks (for example, foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seemed clearly appropriate. More specifically, the IASB was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the entity's business model is to hold the financial instrument to collect (or pay) contractual cash flows, rather than to sell (or settle/transfer) the instrument before contractual maturity in order to realise the fair value changes. Consequently, some argue that, on the basis of the assertion underlying the business model assessment, the entity should be interested only in the contractual cash flows arising from those investments and not in the changes in fair value.
- BC6.155 The IASB discussed several situations in which a fair value hedge of interest rate risk does not contradict the fact that a financial instrument is held with the objective to collect or pay contractual cash flows. One example is an entity that seeks to invest in a variable-rate asset of a particular credit quality, but could only obtain a fixed-rate asset of the desired credit quality. That entity could

create the cash flow profile of a variable-rate asset indirectly by buying both the available fixed-rate investment and entering into an interest rate swap that transforms the fixed-interest cash flows from that asset into variable-interest cash flows. The IASB noted that this and other examples demonstrated that what is a fair value hedge for accounting purposes is, from a risk management perspective, often a choice between receiving (or paying) fixed versus variable interest cash flows, rather than a strategy to protect against fair value changes. Hence, the IASB considered that a fair value hedge of interest rate risk would not in itself contradict the assertion that a financial instrument is held with the objective to collect or pay contractual cash flows.

- BC6.156 The IASB also noted that, under the classification model for financial instruments in IFRS 9, an entity may sell or transfer some financial instruments that qualify for amortised cost, even if they are held with the objective to collect or pay contractual cash flows. Consequently, the IASB decided that fair value hedge accounting should be available for financial instruments that are held with the objective to collect or pay contractual cash flows.

- BC6.157 The IASB retained its original decisions when redeliberating its Exposure Draft.

Designation of derivatives

- BC6.158 The guidance on implementing IAS 39 stated that derivatives could be designated as hedging instruments only, not as hedged items (either individually or as part of a group of hedged items). As the sole exception, paragraph AG94 in the application guidance in IAS 39 allowed a purchased option to be designated as a hedged item. In practice, this has generally prevented derivatives from qualifying as hedged items. Similarly, positions that are a combination of an exposure and a derivative ('aggregated exposures') failed to qualify as hedged items. The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives (or aggregated exposures that include a derivative) to be designated as hedged items. It stated that derivative instruments were always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.

- BC6.159 However, this rationale is difficult to justify in the light of the exception to permit some purchased options to qualify as hedged items irrespective of whether the option is a stand-alone derivative or an embedded derivative. If a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of an aggregated exposure to be part of a hedged item is arbitrary. Many raised similar concerns in response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* about the prohibition of designating derivatives as hedged items.

- BC6.160 The IASB noted that an entity was sometimes economically required to enter into transactions that result in, for example, both interest rate risk and foreign currency risk. While those two exposures can be managed together at the same time and for the entire term, the IASB noted that entities often use different risk management strategies for the interest rate risk and foreign currency risk. For example, for 10-year fixed-rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument

but require fixed-rate exposure in its functional currency only for the short to medium term (say, two years) and floating-rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates). In such a situation an entity may enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed-rate foreign currency debt into a variable-rate functional currency exposure. This is then overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable-rate debt into fixed-rate debt. In effect, the fixed-rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable-rate debt functional currency exposure for risk management purposes.

- BC6.161 Consequently, for the purpose of its Exposure Draft, the IASB concluded that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude the designation of that aggregated exposure as a hedged item.
- BC6.162 Most respondents to the Exposure Draft supported the proposal to allow aggregated exposures to be designated as hedged items. Those respondents noted that the proposal better aligns hedge accounting with an entity's risk management by allowing hedge accounting to be used for common ways in which entities manage risks. In addition, those respondents noted that the proposal removes the arbitrary restrictions that were in IAS 39 and moves closer towards a principle-based requirement. The IASB therefore decided to retain the notion of an aggregated exposure as proposed in the Exposure Draft.
- BC6.163 The main requests that respondents made to the IASB were:
- (a) to provide examples that would illustrate the accounting mechanics for aggregated exposures;
 - (b) to clarify that accounting for aggregated exposures is not tantamount to 'synthetic accounting'; and
 - (c) to clarify whether an entity would, in a first step (and as a precondition), have to achieve hedge accounting for the combination of the exposure and the derivative that together constitute the aggregated exposure so that, in a second step, the aggregated exposure itself can then be eligible as the hedged item in the other hedging relationship.
- BC6.164 In response to the request for examples of the accounting mechanics for aggregated exposures, the IASB decided to provide illustrative examples to accompany IFRS 9. The IASB considered that numerical examples illustrating the mechanics of the accounting for aggregated exposures would, at the same time, address other questions raised in the feedback on the proposals, such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved. Moreover, the IASB noted that those examples would also demonstrate that the proposed accounting for aggregated exposures is very different from 'synthetic accounting', which would reinforce the second clarification that respondents had requested.

- BC6.165 The IASB thought that the confusion about ‘synthetic accounting’ arose from accounting debates in the past about whether two items should be treated for accounting purposes as if they were one single item. This would have had the consequence that a derivative could have assumed the accounting treatment for a non-derivative item (for example, accounting at amortised cost). The IASB noted that, in contrast, under the Exposure Draft’s proposal for aggregated exposures the accounting for derivatives would always be at fair value and hedge accounting would be applied to them. Hence, the IASB emphasised that accounting for aggregated exposures does not allow ‘synthetic accounting’.
- BC6.166 The IASB noted that most respondents had correctly understood the Exposure Draft (ie that it does not allow ‘synthetic accounting’) but the IASB was still concerned because any misconception that aggregated exposures are tantamount to ‘synthetic accounting’ would result in a fundamental accounting error. Hence, the IASB decided to provide, in addition to illustrative examples, an explicit statement confirming that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value.
- BC6.167 The IASB also discussed the request to clarify whether an entity would have to first (as a precondition) achieve hedge accounting for the combination of the underlying exposure and the derivative that constitute the aggregated exposure (the first level relationship) so that the aggregated exposure itself can be eligible as the hedged item in the other hedging relationship (the second level relationship). The IASB noted that the effect of not achieving hedge accounting for the first level relationship depended on the circumstances (in particular, the types of hedge used). In many circumstances, it would make the accounting for the aggregated exposure more complicated and the outcome inferior compared to achieving hedge accounting for the first level relationship. However, the IASB considered that achieving hedge accounting for the first level relationship was not required to comply with the general hedge accounting requirements for the second level relationship (ie the hedging relationship in which the aggregated exposure is the hedged item). Consequently, the IASB decided not to make achieving hedge accounting for the first level relationship a prerequisite for qualifying for hedge accounting for the second level relationship.
- BC6.168 The IASB also clarified two other aspects that had been raised by some respondents:
- (a) that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure, once it has occurred, is eligible as a hedged item; and
 - (b) how to apply the general requirements of designating a derivative as the hedging instrument in the context of aggregated exposures. The IASB noted that the way in which a derivative is included in the hedged item that is an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure (ie at the level of the first level relationship—if applicable, ie if hedge accounting is applied at that level). If the derivative is not designated as the hedging instrument at the level of the aggregated exposure, it must be designated in its entirety or as a

proportion of it. The IASB noted that, consistent with the general requirements of the hedge accounting model, this also ensures that including a derivative in an aggregated exposure does not allow splitting a derivative by risk, by parts of its term or by cash flows.

Designation of hedged items

Designation of a risk component

- BC6.169 IAS 39 distinguished the eligibility of risk components for designation as the hedged item by the type of item that includes the component:
- (a) for financial items, an entity could designate a risk component if that risk component was separately identifiable and reliably measurable; however,
 - (b) for non-financial items, an entity could only designate foreign currency risk as a risk component.
- BC6.170 Risk components of non-financial items, even when they are contractually specified, were not eligible risk components in accordance with IAS 39. Consequently, other than for foreign currency risk, a non-financial item was required to be designated as the hedged item for all risks. The rationale for including this restriction in IAS 39 was that permitting risk components (portions) of non-financial assets and non-financial liabilities to be designated as the hedged item for a risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing because the portion could be designated so that no ineffectiveness would ever arise.
- BC6.171 The hedge accounting model in IAS 39 used the entire item as the default unit of account and then provided rules to govern what risk components of that entire item were available for separate designation in hedging relationships. This has resulted in the hedge accounting requirements being misaligned with many risk management strategies. The outcome was that the normal approach for risk management purposes was treated as the exception by the hedge accounting requirements.
- BC6.172 Many of the comment letters received on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* criticised the prohibition on designating risk components for non-financial items. This was also the most common issue raised during the IASB's outreach activities.
- BC6.173 The IASB noted that the conclusion in IAS 39, that permitting, as hedged items, risk components of non-financial assets and non-financial liabilities would compromise the principles of identification of the hedged item and effectiveness testing, was not appropriate in all circumstances. As part of its deliberations, the IASB considered whether risk components should be eligible for designation as hedged items when they are:
- (a) contractually specified; and
 - (b) not contractually specified.

- BC6.174 Contractually specified risk components determine a currency amount for a pricing element of a contract independently of the other pricing elements and, therefore, independently of the non-financial item as a whole. Consequently, these components are separately identifiable. The IASB also noted that many pricing formulas that use a reference to, for example, benchmark commodity prices are designed in that way to ensure that there is no gap or misalignment for that risk component compared with the benchmark price. Consequently, by reference to that risk component, the exposure can be economically fully hedged using a derivative with the benchmark as the underlying. This means that the hedge effectiveness assessment on a risk components basis accurately reflects the underlying economics of the transaction (ie that there is no or very little ineffectiveness).
- BC6.175 However, in many situations risk components are not an explicit part of a fair value or a cash flow. Nonetheless, many hedging strategies involve the hedging of components even if they are not contractually specified. There are different reasons for using a component approach to hedging, including:
- (a) the entire item cannot be hedged because there is a lack of appropriate hedging instruments;
 - (b) it is cheaper to hedge the single components individually than the entire item (for example, because an active market exists for the risk components, but not for the entire item); and
 - (c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (for example, because one of the risk components is particularly volatile and it therefore justifies the costs of hedging it).
- BC6.176 The IASB learned from its outreach activities that there are circumstances in which entities are able to identify and measure many risk components (not only foreign currency risk) of non-financial items with sufficient reliability. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure related to that risk. Consequently, the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances (ie careful analysis and knowledge of the relevant markets). The IASB noted that as a result there is no 'bright line' to determine eligible risk components of non-financial items.
- BC6.177 Consequently, in its Exposure Draft, the IASB proposed that risk components (both those that are and those that are not contractually specified) should be eligible for designation as hedged items as long as they are separately identifiable and reliably measurable. This proposal would align the eligibility of risk components of non-financial items with that of financial items in IAS 39.
- BC6.178 Most respondents to the Exposure Draft supported the IASB's proposal and its rationale for allowing risk components (both those that are and those that are not contractually specified) to be eligible for designation as hedged items. Those respondents noted that the proposal on risk components was a key aspect of the new hedge accounting model because it would allow hedge accounting to reflect that, in commercial reality, hedging risk components was the norm and hedging items in their entirety was the exception.

- BC6.179 Many respondents noted that IAS 39 was biased against hedges of non-financial items such as commodity hedges. They considered the distinction between financial and non-financial items for determining which risk components would be eligible hedged items as arbitrary and without conceptual justification. The main request by respondents was for additional guidance or clarifications.
- BC6.180 Only a few respondents disagreed with the IASB's proposal on risk components. Those respondents believed that, in situations in which non-contractually specified risk components of non-financial items would be designated as hedged items, no hedge ineffectiveness would be recognised.
- BC6.181 The IASB noted that the debate about risk components suffered from some common misunderstandings. In the IASB's opinion, the root cause of those misunderstandings is the large number of markets and circumstances in which hedging takes place. This results in an inevitable lack of familiarity with many markets. In the light of the arguments raised and to address some of the misunderstandings, the IASB focused its discussions on non-contractually specified risk components of non-financial items and, in particular, on:
- (a) the effect of risk components; and
 - (b) hedge ineffectiveness when designating a risk component.
- BC6.182 The IASB noted that some believe that designating a risk component as a hedged item should not be allowed if it could result in the value of that risk component moving in an opposite direction to the value of the entire item (ie its overall price). For example, if the hedged risk component increases in value this would offset the loss on the hedging instrument, while decreases in the value of other unhedged risk components remain unrecognised.
- BC6.183 The IASB noted that this was not specific to non-contractually specified risk components of non-financial items, but that it applied to risk components in general. For example, consider an entity that holds a fixed-rate bond and the benchmark interest rate decreases but the bond's spread over the benchmark increases. If the entity hedges only the benchmark interest rate using a benchmark interest rate swap, the loss on the swap is offset by a fair value hedge adjustment for the benchmark interest rate component of the bond (even though the bond's fair value is lower than its carrying amount after the fair value hedge adjustment because of the increase in the spread).
- BC6.184 The IASB also noted that designating a risk component was not tantamount to 'hiding losses' or avoiding their recognition by applying hedge accounting. Instead, it would help to mitigate accounting mismatches that would otherwise result from how an entity manages its risks. If hedge accounting is not applied, only the gain or loss from the change in the fair value of the financial instrument that hedges the risk is recognised in profit or loss, whereas the gain or loss on the entire item that gives rise to the risk remains fully unrecognised (until it is realised in a later period) so that any offset is obscured. If designation on a risk component basis is not available, that initially creates an issue of whether the hedge qualifies at all for hedge accounting and is inconsistent with the economic decision of hedging done on a components basis. Consequently, the accounting assessment would be completely disconnected from the decision making of an entity, which is driven by risk management purposes. The IASB

also noted that this consequence would be amplified by the fact that the hedged component is not necessarily the main or largest component (for example, in the case of a power purchase agreement with a contractual pricing formula that includes indexations to fuel oil and inflation, only the inflation risk but not the fuel oil price risk is hedged).

- BC6.185 The IASB noted that even if hedge accounting can be achieved between the hedging instrument and the item (which includes the hedged risk component) in its entirety, the accounting outcome would be more akin to a fair value option for the entire item than reflecting the effect of the economic hedge. However, because hedge accounting would be disconnected from what is economically hedged, there would also be ramifications for the hedge ratio that would have to be used for designating the hedging relationship. The hedge ratio that an entity actually uses (ie for decision making purposes driven by risk management) would be based on the economic relationship between the underlyings of the hedged risk component and the hedging instrument. This is the sensible basis for hedging decisions. However, for accounting purposes, an entity would be forced to compare changes in the value of the hedging instrument to those of the entire item. This means that, in order to improve the offset for the hedging relationship that is designated for accounting purposes, an entity would have to create a deliberate mismatch compared to the economic hedging relationship, which is tantamount to distorting the economic hedge ratio for accounting purposes. The IASB noted that distorting the hedge ratio also meant that prohibiting the designation of hedged items on a risk components basis would, ultimately, not necessarily result in the financial statements reflecting the change in the value of the unhedged risk component as a gain or loss for which there is no offset. Hence, prohibiting that kind of designation would not achieve transparency about the changes in the value of unhedged components by showing a gain or loss for which there is no offset.
- BC6.186 The IASB also noted that designating risk components as hedged items would reflect the fact that risk management typically operates on a 'by risk' basis instead of on a 'by item' basis (which is the unit of account for financial reporting purposes). Hence, the use of risk components as hedged items would reflect what in commercial reality is the norm instead of requiring that all hedged items are 'deemed' to be hedged in their entirety (ie for all risks).
- BC6.187 The IASB also considered the effect that risk components have on the recognition of hedge ineffectiveness. A few respondents believed that if a risk component was designated as the hedged item, it would result in no hedge ineffectiveness being recognised.
- BC6.188 The IASB noted that the effect of designating a risk component as the hedged item was that it became the point of reference for determining offset (ie the fair value change on the hedging instrument would be compared to the change in value of the designated risk component instead of the entire item). This would make the comparison more focused because it would exclude the effect of changes in the value of risks that are not hedged, which would also make hedge ineffectiveness a better indicator of the success of the hedge. The IASB noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components.

Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised. For example:

- (a) a floating-rate debt instrument is hedged against the variability of cash flows using an interest rate swap. The two instruments are indexed to the same benchmark interest rate but have different reset dates for the variable payments. Even though the hedged item is designated as the benchmark interest rate related variability in cash flows (ie as a risk component), the difference in reset dates causes hedge ineffectiveness. There is no market structure that would support identifying a 'reset date' risk component in the variable payments on the floating rate debt that would mirror the reset dates of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto floating rate debt.
- (b) a fixed-rate debt instrument is hedged against fair value interest rate risk using an interest rate swap. The two instruments have different day count methods for the fixed-rate payments. Even though the hedged item is designated as the benchmark interest rate related change in fair value (ie as a risk component), the difference in the day count methods causes hedge ineffectiveness. There is no market structure that would support identifying a 'day count' risk component in the payments on the debt that would mirror the day count method of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto the fixed-rate debt.
- (c) an entity purchases crude oil under a variable-price oil supply contract that is indexed to a light sweet crude oil benchmark. Because of the natural decline of the benchmark oil field the derivatives market for that benchmark has suffered a significant decline in liquidity. In response, the entity decides to use derivatives for a different benchmark for light sweet crude oil in a different geographical area because the derivatives market is much more liquid. The changes in the crude oil price for the more liquid benchmark and the less liquid benchmark are closely correlated but vary slightly. The variation between the two oil benchmark prices causes hedge ineffectiveness. There is no market structure that would support identifying the more liquid benchmark as a component in the variable payments under the oil supply contract. In particular, the terms and conditions of the derivatives indexed to the more liquid benchmark cannot simply be imputed by projecting terms and conditions of those derivatives onto the oil supply contract.
- (d) an entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude oil benchmark for jet fuel purchases at its North American locations is West Texas Intermediate (WTI) whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its

jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe. Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness related to the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot simply be imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

- BC6.189 Consequently, the IASB noted that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.
- BC6.190 The IASB noted that the concerns about hedge ineffectiveness not being recognised related particularly to non-contractually specified risk components of non-financial items. However, the IASB considered that this was not a financial versus non-financial item problem. Determining the hedge ineffectiveness, for example, for a fixed-rate debt instrument when designating the benchmark interest rate component as the hedged item is no more or less troublesome than doing so for commodity price risk. In both cases the appropriate designation of a risk component depends on an appropriate analysis of the market structure. The IASB noted that the derivative markets for commodity risk had evolved and had resulted in customs that helped improve the effectiveness of hedging. For example, very liquid commodity benchmarks have evolved, allowing for a market volume for derivatives that is far larger than the physical volume of the underlying commodity, thus facilitating benchmarks that can be widely used.
- BC6.191 In the light of those considerations and the responses received on the Exposure Draft, the IASB decided to retain the notion of risk components as eligible hedged items. Because of the large variety of markets and circumstances in which hedging takes place, the IASB considered that, in order to avoid arbitrary discrimination against some markets, risks or geographies, there was no alternative to using a criteria-based approach to identifying eligible risk components. Consequently, the IASB decided that for risk components (of both financial and non-financial items) to qualify as eligible hedged items, they must be separately identifiable and reliably measureable. In response to requests from respondents, the IASB also decided to expand the examples of how to determine eligible risk components, including illustrations of the role of the market structure.
- BC6.192 The IASB also discussed the proposal in the Exposure Draft to prohibit the designation of non-contractually specified inflation risk components of financial instruments. That prohibition was carried over from IAS 39. The IASB noted that an outright ban meant that the general criteria for the eligibility of risk components could not be applied and, as a result, would leave no room for the possibility that in some situations there might be circumstances that could

support identifying a risk component for inflation risk. On the other hand, the IASB was concerned that the removal of the restriction would encourage the use of inflation risk components for hedge accounting when it was not necessarily appropriate to do so. This would be the case when a risk component, instead of being supported by the market structure and independently determined for the hedged item, would, for example, be determined by simply projecting the terms and conditions of the inflation derivative that was actually used as the hedge onto the hedged item. In the light of this trade-off, the IASB also considered that financial markets continuously evolve and that the requirements should be capable of addressing changes in the market over time.

- BC6.193 On balance, the IASB decided to remove the prohibition. However, it was concerned that its decision could be misunderstood as simply ‘rubber stamping’ the use of inflation risk components for hedge accounting without proper application of the criteria for designating risk components. The IASB therefore agreed to include a caution in the final requirements that, in order to determine whether inflation risk is an eligible risk component, a careful analysis of the facts and circumstances is required so that the criteria for designating risk components are properly applied. Consequently, the IASB decided to add a rebuttable presumption related to non-contractually specified inflation risk components of financial instruments.

Designation of ‘one-sided’ risk components

- BC6.194 IAS 39 permitted an entity to designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a ‘one-sided’ risk). So, an entity might hedge an exposure to a specific type of risk of a financial instrument (for example, interest rates) above a pre-determined level (for example, above five per cent) using a purchased option (for example, an interest rate cap). In this situation an entity hedged some parts of a specific type of risk (ie interest exposure above five per cent).
- BC6.195 Furthermore, the IASB noted that hedging one-sided risk exposures is a common risk management activity. The IASB also noted that the main issue that relates to the hedging of one-sided risk is the use of options as hedging instruments. Consequently, the IASB decided to permit the designation of one-sided risk components as hedged items, as was the case in IAS 39 for some risk components. However, the IASB decided to change the accounting for the time value of options (see paragraphs BC6.386–BC6.413).
- BC6.196 The IASB retained its original decisions about the eligibility of one-sided risk components as hedged items when redeliberating its Exposure Draft.

Components of a nominal amount—designation of a component that is a proportion

- BC6.197 The IASB noted that components that form some quantifiable nominal part of the total cash flows of the instrument are typically separately identifiable. For example, a proportion, such as 50 per cent, of the contractual cash flows of a loan includes all the characteristics of that loan. In other words, changes in the value and cash flows for the 50 per cent component are half of those for the entire instrument.

- BC6.198 The IASB noted that a proportion of an item forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The IASB concluded that if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a proportion of an item as a hedged item (as previously permitted by IAS 39).
- BC6.199 The IASB retained its original decisions when redeliberating its Exposure Draft.

Components of a nominal amount—designation of a layer component

- BC6.200 IAS 39 required an entity to identify and document anticipated (ie forecast) transactions that are designated as hedged items with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. As a result, IAS 39 permitted forecast transactions to be identified as a 'layer' component of a nominal amount, for example, the first 100 barrels of the total oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item related to the amount or timing. This uncertainty does not affect the hedging relationship to the extent that the hedged volume occurs (irrespective of which particular individual items make up that volume).
- BC6.201 The IASB considered whether similar considerations should also apply to a hedge of an existing transaction or item in some situations. For example, a firm commitment or a loan might also involve some uncertainty because:
- (a) a contract might be cancelled for breach of contract (ie non-performance); or
 - (b) a contract with an early termination option (for repayment at fair value) might be terminated before maturity.
- BC6.202 Because there is uncertainty for both anticipated transactions and existing transactions and items, the IASB decided not to distinguish between such transactions and items for the purposes of designating a layer component.
- BC6.203 The IASB noted that designating as the hedged item a component that is a proportion of an item can give rise to a different accounting outcome when compared with designating a layer component. If the designation of those components is not aligned with the risk management strategy of the entity, it might result in profit or loss providing confusing or less useful information to users of financial statements.
- BC6.204 In the IASB's view there might be circumstances when it is appropriate to designate a layer component as a hedged item. Consequently, in its Exposure Draft the IASB proposed to permit the designation of a layer component as the hedged item (for anticipated and existing transactions). The IASB also proposed that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The IASB noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately

identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how the hedge effectiveness would be measured).

- BC6.205 Most respondents to the Exposure Draft agreed with the proposed change for fair value hedges, which would allow an entity to designate a layer component from a defined nominal amount. They agreed that such layers would allow entities to better reflect what risk they actually hedge.
- BC6.206 However, many respondents disagreed with the IASB's proposal to prohibit, in any circumstances, the designation of a layer component in a fair value hedge for all contracts that include any prepayment option whose fair value is affected by changes in the hedged risk. Those respondents' main objection was that the proposal was inconsistent with common risk management strategies and that the fair value changes of a prepayment option were irrelevant in the context of a bottom layer.
- BC6.207 In the light of the comments received, the IASB discussed:
- (a) whether the prohibition to designate a layer component as the hedged item in a fair value hedge should relate to an entire item or contract containing a prepayment option or whether it should relate only to those situations in which the designated layer contains a prepayment option;
 - (b) whether a layer component can be designated as the hedged item in a fair value hedge if it includes the effect of a related prepayment option; and
 - (c) whether the requirement should differentiate between written and purchased prepayment options, thereby allowing a layer component to be designated for items with a purchased option, ie if the entity is the option holder (for example, a debtor's call option included in prepayable debt).
- BC6.208 The IASB discussed situations in which a contract is prepayable for only a part of its entire amount, which means that the remainder is not prepayable and hence does not include a prepayment option. For example, a loan with a principal amount of CU100 and a maturity of five years that allows the debtor to repay (at par) up to CU10 at the end of each year would mean that only CU40 is prepayable (at different points in time), whereas CU60 is non-prepayable but has a five-year fixed term. Because the CU60 is fixed-term debt that is not affected by prepayments, its fair value does not include the effect of a prepayment option. Consequently, the changes in the fair value related to the CU60 are unrelated to the fair value changes of the prepayment option for other amounts. This means that if the CU60 were designated as a layer component, the hedge ineffectiveness would appropriately exclude the change in the fair value of the prepayment option. The IASB considered that this would be consistent with its rationale for proposing to prohibit a layer component of an (entire) item or contract that contains a prepayment option (see paragraph BC6.204) to be designated. However, the IASB noted that the changes in fair value of the amounts that are prepayable (ie the CU40 at inception, CU30 after one year, CU20 after two years and CU10 after three years) include a prepayment option and the designation of

a layer for these amounts would therefore contradict the IASB's rationale (see paragraph BC6.204). The IASB noted that the layer of CU60 in this example should not be confused with a bottom layer of CU60 that is expected to remain at maturity from a total amount of CU100 that is prepayable in its entirety. The difference is that the expected remaining amount of a larger prepayable amount is the expected eventual outcome of a variable contractual maturity, whereas the CU60 in this example is the definite outcome of a fixed contractual maturity.

- BC6.209 Consequently, the IASB decided to:
- (a) confirm the proposals in the Exposure Draft to allow a layer-based designation of a hedged item (when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk); and
 - (b) to allow a layer-based designation for those amounts that are not prepayable at the time of designation of a partially prepayable item.
- BC6.210 The IASB also discussed whether a layer component should be available for designation as the hedged item in a fair value hedge if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.
- BC6.211 Including the change in fair value of the prepayment option that affects a layer when determining hedge ineffectiveness has the following consequences:
- (a) the designated hedged item would include the entire effect of changes in the hedged risk on the fair value of the layer, ie including those resulting from the prepayment option; and
 - (b) if the layer was hedged with a hedging instrument (or a combination of instruments that are designated jointly) that does not have option features that mirror the layer's prepayment option, hedge ineffectiveness would arise.
- BC6.212 The IASB noted that a designation of a layer as the hedged item, if it included the effects of a related prepayment option when determining the change in fair value of the hedged item, would not conflict with its rationale for proposing the requirements related to the implication of prepayment options for layer designations (see paragraph BC6.204).
- BC6.213 Consequently, the IASB decided that designating a layer as the hedged item should be allowed if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.
- BC6.214 The IASB also considered whether it should differentiate between written and purchased prepayment options for the purpose of determining the eligibility of a layer-based designation of a hedged item in a fair value hedge. Some respondents had argued that if the entity was the option holder, it would control the exercise of the option and could therefore demonstrate that the option was not affected by the hedged risk.
- BC6.215 However, the IASB noted that the hedged risk affects the fair value of a prepayment option irrespective of whether the particular option holder actually exercises it at that time or intends to actually exercise it in the future. The fair

value of the option captures the possible outcomes and hence the risk that an amount that would be in the money might be repaid at a different amount than at fair value before taking the prepayment option into account (for example, at par). Consequently, the IASB noted that whether a prepayment option is a purchased or a written option does not affect the change in the option's absolute fair value but instead determines whether it is either a gain or a loss from the entity's perspective. In other words, the IASB considered that the aspect of who controls the exercise of the option relates to whether any intrinsic value would be realised (but not whether it exists).

- BC6.216 Consequently, the IASB decided not to differentiate between written and purchased prepayment options for the purpose of the eligibility of a layer-based designation of hedged items.

Relationship between components and the total cash flows of an item

- BC6.217 IAS 39 allowed an entity to designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate that is below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).
- BC6.218 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing a variable-interest coupon at LIBOR minus a spread or an equivalent fixed-rate coupon), the negative spread represents a positive margin for the borrower. This is because banks on average pay LIBOR for their funding in the interbank market. Another example of when this occurs is when the reference rate is highly correlated with LIBOR and the negative spreads arise because of the better credit risk of the contributors to the reference index compared with LIBOR. When entering into hedging relationships, an entity cannot obtain (at a reasonable cost) a standardised hedging instrument for all transactions that are priced sub-LIBOR. Consequently, such an entity uses hedging instruments that have LIBOR as their underlying.
- BC6.219 In the deliberations leading to the Exposure Draft, the IASB noted that it had received feedback on the sub-LIBOR issue from its outreach activities that accompanied those deliberations. That feedback showed that some participants believed that designating a risk component that assumes cash flows that would exceed the actual cash flows of the financial instrument reflected risk management in situations in which the hedged item has a negative spread to the benchmark rate. They believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argued that they were hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.

- BC6.220 In the deliberations leading to the Exposure Draft, the IASB noted that, for risk management purposes, an entity normally does not try to hedge the effective interest rate of the financial instrument but rather the change in the variability of the cash flows attributable to LIBOR. By doing this, such an entity ensures that exposure to benchmark interest rate risk is managed and that the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes, provided that LIBOR is not below the absolute value of the negative spread. This risk management strategy provides offsetting changes related to the LIBOR-related interest rate risk in a similar way to situations in which the spread above LIBOR is zero or positive. However, if LIBOR falls below the absolute value of that negative spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The IASB noted that these outcomes are inconsistent with the economic phenomenon to which they relate.
- BC6.221 To avoid those outcomes, the IASB proposed retaining the restriction in IAS 39 for the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the IASB emphasised that hedge accounting would still be available on the basis of designating all the cash flows of an item for a particular risk, ie a risk component for the actual cash flows of the item (see paragraph BC6.217).
- BC6.222 The IASB received mixed views on its proposal to retain this restriction. Some agreed with the restriction and the IASB's rationale for retaining it. Others were concerned that the restriction was inconsistent with common risk management practices. Those who disagreed believed that it should be possible to designate as the hedged item a benchmark risk component that is equivalent to the entire LIBOR and to treat the spread between the entire LIBOR and the contractual rate as a negative residual component. Their view reflects the fact that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps (see paragraph BC6.226 for an example). In their view, the IASB's proposal would not allow them to properly reflect the hedging relationship, and would force them to recognise hedge ineffectiveness that, in their view, would not reflect their risk management strategy.
- BC6.223 In response to the concerns raised, the IASB considered whether it should allow the designation of risk components on a benchmark risk basis that assumes cash flows exceeding the total actual cash flows of the hedged item.
- BC6.224 As part of its redeliberations, the IASB discussed how contractual terms and conditions that determine whether an instrument has a zero interest rate floor or 'negative' interest (ie no floor) might affect the designation of a full LIBOR component of a sub-LIBOR instrument.
- BC6.225 The IASB discussed an example of an entity that has a liability that pays a fixed rate and grants a loan at a floating rate with both instruments being priced at sub-LIBOR interest rates. The entity enters into a LIBOR-based interest rate swap with the aim of locking in the margin that it will earn on the combined position. If the entity wants to designate the hedged item on the basis of the interest rate risk that results from its financial asset, this would be an example of a cash flow hedge of variable-rate interest cash flows from a sub-LIBOR asset.

- BC6.226 The IASB noted that if the floating-rate asset had a zero interest rate floor and LIBOR decreased below the absolute value of the negative spread on the asset, the return on the asset (after taking into account the effect of the swap) would increase as a result of the interest rate swap not having a floor. This means that if designated on a full LIBOR risk component basis, the hedging relationship would have outcomes that would be inconsistent with the notion of a locked margin. In this example, the margin could become variable instead of being locked. The IASB was of the view that, in the context of hedge accounting, this would give rise to hedge ineffectiveness that must be recognised in profit or loss. The IASB noted that this hedge ineffectiveness resulted from the absence of offsetting cash flows and hence represented a genuine economic mismatch between changes in cash flows on the floating-rate asset and the swap. Hence, if a full LIBOR component was imputed for interest bearing instruments that are priced sub-LIBOR, it would inappropriately defer hedge ineffectiveness in other comprehensive income. In the IASB's view this would be tantamount to accrual accounting for the interest rate swap.
- BC6.227 In contrast, the IASB noted that if the floating-rate asset had no floor, the sub-LIBOR instrument included in the hedging relationship would still have changes in their cash flows that would move with LIBOR even if LIBOR was below the absolute value of the spread. Consequently, the variability in cash flows of the hedging instrument that locks the margin would be offset by the variability of the cash flows of the sub-LIBOR instrument irrespective of the LIBOR level. In other words, the LIBOR-related cash flow variability when the asset had no floor would be equivalent to that of a full LIBOR component and therefore the proposed requirement would not prohibit designating the hedged item accordingly (ie as changes in cash flows of a full LIBOR risk component).
- BC6.228 As a result, the IASB decided to confirm the proposal in the Exposure Draft that if a component of the cash flows of a financial or non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item.
- BC6.229 Furthermore, the IASB noted that the examples carried over from IAS 39 to the Exposure Draft only included financial items because under IAS 39 the issue could only apply to that type of item. But, given that under the new hedge accounting model this issue also applies to non-financial items that are traded below their respective benchmark price, the IASB decided to add an example of a hedge of commodity price risk in a situation in which the commodity is priced at a discount to the benchmark commodity price.

Qualifying criteria for hedge accounting

Effectiveness assessment

- BC6.230 To qualify for hedge accounting in accordance with IAS 39, a hedge had to be highly effective, both prospectively and retrospectively. Consequently, an entity had to perform two effectiveness assessments for each hedging relationship. The prospective assessment supported the expectation that the hedging relationship would be effective in the future. The retrospective assessment determined that the hedging relationship had been effective in the reporting period. All

retrospective assessments were required to be performed using quantitative methods. However, IAS 39 did not specify a particular method for testing hedge effectiveness.

- BC6.231 The term ‘highly effective’ referred to the degree to which the hedging relationship achieved offsetting between changes in the fair value or cash flows of the hedging instrument and changes in the fair value or cash flows of the hedged item attributable to the hedged risk during the hedge period. In accordance with IAS 39, a hedge was regarded as highly effective if the offset was within the range of 80–125 per cent (often colloquially referred to as a ‘bright line test’).
- BC6.232 In the deliberations leading to the Exposure Draft, the IASB noted that it had received feedback on the hedge effectiveness assessment under IAS 39 from its outreach activities that accompanied those deliberations. The feedback showed that:
- (a) many participants found that the hedge effectiveness assessment in IAS 39 was arbitrary, onerous and difficult to apply;
 - (b) as a result, there was often little or no link between hedge accounting and the risk management strategy; and
 - (c) because hedge accounting was not achieved if the hedge effectiveness was outside the 80–125 per cent range, it made hedge accounting difficult to understand in the context of the risk management strategy of the entity.
- BC6.233 Consequently, in its Exposure Draft the IASB proposed a more principle-based hedge effectiveness assessment. The IASB proposed that a hedging relationship meets the hedge effectiveness requirements if it:
- (a) meets the objective of the hedge effectiveness assessment (ie that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and
 - (b) is expected to achieve other than accidental offsetting.
- BC6.234 Most respondents to the Exposure Draft supported the removal of the 80–125 per cent quantitative test. Those respondents also supported the IASB in avoiding the use of bright lines in hedge accounting generally and the move towards a more principle-based effectiveness assessment.
- BC6.235 Only a few respondents disagreed with the proposal, largely because they believed that the quantitative threshold in IAS 39 was appropriate. They also believed that an approach that was completely principle-based would generate operational difficulties and would have the potential to inappropriately extend the application of hedge accounting.
- BC6.236 The sections below elaborate on the IASB’s considerations.
- The objective of the hedge effectiveness assessment*
- BC6.237 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The IASB noted that this resulted in hedge accounting that was considered by some as arbitrary and onerous.

Furthermore, the arbitrary 'bright line' of 80–125 per cent resulted in a disconnect between hedge accounting and risk management. Consequently, it made it difficult to explain the results of hedge accounting to users of financial statements. To address those concerns, the IASB decided that it would propose an objective-based model for testing hedge effectiveness instead of the 80–125 per cent 'bright line test' in IAS 39.

- BC6.238 During its deliberations, the IASB initially considered an objective-based assessment to determine which hedging relationships would qualify for hedge accounting. The IASB's intention was that the assessment should not be based on a particular level of hedge effectiveness. The IASB decided that, in order to avoid the arbitrary outcomes of the assessment under IAS 39, it had to remove, rather than just move, the bright line. The IASB held the view that the objective of the hedge effectiveness assessment should reflect the fact that hedge accounting was based on the notion of offset.
- BC6.239 In accordance with the approach that the IASB initially considered, the effectiveness assessment would have aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment would have been based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it could be expected to meet the risk management objective. The IASB believed that the proposed approach would therefore have strengthened the relationship between hedge accounting and risk management practice.
- BC6.240 However, the IASB was concerned that this approach might not be rigorous enough. This was because, without clear guidance, an entity might designate hedging relationships that would not be appropriate because they would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation of the hedging relationship and hence be biased. The IASB noted that the bright line of 80–125 per cent in IAS 39 created a trade-off when an entity chose a hedge ratio that would have a biased result, because that result came at the expense of higher ineffectiveness and hence increased the risk of falling outside that range. However, the IASB noted that the 80–125 per cent range would be eliminated by its proposals and therefore decided to extend its initial objective of the effectiveness assessment so that it also included the hedge ratio. Consequently, in its Exposure Draft, the IASB proposed that the objective of assessing the effectiveness of a hedging relationship was that the entity designated the hedging relationship so that it gave an unbiased result and minimised expected ineffectiveness.
- BC6.241 The IASB noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of differences in the underlyings or other differences between the hedging instrument and the hedged item that the entity accepts in order to achieve a cost-effective hedging relationship. The IASB considered that when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, the IASB proposed in its Exposure Draft that hedging relationships should not be

established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument.

BC6.242 However, many respondents to the Exposure Draft asked the IASB to provide further guidance on the objective-based effectiveness assessment, particularly on the notions of 'unbiased result' and 'minimise expected hedge ineffectiveness'. Those respondents were concerned that the requirements, as drafted in the Exposure Draft, could be interpreted to be more restrictive and onerous than the bright line effectiveness test in IAS 39 and would be inconsistent with risk management practice. More specifically, those respondents were concerned that the objective of the hedge effectiveness assessment as drafted in the Exposure Draft could be interpreted as requiring entities to set up a hedging relationship that was 'perfectly effective'. They were concerned that this would result in an effectiveness assessment that would be based on a bright line of 100 per cent effectiveness, and that such an approach:

- (a) would not take into account that, in many situations, entities do not use a hedging instrument that would make the hedging relationship 'perfectly effective'. They noted that entities use hedging instruments that do not achieve perfect hedge effectiveness because the 'perfect' hedging instrument is:
 - (i) not available; or
 - (ii) not cost-effective as a hedge (compared to a standardised instrument that is cheaper and/or more liquid, but does not provide the perfect fit).
- (b) could be interpreted as a mathematical optimisation exercise. In other words, they were concerned that it would require entities to search for the perfect hedging relationship at inception (and on a continuous basis), because if they did not, the results could be considered to be biased and hedge ineffectiveness would probably not be 'minimised'.

BC6.243 In the light of the concerns about the use of hedging instruments that are not 'perfectly effective', the IASB noted that the appropriate hedge ratio was primarily a risk management decision rather than an accounting decision. When determining the appropriate hedge ratio, risk management would take into consideration, among other things, the following factors:

- (a) the availability of hedging instruments and the underlyings of those hedging instruments (and, as a consequence, the level of the risk of differences in value changes involved between the hedged item and the hedging instrument);
- (b) the tolerance levels in relation to expected sources of hedge ineffectiveness (which determine when the hedging relationship is adjusted for risk management purposes); and
- (c) the costs of hedging (including the costs of adjusting an existing hedging relationship).

BC6.244 The IASB's intention behind its proposal in the Exposure Draft was that an entity would choose the actual hedge basing its decision on commercial

considerations, designate it as the hedging instrument and use it as a starting point to determine the hedge ratio that would comply with the proposed requirements. In other words, the IASB did not intend that an entity would have to consider the hedge effectiveness and related hedge ratio that could have been achieved with a different hedging instrument that might have been a better fit for the hedged risk if it did not enter into that hedging instrument.

- BC6.245 The IASB also reconsidered the proposed objective of the hedge effectiveness assessment in the light of the concerns that it might result in a mathematical optimisation exercise. In particular, the IASB considered the effect of its proposal in situations in which a derivative is designated as a hedging instrument only after its inception so that it is already in or out of the money at the time of its designation (often colloquially referred to as a 'late hedge'). The IASB considered whether the hedge ratio would have to be adjusted to take into account the (non-zero) fair value of the derivative at the time of its designation. This is because the fair value of the hedging instrument at the time of its designation is a present value. Over the remaining life of the hedging instrument this present value will accrete to the undiscounted amount (the 'unwinding of the discount'). The IASB noted that there is no offsetting fair value change in the hedged item for this effect (unless the hedged item was also in or out of the money in an equal but opposite way). Consequently, in situations in which the derivative is designated as the hedging instrument after its inception, an entity would expect that the changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item (ie the hedge ratio would not be 'unbiased'). To meet the proposed objective of the hedge effectiveness assessment an entity would need to explore whether it could adjust the hedge ratio to avoid the systematic difference between the value changes of the hedging instrument and the hedged item over the hedging period. However, to determine the ratio that would avoid that systematic difference, an entity would need to know what the actual price or rate of the underlying will be at the end of the hedging relationship. Hence, the IASB noted that the proposed objective of the hedge effectiveness assessment could be interpreted to the effect that, in the (quite common) situations in which an entity has a 'late hedge', the proposed hedge effectiveness requirements would not be met. This is because the entity would not be able to identify a hedge ratio for the designation of the hedging relationship that would not involve an expectation that the changes in value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item. The IASB did not intend this outcome when it developed its proposals in its Exposure Draft.
- BC6.246 The IASB noted that the feedback about the requirement that the hedging relationship should minimise hedge ineffectiveness suggested that identifying a 'minimum' would involve considerable effort in all situations in which the terms of the hedging instrument and the hedged item are not fully matched. Hence, the requirement to minimise hedge ineffectiveness would bring back many of the operational problems of the hedge effectiveness assessment in IAS 39. Furthermore, regardless of the effort involved, it would be difficult to demonstrate that the 'minimum' had been identified.

BC6.247 The IASB noted that when it developed its Exposure Draft, it included the notions of ‘unbiased’ and ‘minimise expected hedge ineffectiveness’ to ensure that:

- (a) entities would not deliberately create a difference between the quantity actually hedged and the quantity designated as the hedged item in order to achieve a particular accounting outcome; and
- (b) an entity would not inappropriately designate a hedging relationship such that it would give rise to systematic hedge ineffectiveness, which could be avoided by a more appropriate designation.

The IASB noted that both aspects could result in undermining the ‘lower of’ test for cash flow hedges or achieving fair value hedge adjustments on a greater quantity of the hedged item than an entity actually hedged (ie fair value accounting would be disproportionately expanded compared to the quantity actually hedged).

BC6.248 Taking into account the responses to the Exposure Draft, the IASB decided to remove the terms ‘unbiased’ (ie no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item such that they would produce a biased result) and ‘minimising expected hedge ineffectiveness’. Instead, the IASB decided to state, more directly, that the entity’s designation of the hedging relationship shall use a hedge ratio based on:

- (a) the quantity of the hedged item that it actually hedges; and
- (b) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item.

BC6.249 The IASB noted that this approach has the following advantages:

- (a) the use of the hedge ratio resulting from the requirement in this IFRS provides information about the hedge ineffectiveness in situations in which an entity uses a hedging instrument that does not provide the best fit (for example, because of cost-efficiency considerations). The IASB noted that the hedge ratio determined for risk management purposes has the effect of showing the characteristics of the hedging relationship and the entity’s expectations about hedge ineffectiveness. This includes hedge ineffectiveness that results from using a hedging instrument that does not provide the best fit.
- (b) it also aligns hedge accounting with risk management and hence is consistent with the overall objective of the new hedge accounting model.
- (c) it addresses the requests from respondents to the Exposure Draft for clarification that the relevant hedging instrument to be considered in the hedge effectiveness assessment is the actual hedging instrument the entity decided to use.
- (d) it retains the notion proposed in the Exposure Draft that the hedge ratio is not a free choice for accounting purposes as it was in IAS 39 (subject to passing the 80–125 per cent bright line test).

BC6.250 The IASB noted that the only situation open to abuse is if the entity purposefully (for risk management purposes) used a hedge ratio that would be considered ‘inappropriately loose’ from an accounting perspective, for example:

- (a) if an entity uses an excess quantity of the hedging instrument it would have more costs and risks because of having more hedging instruments than needed to mitigate the risks resulting from the hedged items. However, from an accounting perspective, this would not lead to any advantage because it would create fair value changes for the hedging instrument that affect profit or loss for both fair value hedges and cash flow hedges. The result of an entity using an excess quantity of the hedging instrument would therefore solely be the presentation of fair value changes within profit or loss as hedge ineffectiveness instead of other or trading gains or losses. This would increase the hedge ineffectiveness in an entity’s financial statements while having no impact on overall profit or loss.
- (b) if an entity uses a quantity of the hedging instrument that is too small it would leave, economically, a gap in its hedging. From an accounting perspective, this might create an advantage for fair value hedges if an entity wanted to achieve fair value hedge adjustments on a greater quantity of ‘hedged items’ than it would achieve when using an appropriate hedge ratio. In addition, for cash flow hedges, an entity could abuse the ‘lower of’ test because the hedge ineffectiveness arising from the larger change in fair value on the hedged item compared to that on the hedging instrument would not be recognised. Consequently, even though using a ‘deficit’ quantity of the hedging instrument would not be economically advantageous, from an accounting perspective it might have the desired outcome for an entity.

BC6.251 The IASB noted that the potential for abuse, as illustrated above, was implicitly addressed in IAS 39 by the 80–125 per cent bright line of the retrospective hedge effectiveness assessment. Given its decision to remove that bright line (see paragraph BC6.237), the IASB decided to explicitly address this potential for abuse. As a consequence, this IFRS requires that, for the purpose of hedge accounting, an entity shall not designate a hedging relationship in a manner that reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

Other than accidental offsetting

BC6.252 IAS 39 was based on a purely accounting-driven percentage-based bright line test (the 80–125 per cent range). This disconnected accounting from risk management (see paragraph BC6.237). Consequently, the IASB proposed replacing the bright line test with a notion that aims to reflect the way entities look at the design and monitoring of hedging relationships from a risk management perspective. Inherent in this was the notion of ‘other than accidental offsetting’. This linked the risk management perspective with the hedge accounting model’s general notion of offset between gains and losses on

hedging instruments and hedged items. The IASB also considered that this link reflected the intention that the effectiveness assessment should not be based on a particular level of effectiveness (hence avoiding a new bright line).

- BC6.253 Many respondents to the Exposure Draft asked the IASB to provide further guidance on the notion of ‘other than accidental offsetting’. Many also suggested that the IASB revise the proposed guidance by introducing a direct reference to the aspect of an economic relationship between the hedged item and the hedging instrument that was included in the application guidance proposed in the Exposure Draft.
- BC6.254 The IASB noted that qualifying criteria that use terminology such as ‘other than accidental offsetting’ can be abstract. The feedback suggested that this makes the relevant aspects or elements of the hedge effectiveness assessment more difficult to understand. The IASB considered that it could address the respondents’ request and reduce the abstractness of this proposal by avoiding the use of an ‘umbrella term’ and instead making explicit all aspects that the requirement comprises. This would provide greater clarity and facilitate a better understanding of what aspects are relevant when assessing hedge effectiveness.
- BC6.255 Consequently, the IASB decided to replace the term ‘other than accidental offsetting’ with requirements that better conveyed its original notion:
- (a) an economic relationship between the hedged item and the hedging instrument, which gives rise to offset, must exist at inception and during the life of the hedging relationship; and
 - (b) the effect of credit risk does not dominate the value changes that result from that economic relationship.

A ‘reasonably effective’ threshold

- BC6.256 A few respondents suggested that the IASB could consider using a ‘qualitative threshold’ instead of a principle-based hedge effectiveness assessment. Those respondents believed that, in order to meet the hedge effectiveness criteria, a hedging relationship should be required to be ‘reasonably effective’ in achieving offsetting changes in the fair value of the hedged item and in the fair value of the hedging instrument.
- BC6.257 The IASB noted that a ‘reasonably effective’ criterion would retain the threshold design of the effectiveness assessment that was used in IAS 39. The IASB considered that moving, rather than removing, the threshold would not address the root cause of the problem (see paragraph BC6.237). The suggested approach would instead only change the level of the threshold. The IASB considered that, even though the threshold would be of a qualitative nature, it would still create a danger of reverting back to a quantitative measure (such as the percentage range of IAS 39) in order for it to be operational. The IASB noted that similar concerns had been raised as part of the feedback to the Exposure Draft.
- BC6.258 The IASB also noted that one of the major concerns that respondents had raised about the reference in the Exposure Draft to ‘unbiased result’ was that it could be perceived as requiring entities to identify the ‘perfect’ hedging instrument or

that the entity's commercial decision of which hedging instrument to actually use could be restricted or second guessed (see paragraph BC6.242).

- BC6.259 The IASB considered that using a reference to 'reasonably effective' would give rise to similar concerns because it would raise the question of how much ineffectiveness that results from the choice of the actual hedging instrument is 'reasonable' (similar to the notion of 'unbiased' proposed in the Exposure Draft). The IASB was also concerned that this might have a particular impact on emerging economies because entities in those economies often have to transact hedging instruments in more liquid markets abroad, which means that it is more difficult for them to find a hedging instrument that fits their actual exposure than it is for entities in economies with those liquid markets.
- BC6.260 Furthermore, the IASB was concerned that using the single term 'reasonably effective' would mingle different aspects, which would be tantamount to aggregating the different aspects of the effectiveness assessment that the IASB had considered (ie the economic relationship, the effect of credit risk and the hedge ratio). The IASB noted that it was clear from feedback received on its proposed objective of the hedge effectiveness assessment that a single term was too abstract if the notion described by that term included a number of different aspects (see also paragraph BC6.254).
- BC6.261 Consequently, the IASB decided not to use a qualitative 'reasonably effective' threshold for assessing hedge effectiveness.

Frequency of assessing whether the hedge effectiveness requirements are met

- BC6.262 In the deliberations leading to the Exposure Draft, as a consequence of its proposed hedge effectiveness requirements, the IASB considered how frequently an entity should assess whether the hedge effectiveness requirements were met. The IASB decided that an entity should perform this assessment at the inception of the hedging relationship.
- BC6.263 Furthermore, the IASB considered that an entity should assess, on an ongoing basis, whether the hedge effectiveness requirements are still met, including any adjustment (rebalancing) that might be required in order to continue to meet those requirements (see paragraphs BC6.300–BC6.313). This was because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship. The IASB also decided that the assessment of those requirements should be only forward-looking (ie prospective) because it related to expectations about hedge effectiveness.
- BC6.264 Hence, in the deliberations leading to the Exposure Draft, the IASB concluded that the reassessment of the hedge ratio should be performed at the beginning of each reporting period or upon a significant change in the circumstances underlying the effectiveness assessment, whichever comes first.
- BC6.265 Given that the changes made to the proposed hedge effectiveness requirements when redeliberating the Exposure Draft did not affect the IASB's rationale for its proposals for the frequency of the assessment, the IASB retained its original decision.

Method of assessing hedge effectiveness

- BC6.266 The method used to assess the effectiveness of the hedging relationship needs to be suitable to demonstrate that the objective of the hedge effectiveness assessment has been achieved. The IASB considered whether the effectiveness of a hedging relationship should be assessed on either a qualitative or a quantitative basis.
- BC6.267 Hedging relationships have one of two characteristics that affect the complexity of the hedge effectiveness assessment:
- (a) the critical terms of the hedged item and hedging instrument match or are closely aligned. If there are no substantial changes in the critical terms or in the credit risk of the hedging instrument or hedged item, the hedge effectiveness can typically be determined using a qualitative assessment.
 - (b) the critical terms of the hedged item and hedging instrument do not match and are not closely aligned. These hedging relationships involve an increased level of uncertainty about the degree of offset and so the effectiveness of the hedge during its term is more difficult to evaluate.
- BC6.268 Qualitative hedge effectiveness assessments use a comparison of the terms of the hedged item and the hedging instrument (for example, the commonly termed 'critical-terms-match' approach). The IASB considered that, in the context of an effectiveness assessment that does not use a threshold, it can be appropriate to assess the effectiveness qualitatively for a hedging relationship for which the terms of the hedging instrument and the hedged item match or are closely aligned.
- BC6.269 However, assessing the hedging relationship qualitatively is less effective than a quantitative assessment in other situations. For example, when analysing the possible behaviour of hedging relationships that involve a significant degree of potential ineffectiveness resulting from terms of the hedged item that are less closely aligned with the hedging instrument, the extent of future offset has a high level of uncertainty and is difficult to determine using a qualitative approach. The IASB considered that a quantitative assessment would be more suitable in such situations.
- BC6.270 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The IASB noted that selecting the appropriate tool or technique depends on the complexity of the hedge, the availability of data and the level of uncertainty of offset in the hedging relationship. The type of assessment and the method used to assess hedge effectiveness therefore depends on the relevant characteristics of the hedging relationship. Consequently, in the deliberations leading to the Exposure Draft, the IASB decided that an entity should assess the effectiveness of a hedging relationship either qualitatively or quantitatively depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. However, the IASB decided not to prescribe any specific method of assessing hedge effectiveness.
- BC6.271 The IASB retained its original decisions when redeliberating its Exposure Draft.

Accounting for qualifying hedging relationships

Hedge of a foreign currency risk of a firm commitment

- BC6.272 IAS 39 allowed an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. When developing the Exposure Draft, the IASB considered whether it should continue to allow this choice.
- BC6.273 The IASB noted that requiring an entity to apply cash flow hedge accounting for all hedges of foreign currency risk of a firm commitment could result in what some regard as 'artificial' other comprehensive income and equity volatility (see paragraphs BC6.353–BC6.354). The IASB also noted that, by requiring an entity to apply cash flow hedge accounting, the 'lower of' test would apply to transactions that already exist (ie firm commitments).
- BC6.274 However, the IASB also noted that requiring an entity to apply fair value hedge accounting for all hedges of foreign currency risk of a firm commitment would require a change in the type of hedging relationship to a fair value hedge when the foreign currency cash flow hedge of a forecast transaction becomes a hedge of a firm commitment. This results in operational complexity. For example, this would require changing the measurement of ineffectiveness from a 'lower of' test to a symmetrical test.
- BC6.275 The IASB also noted that for existing hedged items (such as firm commitments) foreign currency risk affects both the cash flows and the fair value of the hedged item and hence has a dual character.
- BC6.276 Consequently, the IASB proposed in its Exposure Draft to continue to permit an entity the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge.
- BC6.277 The IASB retained its original decision when redeliberating its Exposure Draft.

Measuring the ineffectiveness of a hedging relationship

- BC6.278 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the IASB in its deliberations leading to the Exposure Draft decided that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).
- BC6.279 The IASB retained its original decision when redeliberating its Exposure Draft.

Time value of money

- BC6.280 The objective of measuring hedge ineffectiveness is to recognise, in profit or loss, the extent to which the hedging relationship did not achieve offset (subject to the restrictions that apply to the recognition of hedge ineffectiveness for cash flow hedges—often referred to as the 'lower of' test).
- BC6.281 The IASB noted that hedging instruments are subject to measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts that are compared with the changes in the value of the hedging instrument must also be determined on

a present value basis. The IASB noted that hedge accounting does not change the measurement of the hedging instrument, but that it might change only the location of where the change in its carrying amount is presented. As a result, the same basis (ie present value) for the hedged item must be used in order to avoid a mismatch when determining the amount to be recognised as hedge ineffectiveness.

BC6.282 Consequently, in the deliberations leading to the Exposure Draft, the IASB decided that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.

BC6.283 The IASB retained its original decision when redeliberating its Exposure Draft.

Hypothetical derivatives

BC6.284 In its deliberations leading to the Exposure Draft, the IASB considered the use of a 'hypothetical derivative', which is a derivative that would have critical terms that exactly match those of a hedged item. The IASB considered the use of a hypothetical derivative in the context of the hedge effectiveness assessment as well as for the purpose of measuring hedge ineffectiveness.

BC6.285 The IASB noted that the purpose of a hypothetical derivative is to measure the change in the value of the hedged item. Consequently, a hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring hedge ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods (for example, statistical methods or dollar-offset) to assess the effectiveness of the hedging relationship or to measure ineffectiveness.

BC6.286 Consequently, in the deliberations leading to the Exposure Draft, the IASB decided that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The IASB noted that this notion of a hypothetical derivative means that using a hypothetical derivative is only one possible way to determine the change in the value of the hedged item and would result in the same outcome as if that change in the value was determined by a different approach (ie it is a mathematical expedient).

BC6.287 When redeliberating its Exposure Draft the IASB considered feedback that disagreed with this proposal. The main reasons cited for disagreement were:

- (a) cash flow hedges and fair value hedges are different concepts. Unlike fair value hedges, cash flow hedges are not based on a valuation concept and therefore do not give rise to hedge ineffectiveness from differences in value changes between the hedging instrument and the hedged item as long as their variable cash flows match. However, some conceded that credit risk was a source of hedge ineffectiveness even if all variable cash flows were perfectly matched.

- (b) the new hedge accounting model has the objective of aligning hedge accounting more closely with risk management. Risk management has a 'flow perspective' that considers cash flow hedges as (fully) effective if the variable cash flows of the actual derivative match those of the hedged item (ie if the entity uses a 'perfect derivative' to hedge the risk exposure).
 - (c) the accounting treatment for the effect of a foreign currency basis spread is inconsistent with that for the time value of options and the forward element of forward contracts, ie the notion of 'costs of hedging' that the new hedge accounting model introduces. The foreign currency basis spread is also a cost of hedging and should be treated consistently with the other types of costs of hedging.
- BC6.288 The IASB considered whether a cash flow hedge is a different concept from a fair value hedge. The IASB noted that IFRSs use a hedge accounting model that is based on a valuation at the reporting date of both the hedging instrument and the hedged item (valuation model); hedge (in)effectiveness is then measured by comparing the changes in the value of the hedging instrument and the hedged item. Consequently, for determining the effective part of a cash flow hedge, an entity also needs to look at the change in cash flows on a present value basis, ie based on a valuation. Therefore, simply comparing the cash flow variability of the hedging instrument and the hedged item (ie a pure 'flow perspective' without involving a valuation) was not appropriate.
- BC6.289 The IASB also noted that IFRSs use a hedge accounting model that does not allow perfect hedge effectiveness to be assumed, and that this applies even if for a cash flow hedge the critical terms of the hedging instrument and the hedged item perfectly match. Doing so could conceal differences in credit risk or liquidity of the hedging instrument and the hedged item, which are potential sources of hedge ineffectiveness for fair value hedges and cash flow hedges alike.
- BC6.290 The IASB therefore rejected the view that cash flow hedges and fair value hedges were different concepts in that the former represented a mere comparison of cash flows whereas only the latter represented a comparison of valuations. Consequently, the IASB also rejected the view that a hypothetical derivative is meant to represent the 'perfect hedge' rather than the hedged item. Instead, the IASB confirmed its view that for fair value hedges and cash flow hedges the hedge accounting model:
- (a) is a valuation model; and
 - (b) requires that the value of the hedged item is measured independently of the value of the hedging instrument.
- BC6.291 The IASB noted that the objective of aligning hedge accounting with risk management meant that the IASB developed a new hedge accounting model that would facilitate hedge accounting in more circumstances than the previous one and would provide more useful information about the risk management associated with hedging. But this objective did not mean that an entity could override accounting requirements with its particular risk management view.

- BC6.292 Consequently, the IASB rejected the view that if risk management considered cash flow hedges as fully effective when the variable cash flows of the actual derivative match those of the hedged item (ie if the entity uses a 'perfect derivative') that hedge should also be considered as fully effective for accounting purposes.
- BC6.293 The IASB then considered the concern that the accounting treatment for the effect of a foreign currency basis spread was inconsistent with that for the time value of options and the forward element of forward contracts, ie the notion of 'costs of hedging' that the new hedge accounting model introduces.
- BC6.294 The IASB noted that its proposals would result in hedge ineffectiveness arising from the fair value changes of the hedging instrument that are attributable to the effect of a foreign currency basis spread. Taking the example of a cross-currency interest rate swap that is a hedge of the foreign currency risk (and the interest rate risk) of a debt instrument that is denominated in a foreign currency, the IASB noted that the cross-currency interest rate swap included a pricing element that reflected that the derivative instrument resulted in the exchange of two currencies. This led to the IASB questioning whether there was a similar feature or characteristic in the hedged item that would offset the effect of the foreign currency basis spread on the fair value of the cross-currency interest rate swap. The IASB noted that the hedged debt instrument was a single-currency instrument, ie unlike the cross-currency interest rate swap, the hedged item itself did not involve the exchange of two currencies. Instead, any exchange of the debt instrument's currency of denomination for another currency was a circumstance of the holder or issuer of that debt instrument instead of a characteristic or feature of the debt instrument itself.
- BC6.295 The IASB noted that whether reflecting the effect of the foreign currency basis spread within hedge ineffectiveness, as proposed in the Exposure Draft, was inconsistent with the new hedge accounting model depended on whether that spread could be regarded as a cost of hedging. Foreign currency basis spreads are an economic phenomenon that would not exist in a perfect market because the existence of such a spread creates economic arbitrage opportunities that would result in its reduction to zero. However, in the actual markets for cross-currency swaps the foreign currency basis spread is not zero because of factors that prevent perfect arbitrage. Those factors include, for example, the credit risk embedded in the underlying reference rates of the currencies as well as the demand and supply for the particular financial product (for example, cross-currency interest rate swaps), which relates to specific situations in foreign currency (product) markets. Also, the interaction between the spot and the forward foreign currency markets can sometimes have an effect.
- BC6.296 The IASB considered that, overall, a foreign currency basis spread could be considered as a charge to convert one currency into another. Consequently, the IASB agreed that the foreign currency basis spread could be subsumed under the notion of 'costs of hedging' that it had developed for the accounting for the time value of options and the forward element of forward contracts. The IASB therefore decided to expand the notion of 'costs of hedging' so as to include

foreign currency basis spreads. In the IASB's view, this would provide the most transparent accounting, reflect best the economics of the transaction and fit into the new hedge accounting model.

- BC6.297 The IASB also considered whether it should expand the notion of 'costs of hedging' by broadening the exception it had proposed for the time value of options and the forward element of forward contracts or by replacing that exception with a broader principle. The IASB acknowledged that, conceptually, a principle would be preferable but it was concerned that using a broader principle for the costs of hedging could result in some types of hedge ineffectiveness being inappropriately deferred in accumulated other comprehensive income as costs of hedging.
- BC6.298 Consequently, the IASB decided to expand the notion of 'costs of hedging' but only for foreign currency basis spreads by broadening the exception for the forward elements of forward contracts so that it also covers those spreads.
- BC6.299 The IASB also decided to more closely align the structure of this exception with that used for the accounting for the time value of options. The IASB noted that for hedges of transaction related hedged items, using the forward rate method to measure the hedged item would allow entities to achieve an equivalent accounting outcome for the forward element of forward contracts (see paragraphs BC6.418–BC6.420). However, the IASB acknowledged that in order to allow a similar accounting outcome not only for the forward element of forward contracts but also for foreign currency basis spreads, entities would need to be able to apply the notion of 'costs of hedging', including for hedges of transaction related hedged items. Consequently, the IASB introduced the notion of 'costs of hedging' also for those types of cost of hedging for both hedges of time–period related hedged items and for hedges of transaction related hedged items.

Rebalancing the hedging relationship

- BC6.300 IAS 39 did not allow adjustments that were not envisaged and documented at the inception of the hedge to be treated as adjustments to a continuing hedging relationship. IAS 39 treated adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The IASB noted that this resulted from a hedge accounting model that did not include the notion of accounting for changes to an existing hedging relationship as a continuation of that relationship.
- BC6.301 The IASB noted that this is inconsistent with risk management practices. There are instances where, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. For example, such adjustments are often required to re-align the hedging relationship with risk management policies in view of changed circumstances. Hence, those adjustments to the hedged item or hedging instrument do not change the original risk management objective but instead reflect a change in how it is executed owing to the changes in circumstances. The IASB considered that in those situations the revised hedging relationship

should be accounted for as a continuation of the existing hedging relationship. The IASB referred to such adjustments of hedging relationships as ‘rebalancing’.

- BC6.302 In its deliberations leading to the Exposure Draft, the IASB also considered the ramifications of the proposed hedge effectiveness requirements, which, for some changes in circumstances, would create the need for an adjustment to the hedging relationship to ensure that those requirements would continue to be met. An example is a change in the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid a level of ineffectiveness that would fail the effectiveness requirements (which would not be met when using the original hedge ratio in the new circumstances).
- BC6.303 The IASB concluded that, in such situations, if the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the IASB proposed that an adjustment to a hedging relationship is treated as a rebalancing when that adjustment changes the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument but risk management otherwise continues the originally designated hedging relationship.
- BC6.304 However, if the adjustment represents an overhaul of the existing hedging relationship, the IASB considered that treating the adjustment as a rebalancing would not be appropriate. Instead, the IASB considered that such an adjustment should result in the discontinuation of that hedging relationship. An example is a hedging relationship with a hedging instrument that experiences a severe deterioration of its credit quality and hence is no longer used for risk management purposes.
- BC6.305 Most respondents to the Exposure Draft agreed that the hedge accounting model should include a notion whereby a hedging relationship can be adjusted and accounted for as the continuation of an existing hedging relationship. Respondents thought that the inclusion of the concept of rebalancing would enhance the application of hedge accounting and would be a better representation of what entities do as part of their risk management activities. However, some respondents requested that the IASB clarify the circumstances in which rebalancing is required or permitted. They were unsure as to whether rebalancing has been designed in the narrower sense to only deal with adjustments to the hedge ratio in the context of the hedge effectiveness requirements, or whether in a wider sense it also relates to the adjustment of hedged volumes when the hedge ratio is still appropriate (ie when the entity simply wants to hedge more or less than originally).
- BC6.306 Even though respondents generally supported the concept of rebalancing, some were concerned that, on the basis of how the hedge effectiveness requirement was proposed in the Exposure Draft, it would be unclear when to rebalance and that the IASB should provide more guidance to ensure consistent application. Some respondents also thought that rebalancing should be permitted but not mandatory. They argued that risk management often chose not to adjust its (economic) hedging relationships based on a mathematical optimisation exercise that was implied in the Exposure Draft (see paragraph BC6.242). This

was because of cost-effectiveness considerations or simply because the hedge was still within the tolerance limits that an entity might use for adjusting the hedging relationship. There was concern that the wording, as proposed in the Exposure Draft, implied a continuous optimisation exercise (ie to always have the 'perfect' hedge ratio) and would therefore require constant rebalancing. Consequently, almost all respondents (directly or indirectly) requested that the IASB clarify that rebalancing should only be required when done for risk management purposes. They believed that hedge accounting should follow and represent rebalancing based on what an entity actually did for risk management purposes but that rebalancing should not be triggered merely by accounting requirements.

BC6.307 In the light of the feedback, the IASB decided to retain the notion of rebalancing but to add some clarification on:

- (a) whether rebalancing should be mandatory or voluntary; and
- (b) the notion of rebalancing.

Mandatory or voluntary rebalancing

BC6.308 The IASB noted that its decision on the hedge effectiveness assessment when deliberating the Exposure Draft had ramifications for rebalancing. This decision resulted in designating hedging relationships using a hedge ratio based on the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item. However, this is provided that the hedge ratio would not reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs BC6.248–BC6.251). The IASB considered that this decision addressed the main concerns respondents had about rebalancing (ie how rebalancing for hedge accounting purposes related to rebalancing for risk management purposes).

BC6.309 The IASB's proposal in the Exposure Draft included the notion of proactive rebalancing as a complement to the proposed hedge effectiveness assessment in order to allow an entity to adjust hedging relationships on a timely basis and at the same time strengthen the link between hedge accounting and risk management. However, the IASB considered that its decision on the hedge effectiveness assessment when deliberating the Exposure Draft (see paragraph BC6.248) had an effect on rebalancing that would facilitate the adjustments to a hedging relationship that the Exposure Draft had addressed by the proposed notion of proactive rebalancing. In other words, if an entity adjusted the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument for risk management purposes (including adjustments that the Exposure Draft would have considered 'proactive'), the hedging relationship for hedge accounting purposes would usually be adjusted in the same way. Consequently, the IASB considered that the notion of proactive rebalancing had become obsolete.

BC6.310 The IASB also noted that the decisions that it made on the hedge effectiveness assessment when deliberating the Exposure Draft addressed respondents'

concerns about the frequency of rebalancing because those decisions also clarified that rebalancing was not a mathematical optimisation exercise (see paragraphs BC6.248–BC6.249).

Clarification of the term ‘rebalancing’

- BC6.311 The IASB noted that it had already clarified the notion of ‘rebalancing’ as a result of its decision on the hedge effectiveness assessment when deliberating the Exposure Draft (see paragraphs BC6.308–BC6.310). However, the IASB considered whether it also needed to provide clarification on the scope of rebalancing—in other words, what adjustments to a hedging relationship constitute rebalancing.
- BC6.312 The IASB noted that the notion of rebalancing, as proposed in its Exposure Draft, was used in the context of adjusting the designated quantities of the hedging instrument or hedged item in order to maintain a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedging instrument or of a hedged item for different purposes did not constitute the notion of ‘rebalancing’ that was proposed in the Exposure Draft.
- BC6.313 Consequently, the IASB decided to clarify that rebalancing only covers adjustments to the designated quantities of the hedged item or of the hedging instrument for the purpose of maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment (ie not when the entity simply wants to hedge more or less than it did originally).

Discontinuation of hedge accounting

Mandatory or voluntary discontinuation of hedge accounting

- BC6.314 In accordance with IAS 39, an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria (including when the hedging instrument no longer existed or was sold). However, in accordance with IAS 39, an entity also had a free choice to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).
- BC6.315 The IASB noted that entities voluntarily discontinued hedge accounting often because of how the effectiveness assessment in IAS 39 worked. For example, entities revoked the designation of a hedging relationship and re-designated it as a new hedging relationship in order to apply a different method of assessing hedge ineffectiveness from the method originally documented (expecting that the new method would be a better fit). Another example was entities that revoked the designation of a hedging relationship because they wanted to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument (typically in response to a change in the relationship between different underlyings). The hedging relationship was then re-designated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The IASB noted that in those situations the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the IASB’s view, those outcomes created a disconnect between

the hedge accounting model in IAS 39 and hedging from a risk management perspective and also undermined the usefulness of the information provided.

BC6.316 In its deliberations leading to the Exposure Draft, the IASB concluded that the proposed hedge accounting model would improve the link between hedge accounting and risk management because:

- (a) the new hedge effectiveness assessment requirements would not involve a percentage band or any other bright line criterion and would result in changing the method for assessing hedge effectiveness in response to changes in circumstances as part of a continuing hedging relationship; and
- (b) the notion of rebalancing would allow the hedge ratio to be adjusted as part of a continuing hedging relationship.

BC6.317 The IASB also noted that sometimes a hedging relationship was discontinued because of a decrease in the hedged quantities of forecast transactions (ie the volume that remains highly probable of occurring falls or is expected to fall below the volume designated as the hedged item). Under IAS 39 this had resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the volume designated as the hedged item in its entirety. The IASB considered that the quantity of forecast transactions that were still highly probable of occurring was in fact a continuation of the original hedging relationship (albeit with a lower volume). Hence, the IASB decided to propose in its Exposure Draft that hedge accounting should be discontinued only for the volume that was no longer highly probable of occurring and that the remaining volume that was still highly probable of occurring should be accounted for as a continuation of the original hedging relationship. In the IASB's view, this would more closely align hedge accounting with risk management and provide more useful information.

BC6.318 However, the IASB was concerned that this accounting might possibly undermine the requirement that forecast transactions must be highly probable in order to qualify as a hedged item. Hence, the IASB decided to also propose to clarify that a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur would call into question the entity's ability to predict similar forecast transactions accurately. This would affect the assessment of whether similar forecast transactions are highly probable and hence their eligibility as hedged items.

BC6.319 In view of its aim to better link hedge accounting to risk management and provide more useful hedge accounting information, the IASB also discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship, taking into consideration that the designation of a hedging relationship (and hence the discontinuation of hedge accounting) at will does not result in useful information. The IASB noted that this would allow hedge accounting to be discontinued even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective that was part of the qualifying criteria that initially allowed the entity to achieve hedge accounting. The IASB considered that, in

such situations, voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. Hence, the IASB decided to propose not to allow entities a free choice to revoke the designation of a hedging relationship in this situation. The IASB also noted that if the hedging relationship no longer reflected the risk management objective for that particular hedging relationship, discontinuation of hedge accounting was not a choice but was required because the qualifying criteria would no longer be met. The IASB considered that applying hedge accounting without a risk management objective would not provide useful information.

- BC6.320 In its deliberations leading to the Exposure Draft, the IASB did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a business combination. The IASB noted that this was a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.
- BC6.321 The responses to the proposals on the discontinuation of hedge accounting in the Exposure Draft provided mixed views. Those who agreed thought that the proposals would strengthen the reliability of financial reporting because the ability to change accounting for no valid reason would be reduced.
- BC6.322 More specifically, those who agreed also thought that the model in IAS 39 provided an opportunity for structuring. They noted that allowing a hedging relationship to be arbitrarily discontinued at any point in time is not conceptually sound and does not result in useful information.
- BC6.323 Even though many respondents agreed with the proposals, there were also requests that the IASB provide additional guidance on the meaning of 'risk management' and at what level it should be considered for the purpose of hedge accounting.
- BC6.324 Generally, those who disagreed with the proposals argued that if starting hedge accounting was voluntary, ceasing it should also be voluntary. Some respondents who disagreed did so because they believed that voluntary discontinuation was necessary in scenarios in which an entity decided to terminate a hedging relationship on the basis that the hedge was no longer cost efficient (for example, a high administrative burden makes it too onerous and costly to apply hedge accounting). Some of these respondents raised the concern that voluntary discontinuation was an important tool in the current hedge accounting model for financial institutions that normally run hedging programmes based on portfolios of items on a macro basis. Those portfolios were subject to constant changes and entities removed the hedge designation with the aim of adjusting the hedging relationship for new hedged items and hedging instruments.
- BC6.325 Others who disagreed argued that not allowing voluntary discontinuation was inconsistent with the mechanics of cash flow hedge accounting. For example, when an entity entered into a cash flow hedge for forecast sales in a foreign currency, the risk management strategy aimed to protect the cash flows until settlement of the invoice. However, hedge accounting was only applied until the moment when the sales invoice became an on-balance-sheet item, after which the entity obtained a natural offset in the statement of profit or loss and other

comprehensive income because of the translation of the hedged item in accordance with IAS 21 and the accounting for the hedging instrument at fair value through profit or loss. Those respondents thought that voluntary discontinuation of the hedging relationship was necessary at the time that the forecast transaction became an on-balance-sheet item (for example, a trade receivable).

- BC6.326 Based on this feedback, the IASB, in its redeliberations, considered:
- (a) whether voluntary discontinuation should be allowed, given that hedge accounting remained optional; and
 - (b) how the link of the proposed discontinuation requirements to the risk management objective and strategy would work.
- BC6.327 The IASB noted that even though the application of hedge accounting remained optional, it facilitated the provision of useful information for financial reporting purposes (ie how hedging instruments are used to manage risk). The IASB considered that this purpose could not be ignored when considering the voluntary discontinuation of hedge accounting. If an entity chose to apply hedge accounting, it did so with the aim of using that particular accounting to represent in the financial statements the effect of pursuing a particular risk management objective. If the risk management objective had not changed and the other qualifying criteria for hedge accounting were still met, the ability to discontinue hedge accounting would undermine the aspect of consistency over time in accounting for, and providing information about, that hedging relationship. The IASB noted that a free choice to discontinue hedge accounting reflected a view that hedge accounting is a mere accounting exercise that does not have a particular meaning. Consequently, the IASB considered that it was not valid to argue that because hedge accounting was voluntary, the discontinuation of hedge accounting should also be voluntary.
- BC6.328 In addition, the IASB noted that other optional accounting treatments of IFRSs do not allow the entity to overturn its initial election:
- (a) the fair value option in IAS 39 and IFRS 9; and
 - (b) the lessee's option to account for a property interest held under an operating lease as an investment property, which is available (irrevocably) on a property-by-property basis.
- BC6.329 The IASB also did not think that the ability to voluntarily discontinue hedge accounting was necessary for hedge accounting to work as intended in particular situations mentioned in the feedback (see paragraphs BC6.324–BC6.325). The IASB considered that the impression of some respondents that voluntary discontinuation was necessary in those situations resulted from a lack of clarity about the distinction between the notions of risk management strategy and risk management objective. The IASB noted that that distinction was important for determining when the discontinuation of a hedging relationship was required (or not allowed). The IASB also noted that the term 'risk management strategy' was used in the Exposure Draft as a reference to the highest level at which an entity determines how it manages risk. In other words, the risk management strategy typically identified the risks to which the

entity was exposed and set out how the entity responded to them. Conversely, the Exposure Draft used the term 'risk management objective' (for a hedging relationship) to refer to the objective that applies at the level of that particular hedging relationship (instead of what the entity aims to achieve with the overall strategy). In other words, it related to how the particular designated hedging instrument is used to hedge the particular exposure designated as the hedged item.

- BC6.330 The IASB noted that a risk management strategy could (and often would) involve many different hedging relationships whose risk management objectives relate to executing that risk management strategy. Hence, the risk management objective for a particular hedging relationship could change even though an entity's risk management strategy remained unchanged. The IASB's intention was to prohibit voluntary discontinuation of hedge accounting when the risk management objective at the level of a particular hedging relationship (ie not only the risk management strategy) remained the same and all other qualifying criteria were still met.
- BC6.331 Consequently, the IASB decided to prohibit the voluntary discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same and all the other qualifying criteria are still met. However, the IASB also decided to add additional guidance on how the risk management objective and the risk management strategy relate to each other using examples that contrast these two notions, including for situations in which 'proxy hedging' designations are used.

Novation of derivatives

- BC6.332 When deliberating its Exposure Draft, the IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.² This question applied equally to the designation of hedging instruments in accordance with IAS 39 and under the new hedge accounting model for IFRS 9 that the IASB was redeliberating. Consequently, the IASB considered this question and possible solutions, both in the context of hedge accounting under IAS 39 and IFRS 9.³
- BC6.333 The IASB considered the derecognition requirements of IFRS 9 to determine whether the novation in such a circumstance would lead to the derecognition of an existing derivative that had been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a

² In this context, the term 'novation' indicates that the parties to a derivative agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.

³ The references in the Basis for Conclusions of this Standard are to the relevant requirements of IFRS 9. The Basis for Conclusions of the equivalent amendment to IAS 39 referred to the relevant requirements in that Standard (which were equivalent).

financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).

- BC6.334 The IASB observed that paragraph 3.2.3(a) of IFRS 9 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus, the original derivative with Party B has expired and, as a consequence, the original derivative through which Party A has engaged with Party B meets the derecognition criteria for a financial asset.
- BC6.335 The IASB also observed that paragraph B3.3.1(b) of IFRS 9 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and would also oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.
- BC6.336 Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.
- BC6.337 Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered the guidance it had proposed on the discontinuation of hedge accounting, which would require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.
- BC6.338 The IASB was, however, concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation.
- BC6.339 The IASB, taking note of this financial reporting effect, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The IASB also considered the feedback from outreach that involved the members of the International

Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.

- BC6.340 The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.
- BC6.341 Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* ('ED/2013/2'), which proposed amendments to IAS 39 and revisions to the IASB's hedge accounting proposals to IFRS 9. In ED/2013/2, the IASB proposed revised requirements for the discontinuation of hedge accounting to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets particular criteria.
- BC6.342 When developing ED/2013/2, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty. However, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of, or are incidental to, the novation were acknowledged in the proposals. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates or the contractual cash flows or the basis of their calculation, except for changes that may arise as a consequence of transacting with a CCP.
- BC6.343 When developing ED/2013/2, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposals. The IASB considered that it was not appropriate to mandate a specific disclosure in this situation because, from the perspective of a user of financial statements, hedge accounting would continue.
- BC6.344 The vast majority of respondents agreed that the proposed revisions are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that the guidance on the discontinuation of hedge accounting expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if "[a] replacement or rollover is part of, and consistent with, the entity's documented risk management objective". The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented risk management objective'.

- BC6.345 Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposals. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope should therefore be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.
- BC6.346 When considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation owing to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.
- BC6.347 The IASB observed, however, that for hedge accounting to continue, voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws or regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.
- BC6.348 Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation can also occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.
- BC6.349 On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting the clearing with a CCP rather than limiting relief to situations in which novation is direct to a CCP. The IASB decided that in those circumstances the novation had occurred in order to effect clearing through a CCP, albeit indirectly. The IASB thus decided to also include such novations in the scope of the amendments because they are

consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

- BC6.350 Respondents raised a concern about the phrase ‘if and only if’ that was used in ED/2013/2 when describing that the relief is provided ‘if and only if’ the criteria are met. In considering respondents’ comments, the IASB noted that ED/2013/2 was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase ‘if and only if’ to ‘if’ would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for the continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).
- BC6.351 ED/2013/2 did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7, which requires qualitative and quantitative disclosures about credit risk.
- BC6.352 The IASB also decided to retain the transition requirements proposed in ED/2013/2 so that the revised guidance should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).

Fair value hedges

Accounting for fair value hedges

- BC6.353 In its deliberations leading to the Exposure Draft, the IASB considered reducing the complexity of hedge accounting by replacing the fair value hedge accounting mechanics with the cash flow hedge accounting mechanics. Such an approach would recognise gains or losses on the hedging instruments outside profit or loss in other comprehensive income instead of requiring the hedged item to be remeasured. The IASB considered such an approach because it would:
- (a) improve the usefulness of the reported information for users of financial statements. In accordance with such an approach, all hedging activities to which hedge accounting is applied (including hedges of fair value risk) would be reflected in other comprehensive income, resulting in greater transparency and comparability. In addition, the measurement of the hedged item would not be affected.

- (b) simplify existing requirements. Although fair value and cash flow hedge accounting are designed to address different exposures, the same mechanisms can be used to reflect how an entity manages these exposures in the financial statements. Eliminating one of two different methods (fair value hedge accounting or cash flow hedge accounting) would reduce complexity. Such an approach would align fair value hedge accounting and cash flow hedge accounting, resulting in a single method for hedge accounting.
- (c) be an expeditious approach to finalise this phase of the project to replace IAS 39. Such an approach would draw on the existing mechanics of cash flow hedge accounting in IAS 39 and, consequently, such an approach would not require much further development.

BC6.354 However, during its outreach activities conducted before publishing the Exposure Draft, the IASB received mixed views on this approach. Some supported the approach for the reasons that the IASB had considered, which was consistent with the feedback received on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*. However, others raised concerns that such an approach:

- (a) would not reflect the underlying economics. They argued that if an entity applies a fair value hedge, the hedged item exists and hence there is an actual gain or loss on the hedged item (not just an anticipated gain or loss on a forecast transaction that does not yet exist). Consequently, hedge accounting should not cause 'artificial' volatility in other comprehensive income and equity.
- (b) would make the movements in other comprehensive income less understandable.
- (c) would make it difficult to identify the type of risk management strategy that the entity employs.
- (d) could result in scenarios in which equity would be significantly reduced or even negative because of losses on the hedging instrument deferred in other comprehensive income. This could have serious implications in terms of solvency and regulatory requirements.

BC6.355 In the light of the views received, the IASB decided to propose a different approach in the Exposure Draft. The IASB proposed to continue to account for fair value hedges differently from cash flow hedges. However, the IASB proposed some changes to the presentation and mechanics of fair value hedge accounting:

- (a) in relation to the gain or loss on remeasuring the hedging instrument—IAS 39 required the gain or loss to be recognised in profit or loss. The IASB proposed to require the recognition of the gain or loss in other comprehensive income.
- (b) in relation to the gain or loss on the hedged item—IAS 39 required such a gain or loss to result in an adjustment to the carrying amount of the hedged item and to be recognised in profit or loss. The IASB proposed to require the gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position

and in other comprehensive income. That separate line item would have been presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).

- BC6.356 The IASB noted that the separate line item represented measurement adjustments to the hedged items rather than separate assets or liabilities in their own right. The IASB thought that the additional line item might be perceived to add complexity and would increase the number of line items in the statement of financial position. In addition, the IASB noted that this approach is more complex than the approach initially considered, which would have eliminated fair value hedge accounting mechanics.
- BC6.357 However, the IASB decided to propose these changes because they would:
- (a) eliminate the mixed measurement for the hedged item (for example, an amount that is amortised cost with a partial fair value adjustment).
 - (b) avoid volatility in other comprehensive income and equity that some consider artificial.
 - (c) present in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges).
 - (d) provide information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges.
- BC6.358 Most respondents supported providing the information proposed in the Exposure Draft, but many disagreed with providing this information on the face of the financial statements.
- BC6.359 With respect to recognising gains or losses on the hedging instrument and the hedged item in other comprehensive income, many respondents thought that the use of other comprehensive income should be limited until the IASB completed a project on what 'other comprehensive income' represents. Many respondents expressed a preference for the approach in IAS 39 (ie presenting the gain or loss on the hedging instrument and the hedged item in profit or loss). As an alternative, those respondents suggested that the gain or loss on the hedging instrument and the hedged item should be disclosed in the notes to the financial statements.
- BC6.360 With respect to presenting separate line items in the statement of financial position, many respondents expressed concern about the excessive number of additional line items in the statement of financial position that could result from the proposals in the Exposure Draft. Those respondents thought that the statement of financial position would appear too cluttered. As an alternative, those respondents suggested that entities disclose the accumulated adjustment made to the carrying amount of the hedged item in the notes to the financial statements.
- BC6.361 In the light of this feedback, the IASB, in its redeliberations, decided to retain the fair value hedge accounting mechanics that were in IAS 39. However, the IASB also decided that it would require information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the

financial statements and that all hedge accounting disclosures are presented in a single note or separate section in the financial statements (those disclosure requirements were included in IFRS 7).

Linked presentation for fair value hedges

- BC6.362 During its outreach activities conducted before the publication of the Exposure Draft, the IASB was alerted to the effect on financial reporting that fair value hedge accounting has on hedges of the foreign currency risk of firm commitments in a specific industry. This issue is a particular concern to that industry because of the magnitude of firm commitments that are denominated in a foreign currency because of the industry's business model. In response to that concern, the IASB considered whether applying linked presentation for fair value hedges of firm commitments might be appropriate. Linked presentation is a way of presenting information so that it shows how particular assets and liabilities are related. Linked presentation is not the same as offsetting, which presents a net asset or liability. Linked presentation displays the 'gross' amount of related items in the statement of financial position (while the net amount is included in the total for assets or liabilities).
- BC6.363 The industry was concerned that the presentation resulting from fair value hedge accounting would not reflect the economic effects of hedges of foreign currency risk. For example, an entity that has a large firm commitment for a sale denominated in a foreign currency enters into currency forward contracts to hedge the foreign currency risk of that firm commitment (the forward contract and the firm commitment could be considered 'linked transactions'). The fair value of the derivative liability (asset) and the firm commitment asset (liability) could be significant depending on the volatility of the currency being hedged. That industry was concerned that, as a result, on the basis of the statement of financial position, the entity would appear to be exposed to a higher risk than it actually was. In that industry's view, confusion might arise because the statement of financial position would show large amounts for total assets and total liabilities and hence a high leverage (which typically suggests higher risk) even though the entity hedged the foreign currency risk of the firm commitment and thus sought to reduce risk.
- BC6.364 That industry argued that linked presentation of the firm commitment (recognised as a result of fair value hedge accounting) and the hedging instrument could present the effect of an entity's hedging activity and the relationship of the hedged item and the hedging instrument. Linked presentation would not require changing the requirements of offsetting in IAS 32 *Financial Instruments: Presentation* or other requirements in IAS 39 and IFRS 9.
- BC6.365 Moreover, that industry argued that a firm commitment is recognised in the statement of financial position only when fair value hedge accounting is applied. Consequently, that industry advocated that a firm commitment and the related hedging instrument should be accounted for as two parts of a single transaction. That industry also argued that totals for assets and liabilities that include only the 'net' amount (of the linked transactions) would be most appropriate for financial analysis purposes. That industry believed that the

ratios, such as leverage, should be calculated on the basis of the difference between the hedged item and the hedging instrument, ie the net amount rather than the gross amount of those items.

- BC6.366 The IASB noted that while linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk that are covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (for example, only the currency risk but not the credit risk or interest rate risk). Furthermore, the IASB did not consider that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affected only one risk but not all risks. Instead, the IASB believed that disclosures about hedging would be a better alternative for providing information that allows users of financial statements to assess the relevance of the information for their own analysis.
- BC6.367 Consequently, the IASB decided not to propose the use of linked presentation for the purposes of hedge accounting.
- BC6.368 Most respondents to the Exposure Draft agreed with the IASB's conclusion not to allow linked presentation. Some respondents also thought that linked presentation is not an appropriate topic for a project on hedge accounting, but rather that it should be considered as a separate project or as part of a project on either financial statement presentation or the *Conceptual Framework*.
- BC6.369 However, those respondents that supported linked presentation argued that, without it, entities that use hedge accounting would be perceived to be riskier than those that do not, and that the true economic effects of hedges of foreign currency risk of firm commitments would not be reflected.
- BC6.370 The IASB noted that in the absence of a clear principle for linked presentation, it should be considered in a broader context than just hedge accounting. Consequently, the IASB decided not to require or allow the use of linked presentation for the purpose of hedge accounting.

Cash flow hedges

The 'lower of' test

- BC6.371 When a hedge accounting relationship is fully effective, the fair value changes of the hedging instrument perfectly offset the value changes of the hedged item. Hedge ineffectiveness arises when the value changes of the hedging instrument exceed those of the hedged item, or when the value changes of the hedging instrument are less than those of the hedged item.
- BC6.372 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on those items in excess of the gains and losses on the hedging instrument is tantamount

to recognising gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument). The IASB noted that this would be conceptually questionable as well as a counter-intuitive outcome.

- BC6.373 IAS 39 required a 'lower of' test for determining the amounts that were recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. In contrast, the 'lower of' test did not apply to fair value hedges because, for that type of hedge, the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRSs, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.
- BC6.374 In its deliberations leading to the Exposure Draft, the IASB discussed whether the requirements for measuring the hedge ineffectiveness that is recognised in profit or loss should be aligned for fair value hedges and cash flow hedges. The IASB noted that the requirements could be aligned by also applying the 'lower of' test to fair value hedges or by eliminating it for cash flow hedges. In the IASB's view, aligning the requirements would reduce complexity. However, the IASB considered that, for conceptual reasons, recognising gains and losses on items that do not yet exist instead of only deferring the gain or loss on the hedging instrument was not appropriate. On the other hand, the IASB considered that the nature of fair value hedges is different from that of cash flow hedges. Also applying the 'lower of' test to fair value hedges, even though that test was designed to address only the specific characteristics of cash flow hedges, was not justified. Consequently, the IASB decided to retain the 'lower of' test for cash flow hedges and not to introduce it for fair value hedges.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

- BC6.375 A forecast transaction could subsequently result in the recognition of a non-financial asset or a non-financial liability. Similarly, a forecast transaction for a non-financial asset or non-financial liability could subsequently result in the recognition of a firm commitment for which fair value hedge accounting is applied. In these cases IAS 39 permitted an entity an accounting policy choice:
- (a) to reclassify the associated gains or losses that were recognised in other comprehensive income to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or
 - (b) to remove the associated gains or losses that were recognised in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability. This approach was commonly referred to as a 'basis adjustment'.
- BC6.376 In its deliberations leading to the Exposure Draft, the IASB considered whether to continue allowing this accounting policy choice. The IASB noted that if an entity was precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging

relationship had ended) and to match them to the period or periods in which the non-financial item that had resulted from the hedged transaction affected profit or loss. The entity would also need to consider whether or not the remaining amount in other comprehensive income was recoverable in one or more future periods. In contrast, if an entity applied a basis adjustment, the hedging gain or loss was included in the carrying amount of the non-financial item and automatically recognised in profit or loss in the period in which the related non-financial item affected profit or loss (for example, through depreciation expense for items of property, plant and equipment or cost of sales for inventories). It would also be automatically considered when an entity tested a non-financial asset for impairment. The IASB noted that for a non-financial asset that is tested for impairment as part of a cash-generating unit, tracking amounts in other comprehensive income and including them in the impairment test is difficult (even more so if the composition of cash-generating units changes over time).

- BC6.377 The IASB acknowledged that there were different views on whether a basis adjustment would achieve or reduce comparability. One view was that two identical assets purchased at the same time and in the same way (except for the fact that one was hedged) should have the same initial carrying amount. From this viewpoint, basis adjustments would impair comparability.
- BC6.378 The other view was that basis adjustments allowed identical assets for which the acquisitions are subject to the same risk to be measured so that they had the same initial carrying amount. For example, Entity A and Entity B want to purchase the same asset from a supplier that has a different functional currency. Entity A is able to secure the purchase contract denominated in its functional currency. Conversely, while Entity B also wants to fix the purchase price in its functional currency, it has to accept a purchase contract denominated in the functional currency of the supplier (ie a foreign currency) and is therefore exposed to the variability in cash flows arising from movements in the exchange rate. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract which, in effect, fixes the price of the purchase in its functional currency. When taking into account the currency forward contract, Entity B has, in effect, the same foreign currency risk exposure as Entity A. From this viewpoint, basis adjustments would enhance comparability.
- BC6.379 The IASB also considered the interaction between basis adjustments and the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge (see paragraphs BC6.272–BC6.277). The IASB noted that for hedges of the foreign currency risk of a firm commitment the basis adjustment at the end of the cash flow hedge has the same effect on the presentation of the hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for those firm commitments was tantamount to a basis adjustment. The IASB thought that, in this context, basis adjustments would also enhance comparability.
- BC6.380 Consequently, the IASB decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The IASB decided that when the entity removes the associated gain or loss that was recognised in other comprehensive income in order to include it in the initial cost or other carrying amount of the

asset or liability, that gain or loss should be directly applied against the carrying amount of the asset or liability. This means that it would not be a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence would not affect other comprehensive income when removing it from equity and adding it to, or deducting it from, the asset or liability. The IASB noted that accounting for the basis adjustment as a reclassification adjustment would distort comprehensive income because the amount would affect comprehensive income twice but in different periods:

- (a) first (in other comprehensive income) in the period in which the non-financial item is recognised; and
- (b) again in the later periods when the non-financial item affects profit or loss (for example, through depreciation expense or cost of sales).

The IASB also noted that presenting a basis adjustment as a reclassification adjustment would create the misleading impression that the basis adjustment was a performance event.

BC6.381 The IASB acknowledged that the total comprehensive income across periods will be distorted because the gain or loss on the hedging instrument during the period of the cash flow hedge is recognised in other comprehensive income, whereas the cumulative hedging gain or loss that is removed from the cash flow hedge reserve (ie from equity) and directly applied to the subsequently recognised non-financial item does not affect other comprehensive income. The IASB considered that one type of distortion of other comprehensive income was inevitable (ie either in the period of the basis adjustment or over the total period) and hence there was a trade-off. The IASB concluded that, on balance, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect over the total period of not using a reclassification adjustment.

BC6.382 The IASB retained its original decision when deliberating its Exposure Draft.

Hedges of a net investment in a foreign operation

BC6.383 In its deliberations leading to the Exposure Draft, the IASB decided not to address a hedge of a net investment in a foreign operation as part of its hedge accounting project. The IASB noted that a net investment in a foreign operation was determined and accounted for in accordance with IAS 21. The IASB also noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similar to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC6.149), the IASB considered that comprehensively addressing this type of hedge would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements.

BC6.384 Consequently, the IASB proposed retaining the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

BC6.385 The IASB retained its original decision when redeliberating its Exposure Draft.

Accounting for the time value of options

- BC6.386 IAS 39 allowed an entity a choice:
- (a) to designate an option-type derivative as a hedging instrument in its entirety; or
 - (b) to separate the time value of the option and designate as the hedging instrument only the intrinsic value element.
- BC6.387 The IASB noted that under the IAS 39 hedge accounting model entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from the risk management view, whereby entities typically consider the time value of an option (at inception, ie included in the premium paid) as a cost of hedging. It is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes.
- BC6.388 Against this background, the IASB, in its deliberations leading to the Exposure Draft, considered how best to portray the time value of options (in the context of hedging exposures only against changes to one side of a specified level—a ‘one-sided risk’). The IASB noted that the standard-setting debate about accounting for the time value of options had historically been focused on hedge ineffectiveness. Many typical hedged transactions (such as firm commitments, forecast transactions or existing items) do not involve a time value notion because they are not options. Hence, such hedged items do not have a change in their value that offsets the fair value change related to the time value of the option that is used as a hedging instrument. The IASB concluded that, unless the time value of the option was excluded from being designated as the hedging instrument, hedge ineffectiveness would arise.
- BC6.389 However, the IASB noted that the time value of an option could also be considered from a different perspective—that of a premium for protection against risk (an ‘insurance premium’ view).
- BC6.390 The IASB noted that entities that use purchased options to hedge one-sided risks typically consider the time value that they pay as a premium to the option writer or seller as similar to an insurance premium. In order to protect themselves against the downside of an exposure (an adverse outcome) while retaining the upside, they have to compensate someone else for assuming the inverse asymmetrical position, which has only the downside but not the upside. 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. Hence, entities that use purchased options to hedge one-sided risks know that over the life of the option they will lose the time value that they paid. This explains why entities typically view the premium paid as being similar to an insurance premium and hence as a cost of using this hedging strategy.

- BC6.391 The IASB considered that by taking an insurance premium view, the accounting for the time value of options could be aligned with the risk management perspective as well as with other areas of accounting. The IASB noted that under IFRSs some costs of insuring risks were treated as transaction costs that were capitalised into the costs of the insured asset (for example, freight insurance paid by the buyer in accordance with IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*), whereas costs of insuring some other risks were recognised as expenses over the period for which the entity was insured (for example, fire insurance for a building). Hence, the IASB considered that aligning the accounting for the time value of options with such other areas would provide more comparable results that would also be more aligned with how preparers and users of financial statements think about the issue.
- BC6.392 The IASB took the view that, like the distinction between the different types of costs of insuring risk, the time value of options should be distinguished by the type of hedged item that the option hedges, into time value that is:
- (a) transaction related (for example, the forecast purchase of a commodity); or
 - (b) time-period related (for example, hedging an existing commodity inventory for commodity price changes).
- BC6.393 The IASB considered that for transaction related hedged items the cumulative change in fair value of the option's time value should be accumulated in other comprehensive income and be reclassified in a way similar to that for cash flow hedges. In the IASB's view, this would best reflect the character of transaction costs (like those capitalised for inventory or property, plant and equipment).
- BC6.394 In contrast, the IASB considered that for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the IASB considered that the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis. The IASB noted that this would require accumulating the cumulative change in fair value of the option's time value in other comprehensive income and amortising the original time value by transferring in each period an amount to profit or loss. The IASB considered that the amortisation pattern should be determined on a systematic and rational basis, which would best reflect principle-based standard-setting.
- BC6.395 The IASB also considered situations in which the option used has critical terms (such as the nominal amount, the life and the underlying) that do not match the hedged item. This raises the following questions:
- (a) which part of the time value included in the premium relates to the hedged item (and therefore should be treated as costs of hedging) and which part does not?
 - (b) how should any part of the time value that does not relate to the hedged item be accounted for?
- BC6.396 The IASB proposed in the Exposure Draft that the part of the time value of the option that relates to the hedged item should be determined as the time value

that would have been paid for an option that perfectly matches the hedged item (for example, with the same underlying, maturity and notional amount). The IASB noted that this would require an option pricing exercise using the terms of the hedged item as well as other relevant information about the hedged item (in particular, the volatility of its price or cash flow, which is a driver of an option's time value).

- BC6.397 The IASB noted that the accounting for the time value of the option would need to distinguish whether the initial time value of the purchased option (actual time value) is higher or lower than the time value that would have been paid for an option that perfectly matches the hedged item (aligned time value). The IASB noted that if, at inception of the hedging relationship, the actual time value is higher than the aligned time value, the entity pays a higher premium than that which reflects the costs of hedging. Hence, the IASB considered that the amount that is recognised in accumulated other comprehensive income should be determined only on the basis of the aligned time value, whereas the remainder of the actual time value should be accounted for as a derivative.
- BC6.398 Conversely, the IASB noted that if, at inception of the hedging relationship, the actual time value is lower than the aligned time value, the entity actually pays a lower premium than it would have to pay to cover the risk fully. The IASB considered that in this situation, in order to avoid accounting for a higher time value of an option than was actually paid, the amount that is recognised in accumulated other comprehensive income would have to be determined by reference to the lower of the cumulative fair value change of:
- (a) the actual time value; and
 - (b) the aligned time value.
- BC6.399 The IASB also considered whether the balances accumulated in other comprehensive income would require an impairment test. The IASB decided that because the accounting for the time value of the option was closely linked to hedge accounting, an impairment test that uses features of the hedge accounting model would be appropriate. Hence, for transaction related hedged items the impairment test would be similar to that for the cash flow hedge reserve. For time-period related hedged items the IASB considered that the part of the option's time value that remains in accumulated other comprehensive income should be immediately recognised in profit or loss when the hedging relationship is discontinued. That would reflect that the reason for amortising the amount would no longer apply after the insured risk (ie the hedged item) no longer qualifies for hedge accounting. The IASB noted that impairment of the hedged item affects the criteria for qualifying hedges and if those are no longer met it would result in an impairment loss for the remaining unamortised balance of the time value of the option.
- BC6.400 Most of the respondents to the Exposure Draft agreed with the 'insurance premium' view. They thought that the proposal provided a better representation of the performance and effect of the entity's risk management strategy than under IAS 39. In their view, the proposals alleviated undue profit or loss volatility and reflected the economic substance of the transaction. They

also thought that the costs of hedging should be associated with the hedged item rather than being mischaracterised as hedge ineffectiveness.

- BC6.401 However, there were mixed views about the complexity of the proposals, in particular in relation to:
- (a) the requirement to differentiate between transaction related and time-period related hedged items; and
 - (b) the requirement to measure the fair value of the aligned time value. Those concerns included the concern that the costs of implementing the proposals could outweigh the benefits, for instance, for less sophisticated (for example, smaller) entities.
- BC6.402 Some respondents did not agree with the proposed accounting for transaction related hedged items. Some argued that time value should always be expensed over the option period.
- BC6.403 In the light of this feedback the IASB considered in its redeliberations:
- (a) whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the Exposure Draft;
 - (b) whether it should remove the differentiation between transaction related and time-period related hedged items and replace it with a single accounting treatment; and
 - (c) whether it should simplify the requirement to account for the fair value of the aligned time value.
- BC6.404 The IASB discussed whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the Exposure Draft. The IASB noted that such an accounting treatment would have outcomes that would be inconsistent with the notion of the time value being regarded as costs of hedging. This is because it could result in recognising an expense in periods that are unrelated to how the hedged exposure affects profit or loss.
- BC6.405 The IASB also reconsidered whether it was appropriate to defer in accumulated other comprehensive income the time value of options for transaction related hedged items. The IASB noted that the deferred time value does not represent an asset in itself, but that it is an ancillary cost that is capitalised as part of the measurement of the asset acquired or liability assumed. This is consistent with how other IFRSs treat ancillary costs. The IASB also noted that the Exposure Draft included an impairment test to ensure that amounts that are not expected to be recoverable are not deferred.
- BC6.406 The IASB also discussed whether the proposals in the Exposure Draft could be simplified by removing the differentiation between transaction related and time-period related hedged items. However, the IASB noted that a single accounting treatment would be inconsistent with other IFRSs because it would not distinguish situations in a similar way (see paragraphs BC6.391–BC6.392). Hence, the IASB considered that the suggested single accounting treatment

would essentially treat unlike situations as alike. The IASB noted that this would actually diminish comparability and hence not be an improvement to financial reporting.

- BC6.407 The IASB also considered whether it should paraphrase the requirements as a single general principle to clarify the accounting for transaction related and time-period related hedged items, rather than having requirements that distinguish between those two types of hedged items. However, on balance the IASB decided that this approach risked creating confusion, particularly because it would still involve the two different types of accounting treatments.
- BC6.408 The IASB also discussed possible ways to simplify the requirements to account for the fair value of the aligned time value. As part of those discussions the IASB considered:
- (a) applying the proposed accounting treatment for the time value of options to the entire amount of the time value paid even if it differs from the aligned time value. This means that entities would not need to perform a separate valuation for the fair value of the aligned time value. However, the IASB considered that only the time value that relates to the hedged item should be treated as a cost of hedging. Hence, any additional time value paid should be accounted for as a derivative at fair value through profit or loss.
 - (b) providing entities with a choice (for each hedging relationship or alternatively as an accounting policy choice) to account for the time value of options either as proposed in the Exposure Draft or in accordance with the treatment in IAS 39. In the latter case, the amount recognised in profit or loss as a 'trading instrument' is the difference between the change in the fair value of the option in its entirety and the change in fair value of the intrinsic value. In contrast, the proposals in the Exposure Draft would require two option valuations (ie the change in fair value of the actual time value of the option and the aligned time value of the option). However, the IASB noted that the accounting treatment in accordance with IAS 39 would, in effect, present the change in fair value of the time value as a trading profit or loss. This accounting treatment would not be consistent with the character of the changes in the time value that the IASB is seeking to portray, ie that of costs of hedging. In addition, the IASB noted that providing a choice would reduce comparability between entities and it would make financial statements more difficult to understand.
- BC6.409 Consequently, the IASB decided to retain the accounting requirements related to the time value of options proposed in the Exposure Draft (ie that the accounting would depend on the nature of the hedged item and that the new accounting treatment only applied to the aligned time value).

Zero-cost collars

- BC6.410 The proposed accounting treatment for the time value of options in the Exposure Draft only addressed situations in which the option had a time value (other than nil) at inception. That proposed accounting would not have applied

to situations in which there was a combination of a purchased and a written option (one being a put option and one being a call option) that at inception of the hedging relationship had a net time value of nil (often referred to as 'zero-cost collars' or 'zero premium collars').

- BC6.411 Many respondents to the Exposure Draft commented that the proposed accounting for purchased options should also apply to all zero-cost collars. They thought that without generally aligning the accounting treatment for the time value of zero-cost collars and options, it would encourage entities to undertake particular types of transactions and replace zero-cost collars with collars with a nominal cost only to achieve a desired accounting outcome.
- BC6.412 Furthermore, those respondents noted that even though the zero-cost collar had no net time value at inception, the time value of the collar would fluctuate during the life of the hedge. They noted that time value was subject to 'time decay' and that both the purchased and the written option would lose their time value over time as the collar approaches expiry. They argued that the time value of zero-cost collars should also be recognised in other comprehensive income during the life of the hedging relationship. They considered it unjustified to limit the proposed accounting to options that have an initial time value of greater than nil, given that one of the main concerns being addressed by the proposal was the volatility resulting from changes in the time value over the life of the hedge.
- BC6.413 In the light of those arguments, the IASB decided to align the accounting treatment for changes in the time value of options and zero-cost collars.

Accounting for the forward element of forward contracts

- BC6.414 IAS 39 allowed an entity a choice between:
- (a) designating a forward contract as a hedging instrument in its entirety; or
 - (b) separating the forward element and designating as the hedging instrument only the spot element.
- BC6.415 If not designated, the forward element was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss.
- BC6.416 The IASB noted that the characteristics of forward elements depended on the underlying item, for example:
- (a) for foreign exchange rate risk, the forward element represents the interest differential between the two currencies;
 - (b) for interest rate risk, the forward element reflects the term structure of interest rates; and
 - (c) for commodity risk, the forward element represents what is called the 'cost of carry' (for example, it includes costs such as storage costs).
- BC6.417 Respondents to the Exposure Draft as well as participants in the IASB's outreach activities requested that the IASB consider extending the proposal on the accounting for the time value of options (see paragraphs BC6.386–BC6.413) to forward elements.

- BC6.418 The IASB noted that even though under IAS 39 the hedge accounting requirements were identical for forward elements and options, the actual accounting implications were different. In contrast to many typical situations in which options were used to hedge transactions that did not involve a time value notion because they were not options (see paragraph BC6.388), in situations in which forward contracts were used the value of hedged items typically did have a forward element that corresponded to that of the hedge. The IASB noted that this meant that an entity could choose to designate the forward contract in its entirety and use the 'forward rate method' to measure the hedged item.
- BC6.419 Using the forward rate method, the forward element is essentially included in the hedging relationship by measuring the change in the value of the hedged item on the basis of forward prices or rates. An entity can then recognise the forward element as costs of hedging by using the forward rate method, resulting in, for example:
- (a) capitalising the forward element into the cost of the acquired asset or liability assumed; or
 - (b) reclassifying the forward element into profit or loss when the hedged item (for example, hedged sales denominated in a foreign currency) affects profit or loss.
- BC6.420 Consequently, changes in forward elements are not recognised in profit or loss until the hedged item affects profit or loss. The IASB noted that this outcome was equivalent to what it had proposed in its Exposure Draft for accounting for the time value of options that hedge transaction related hedged items. Hence, the IASB considered that, for situations similar to hedges of transaction related hedged items using options, applying the forward rate method would, in effect, achieve an accounting outcome that treated the forward element like costs of hedging. This would be consistent with the IASB's overall approach to accounting for the costs of hedging and would therefore not require any amendments to the proposals in the Exposure Draft.
- BC6.421 However, the IASB acknowledged that in situations that were equivalent to those addressed by its decision on the accounting for time-period related hedged items that were hedged using options, its proposals in the Exposure Draft (like IAS 39) would prevent an entity from achieving an equivalent accounting outcome for the forward element of a forward contract. The reason was that, like IAS 39, the proposals in the Exposure Draft did not allow the forward element to be amortised. For example, if an entity hedged the fair value changes resulting from the price changes of its existing commodity inventory (ie a time-period related hedged item) it could, under the proposals in the Exposure Draft (like IAS 39), either:
- (a) use the forward rate method (ie forward elements are capitalised into the cost of inventory, rather than accounted for as at fair value through profit or loss over the time of the hedge); or
 - (b) designate as the hedging instrument only changes in the spot element (ie fair value changes in the forward element of the forward contract are recognised in profit or loss).

Neither of the above accounting outcomes are aligned with the treatment for the time value of options for time-period related hedged items that requires that the time value is amortised on a systematic and rational basis.

- BC6.422 The IASB also noted that the accounting for monetary financial assets and liabilities denominated in a foreign currency had an important consequence. Like IAS 39, IFRS 9 (see paragraph B5.7.2) requires an entity to apply IAS 21 to those assets and liabilities, which means that they are translated into the entity's functional currency by using the spot exchange rate. Hence, the forward rate method does not provide a solution when entities hedge monetary financial assets and liabilities denominated in a foreign currency.
- BC6.423 Consequently, the IASB acknowledged that aligning the accounting for forward elements with the accounting for the time value of options was a particular concern to entities that, for example, had 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 those 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 net interest margin), such entities commonly enter into foreign exchange derivatives. Such transactions usually involve the following simultaneously:
- (a) swapping the functional currency surplus funds into a foreign currency;
 - (b) investing the funds in a foreign currency financial asset for a period of time; and
 - (c) entering into a foreign exchange derivative 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 the interest at maturity.
- BC6.424 The difference between the forward rate and the spot rate (ie the forward element) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency by the forward points (ie the forward element of the foreign exchange derivative) and then deducting the interest expense. The combination of the three transactions described in paragraph BC6.423 allows the entity to, in effect, 'lock in' a net interest margin and generate a fixed economic return over the investment period.
- BC6.425 Respondents argued that risk management viewed the forward elements as an adjustment of the investment yield on foreign currency denominated assets. They believed that, as in the case of the accounting for the time value of options, it gave rise to a similar need for adjusting profit or loss against other comprehensive income to represent the cost of achieving a fixed economic return in a way that is consistent with the accounting for that return.
- BC6.426 In the light of the arguments raised by respondents, the IASB decided to permit forward points 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 other comprehensive income. The IASB considered that this accounting treatment would provide a better representation of the economic substance of the transaction and the performance of the net interest margin.

Hedges of a group of items

- BC6.427 IAS 39 restricted the application of hedge accounting for groups of items. For example, hedged items that together constitute an overall net position of assets and liabilities could not be designated into a hedging relationship with that net position as the hedged item. Other groups were eligible if the individual items within that group had similar risk characteristics and shared the risk exposure that was designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group had to be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of those restrictions was that a group would generally qualify as a hedged item only if all the items in that group would qualify for hedge accounting for the same hedged risk on an individual basis (ie each as an individual hedged item).
- BC6.428 In response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to achieve hedge accounting for groups of items, including net positions, had resulted in a hedge accounting model that was inconsistent with the way in which an entity actually hedges (ie for risk management purposes). Similar concerns about the restrictions of IAS 39 for applying hedge accounting to groups of items were raised as part of the IASB's outreach activities for its Hedge Accounting project.
- BC6.429 In practice, most entities hedge their risk exposures using different approaches, resulting in hedges of:
- (a) individual items;
 - (b) groups of items that form a gross position; or
 - (c) groups of (partially) offsetting items or risks that result in a net position.
- BC6.430 The group hedging approach involves identifying the risk from particular groups of items (including a net position), and then hedging some or all of that risk with one or more hedging instruments. The group hedging approach views the risk at a higher aggregated level. The reasons for taking this approach include:
- (a) items in the group have some offsetting risk positions that provide a natural hedge for some of those risks and therefore those offsetting risks do not need to be separately hedged;
 - (b) hedging derivatives that hedge different risks together can be more readily available than individual derivatives that each hedge a different risk;
 - (c) it is more expedient (cost, practicality, etc) to enter into fewer derivatives to hedge a group rather than hedging individual exposures;

- (d) the minimisation of counterparty credit risk exposure, because offsetting risk positions are hedged on a net basis (this aspect is particularly important for an entity that has regulatory capital requirements); and
- (e) the reduction of gross assets/liabilities in the statement of financial position, because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.

BC6.431 The restrictions in IAS 39 prevented an entity that hedges on a group or net basis from presenting its activities in a manner that is consistent with its risk management practice. For example, an entity may hedge the net (ie residual) foreign currency risk from a sequence of sales and expenses that arise over several reporting periods (say, two years) using a single foreign currency derivative. Such an entity could not designate the net position of sales and expenses as the hedged item. Instead, if it wanted to apply hedge accounting it had to designate a gross position that best matched its hedging instrument. However, the IASB noted there were a number of reasons why this could render information less useful, for example:

- (a) a matching hedged item might not exist, in which case hedge accounting cannot be applied.
- (b) if the entity did identify and designate a matching gross exposure from the sequence of sales and expenses, that item would be portrayed as the only hedged item and would be presented at the hedged rate. All other transactions (for instance, in earlier reporting periods) would appear unhedged and would be recognised at the prevailing spot rates, which would give rise to volatility in some reporting periods.
- (c) if the designated hedged transaction did not arise, but the net position remained the same, hedge ineffectiveness would be recognised for accounting purposes even though it does not exist from an economic perspective.

BC6.432 Consequently, in its Exposure Draft, the IASB proposed that groups of items (including net positions) should be eligible for hedge accounting. However, the IASB also proposed limiting the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC6.442–BC6.447).

BC6.433 Respondents to the Exposure Draft supported the proposal to allow hedge accounting for groups and net positions and most supported the IASB's rationale for doing so. However, some disagreed with specific aspects of the IASB's proposals in the Exposure Draft. Their concerns focused on the proposals related to cash flow hedges of net positions.

BC6.434 The following subsections set out the IASB's considerations about the application of hedge accounting in the context of groups of items.

Criteria for the eligibility of a group of items as a hedged item

BC6.435 An individual hedge approach involves an entity entering into one or more hedging instruments to manage a risk exposure from an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach.

However, for a group hedge approach an entity seeks to manage the risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument.

BC6.436 An individual hedge approach and a group hedge approach are similar in concept. Hence, the IASB decided that the requirements for qualifying for hedge accounting should also be similar. Consequently, the IASB proposed that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions were retained for cash flow hedges of net positions.

BC6.437 The IASB retained its original decision when redeliberating its Exposure Draft.

Designation of a layer component of a nominal amount for hedges of a group of items

BC6.438 The IASB proposed in its Exposure Draft that an entity could designate a layer component of a nominal amount (a 'layer') of a single item in a hedging relationship. The IASB also considered whether it would be appropriate to extend that decision on single items to groups of items and hence allow the designation of a layer of a group in a hedging relationship.

BC6.439 The IASB noted that the benefits of identifying a layer component of a nominal amount of a group of items are similar to the benefits it had considered for layer components of single items (see paragraphs BC6.200–BC6.204). In addition, the IASB also noted other reasons that support the use of components for groups of items:

- (a) uncertainties such as a breach (or cancellation) of contracts, or prepayment, can be better modelled when considering a group of items;
- (b) in practice, hedging layers of groups of items (for example, a bottom layer) is a common risk management strategy; and
- (c) arbitrarily identifying and designating (as hedged items) specific items from a group of items that are exposed to the same hedged risk can:
 - (i) give rise to arbitrary accounting results if the designated items do not behave as originally expected (while other items, sufficient to cover the hedged amount, do behave as originally expected); and
 - (ii) can provide opportunities for earnings management (for example, by choosing to transfer and derecognise particular items from a group of homogeneous items when only some were specifically designated into a fair value hedge and therefore have fair value hedge adjustments attached to them).

BC6.440 The IASB noted that, in practice, groups of items hedged together are not likely to be groups of identical items. Given the different types of groups that could exist in practice, in some cases it could be easy to satisfy the proposed conditions and in some cases it could be more challenging or even impossible. The IASB considered that it is not appropriate to define the cases in which the proposed conditions were satisfied because it would depend on the specific facts and circumstances. The IASB therefore considered a criteria-based approach would

be more operational and appropriate. Such an approach would allow hedge accounting to be applied in situations in which the criteria are easy to meet as well as in cases in which, although the criteria are more challenging to meet, an entity is prepared to undertake the necessary efforts (for example, to invest in systems in order to achieve compliance with the hedge accounting requirements).

- BC6.441 The IASB retained its original decision when redeliberating its Exposure Draft.

Cash flow hedges of a group of items that constitutes a net position that qualifies for hedge accounting

- BC6.442 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred in other comprehensive income to be reclassified later from accumulated other comprehensive income to profit or loss when the hedged item affects profit or loss. For hedges of net positions, items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group (ie the gains on some items offset the losses on others). Hence, for a cash flow hedge of a net position that is a group of forecast transactions, the cumulative change in value (from the inception of the hedge) that arises on some forecast transactions (to the extent that it is effective in achieving offset) must be deferred in other comprehensive income. This is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss in the later phase until the last hedged item in the net position affects profit or loss.
- BC6.443 The forecast transactions that constitute a hedged net position might differ in their timing such that they affect profit or loss in different reporting periods. For example, sales and unrelated expenditure hedged for foreign currency risk might affect profit or loss in different reporting periods. When this happens, the cumulative change in value of the designated sales (to be reclassified later when the expenditure is recognised as an expense) needs to be excluded from profit or loss and instead be deferred in other comprehensive income. This is required in order to ensure that the effect of the sales on profit or loss is based on the hedged exchange rate.
- BC6.444 Hence, in its deliberations leading to the Exposure Draft, the IASB noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in accumulated other comprehensive income of cumulative gains and losses on some forecast transactions, from the time they occurred until some other forecast transactions would affect profit or loss in later reporting periods. The IASB considered that this would be tantamount to measuring the transactions that occurred first at a different amount from the transaction amount (or other amount that would be required under general IFRS requirements) in contemplation of other forecast transactions that were expected to occur in the future and that would have an offsetting gain or loss. When those other transactions occurred, their measurement would be adjusted for the amounts deferred in accumulated other comprehensive income on forecast transactions that had occurred earlier.
- BC6.445 The IASB acknowledged that this approach would not result in the recognition of gains and losses on items that do not yet exist but would instead defer gains

and losses on some forecast transactions as those transactions occurred. However, the IASB considered that this approach would be a significant departure from general IFRSs regarding the items that resulted from the forecast transactions. The IASB noted that this departure would affect the forecast transactions:

- (a) that occurred in the early phases of the hedging relationship, ie those for which gains and losses were deferred when the transaction occurred; and
- (b) those that occurred in the later phases of the hedging relationship and were adjusted for the gains or losses that had been deferred on the forecast transactions as those transactions had occurred in the early phases of the hedging relationship.

BC6.446 The IASB noted that the accounting for the forecast transactions that occurred in the later phases of the hedging relationship was comparable to that of forecast transactions that were hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occurred in the early phases of the hedging relationship would be more similar to that of a hedging instrument than to that of a hedged item. The IASB concluded that this would be a significant departure from general IFRS requirements and the requirements of the hedge accounting model for hedging instruments.

BC6.447 Consequently, in its Exposure Draft, the IASB proposed that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting risk positions would affect profit or loss in different periods. The IASB noted that when the offsetting risk positions affected profit or loss in the same period those concerns would not apply in the same way as no deferral in accumulated other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the IASB proposed that such net positions should be eligible as hedged items.

BC6.448 Some respondents to the Exposure Draft agreed with the IASB's rationale for not allowing the application of cash flow hedge accounting to net positions that consist of forecast transactions that would affect profit or loss in different reporting periods. They believed that without this restriction the potential for earnings management would arise. Despite agreeing with the proposals, some respondents asked the IASB to provide additional guidance on the treatment of the amounts deferred in accumulated other comprehensive income if, in a cash flow hedge of a net position, the offsetting risk positions that were initially expected to affect profit or loss in the same reporting period subsequently changed and, as a result, were expected to affect profit or loss in different periods.

BC6.449 Others requested the IASB to reconsider the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. Those respondents believed that this restriction would not allow entities to properly reflect their risk management activities. In addition, some respondents requested that the IASB consider the annual reporting period as the basis for this restriction (if retained) instead of any reporting period (ie including an interim

reporting period), noting that the frequency of reporting would otherwise affect the eligibility for this form of hedge accounting.

- BC6.450 The IASB noted that the feedback on its proposals in the Exposure Draft reflected two different perspectives.
- (a) a treasury perspective—this is a cash flow perspective. The respondents who provided comments from this perspective typically look at cash inflows and cash outflows arising from both sides of the net position. The treasury view stops at the level of the cash flows and does not take into account the time lag that might exist between the cash flow and the recognition of related income or expense in profit or loss. From this perspective, once the first forecast transaction is recognised, the natural hedge lapses and the remainder of the net position will be hedged by entering into an additional derivative (or alternatively by using, for example, the foreign currency denominated cash instrument that arises as a result of the occurrence of the first forecast transaction). Subsequently (ie at the time of settlement of the second forecast transaction), the cash flows from the financial instrument being used as a hedging instrument will be used to settle the payments resulting from the forecast transaction.
 - (b) an accounting perspective—this perspective focuses on how to present the effect of the two forecast transactions in profit or loss and in which accounting period. This goes beyond the cash flow view of the treasury perspective. This is because the way in which the item affects profit or loss can be different, while the cash flow is a point-in-time event. For example, while the purchase of services and the sales of goods can be designated as part of a net position in a way that they will affect profit or loss in one reporting period, purchases of property, plant and equipment affect profit or loss over several different reporting periods through the depreciation pattern. Similarly, if inventory is sold in the period after it was purchased, the cash flow and the related effect on profit or loss occur in different periods.
- BC6.451 In the light of the comments received, the IASB reconsidered the restriction on cash flow hedges of net positions with offsetting risk positions that affect profit or loss in different reporting periods, as proposed in the Exposure Draft. The IASB did not think that it was appropriate to completely remove the restriction. However, the IASB considered whether there was an alternative approach that could better reflect an entity's risk management activities but that would also address the earnings management concerns that had been raised.
- BC6.452 The IASB noted that entities would only be able to reflect their risk management activities if it removed the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. However, the IASB noted that it could address the concerns about earnings management by introducing some requirements for documenting the hedging relationship instead of prohibiting the designation altogether.

- BC6.453 The IASB noted that the potential for earnings management could be addressed if the recognition pattern for profit or loss arising from the hedged net position for all reporting periods affected was set at the inception of the hedge, in such a way that it was clear what amounts would affect profit or loss, when they would affect profit or loss and to which hedged volumes and types of items they related.
- BC6.454 However, the IASB had concerns about applying cash flow hedges for net positions to many different types of risks because it might have unintended consequences for some risks. The IASB noted that foreign currency risk was the risk most commented on by respondents and the risk that the IASB intended to address by this type of hedge.
- BC6.455 Consequently, the IASB decided that cash flow hedges of net positions would only be available for hedges of foreign currency risk (but no other risks). In addition, the IASB decided to remove the restriction that the offsetting risk positions in a net position must affect profit or loss in the same reporting period. However, the IASB was concerned that without sufficiently specific documentation of the items within the designated net position, an entity could use hindsight to allocate the hedging gains or losses to those items so as to achieve a particular result in profit or loss (selection effect). Consequently, the IASB decided that for all items within the designated net position for which there could be a selection effect, an entity must specify each period in which the transactions are expected to affect profit or loss as well as the nature and volume of each type of forecast transaction in such a way that it eliminates the selection effect. For example, depending on the circumstances, eliminating a selection effect could require that specifying the nature of a forecast purchase of items of property, plant and equipment includes aspects such as the depreciation pattern for items 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 (such as different useful lives because of being used in different production processes). The IASB noted that this would also address the issue that some respondents had raised about changes in the original expectations of when the risk positions would affect profit or loss resulting in items affecting profit or loss in different reporting periods (see paragraph BC6.449).

Presentation for groups of items that are a net position

- BC6.456 For cash flow hedges of groups of items with offsetting risk positions (ie net positions), the hedged items might affect different line items in the statement of profit or loss and other comprehensive income. Consequently, this raises the question of how hedging gains or losses should be presented for a cash flow hedge of such a group. In its deliberations leading to the Exposure Draft, the IASB noted that hedging gains or losses would need to be grossed up to offset each of the hedged items individually.
- BC6.457 The IASB noted that if it proposed to adjust (gross up) all the affected line items in the statement of profit or loss and other comprehensive income it would result in the recognition of gross (partially offsetting) gains or losses that did not exist, and that this would not be consistent with general accounting principles.

Consequently, in its Exposure Draft, the IASB decided not to propose adjusting (grossing up) all affected line items in the statement of profit or loss and other comprehensive income.

- BC6.458 Instead, the IASB proposed that in the statement of profit or loss or other comprehensive income hedging gains or losses for cash flow hedges of a net position should be presented in a separate line item. This would avoid the problem of distorting gains or losses with amounts that did not exist. However, the IASB acknowledged that this results in additional disaggregation of information in the statement of profit or loss and other comprehensive income. This would also result in hedges of net positions being presented differently from hedges of gross positions.
- BC6.459 In a fair value hedge, changes in the fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in the statement of profit or loss and other comprehensive income. Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the IASB did not believe any changes to the fair value hedge accounting mechanics were necessary to accommodate net positions. However, in situations in which some hedging gains or losses are considered a modification of revenue or an expense (for example, when the net interest accrual on an interest rate swap is considered a modification of the interest revenue or expense on the hedged item), those gains or losses should be presented in a separate line when the hedged item is a net position. In the IASB's view, in those situations the same reasons applied that it had considered for cash flow hedges in relation to their presentation in the statement of profit or loss and other comprehensive income.
- BC6.460 Most of the respondents to the Exposure Draft supported the IASB's proposal to require the hedging gains or losses to be presented in a separate line item for a hedging relationship that includes a group of items with offsetting risks that affect different line items in the statement of profit or loss and other comprehensive income.
- BC6.461 The IASB decided to retain the proposal in the Exposure Draft, as it would make transparent that an entity is hedging on a net basis and would clearly present the effect of those hedges of net positions on the face of the statement of profit or loss and other comprehensive income.

Identifying the hedged item for hedges of a group of items that constitutes a net position

- BC6.462 The IASB considered in its deliberations leading to the Exposure Draft how an entity that applies hedge accounting to net positions should identify the hedged item. The IASB concluded that an entity would need to designate a combination of gross positions if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the IASB proposed that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item.
- BC6.463 The IASB retained its original decision when redeliberating its Exposure Draft.

Hedges of a group of items that results in a net position of nil

- BC6.464 In its deliberations leading to the Exposure Draft, the IASB noted that when an entity managed and hedged risks on a net basis, the proposals would allow the entity to designate the net risk from hedged items into a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the IASB acknowledged that there might be circumstances in which, by coincidence, the net position of hedged items for a particular period was nil.
- BC6.465 The IASB considered whether, when an entity hedges risk on a net basis, a nil net position should be eligible for hedge accounting. Such a hedging relationship could be, in its entirety, outside the scope of hedge accounting if it did not include any financial instruments. Furthermore, eligibility for hedge accounting would be inconsistent with the general requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.
- BC6.466 However, the IASB noted that the accounting result of prohibiting the application of hedge accounting to nil net positions could distort the financial reporting of an entity that otherwise hedged (with eligible hedging instruments) and applied hedge accounting on a net basis, for example:
- (a) in periods in which hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument), the transactions would affect profit or loss at an overall hedged rate or price; whereas
 - (b) in periods in which hedge accounting would not be permitted (because the net position is nil), transactions would affect profit or loss at prevailing spot rates or prices.
- BC6.467 Consequently, the IASB proposed that nil net positions should qualify for hedge accounting. However, the IASB noted that such situations would be coincidental and hence it expected that nil net positions would be rare in practice.
- BC6.468 The IASB retained its original decision when redeliberating its Exposure Draft.

Hedging credit risk using credit derivatives

The IASB's deliberations leading to the Exposure Draft

The issue

- BC6.469 Many financial institutions use credit derivatives to manage their 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 might also reduce the regulatory capital requirement for the loan or loan commitment while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (for example, a facility for a particular client) or the bank's overall lending portfolio.

- BC6.470 However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, the credit risk cannot be isolated in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable (see also paragraph BC6.503).
- BC6.471 As an alternative to hedge accounting, IFRS 9 permits an entity to designate, as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of that Standard if doing so eliminates or significantly reduces an accounting mismatch. However, the fair value option is only available at initial recognition, is irrevocable and an entity must designate the financial item in its entirety (ie for its full nominal amount). Because of the various optional features and the drawdown behavioural pattern of the loans and loan commitments, credit portfolio managers often engage in a flexible and active risk management strategy. Credit portfolio managers most often hedge less than 100 per cent of a loan or loan commitment. They might also hedge longer periods than the contractual maturity of the loan or the loan commitment. Furthermore, the fair value option is available only for instruments that are within the scope of IFRS 9. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37, not IFRS 9. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of the associated restrictions and scope.
- BC6.472 As a result, financial institutions that use credit default swaps to hedge the credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments (ie those that meet the scope exception of IFRS 9). The changes in fair value of the credit default swaps are recognised in profit or loss in every reporting period (as for a trading book). The accounting outcome is an accounting mismatch of gains and losses of the loans and loan commitments versus those of the credit default swaps, which creates volatility in profit or loss. During the IASB's outreach programme, many users of financial statements pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.
- BC6.473 In its Exposure Draft, the IASB proposed that a risk component should be separately identifiable and reliably measurable in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate an equivalent to hedge accounting when entities hedge credit risk, a different accounting requirement would have to be developed specifically for this type of risk, or the proposed hedge accounting requirements would have to be significantly modified (for example, in relation to eligible hedged items and effectiveness testing).

Alternatives considered by the IASB

- BC6.474 In its deliberations leading to the Exposure Draft, the IASB considered three alternative approaches to hedge accounting in order to address situations in

which credit risk is hedged by credit derivatives. Those alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (for example, a bond, loan or loan commitment):

- (a) Alternative 1:
 - (i) to elect fair value through profit or loss only at initial recognition;
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.
- (b) Alternative 2:
 - (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and the then fair value is recognised immediately in profit or loss);
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.
- (c) Alternative 3:
 - (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and the then fair value is amortised or deferred);
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.

BC6.475 The election of fair value through profit or loss would be available for a financial instrument (or a proportion of it) that is managed in such a way that an economic relationship on the basis of the same credit risk exists with credit derivatives (measured at fair value through profit or loss) that causes offset between changes in fair value of the financial instrument and the credit derivatives. This would also apply to financial instruments that fall outside the scope of IFRS 9, for example, loan commitments. Instead of the qualifying criteria for hedge accounting (see paragraphs BC6.230–BC6.271), the IASB considered the following qualifying criteria for electing fair value through profit or loss:

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

BC6.476 The qualification criteria in BC6.475 are set with a view to accommodating economic hedges of credit risk that would otherwise qualify for hedge accounting, but for the fact that the credit risk component within the hedged exposure cannot be separately identified and hence is not a risk component that meets the eligibility criteria for hedged items. Those qualification criteria are

also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions. However, using name matching as a qualifying criterion means that index-based credit default swaps would not meet that criterion.

- BC6.477 For discontinuation, the IASB considered the following criteria:
- (a) the qualifying criteria are no longer met; and
 - (b) retaining the measurement at fair value through profit or loss is not needed because of any other requirements.
- BC6.478 Given the rationale for electing fair value through profit or loss, an entity would typically discontinue accounting at fair value through profit or loss if the discontinuation criteria in BC6.477 are met, because that would ensure that the accounting is aligned with how the exposure is managed (ie the credit risk is no longer managed using credit derivatives). The IASB noted that in circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the IASB considered that it would be logical to make the discontinuation of fair value through profit or loss accounting mandatory (rather than optional) if the discontinuation criteria are fulfilled.
- BC6.479 Alternative 1 permits electing fair value through profit or loss for a component of the nominal amount of the financial instrument if qualifying criteria are met. This is available only at initial recognition. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with Alternative 1, at the date of discontinuation of accounting for the financial instrument at fair value through profit or loss, the fair value of the financial instrument will be its deemed cost. For loan commitments outside the scope of IFRS 9 the recognition and measurement criteria of IAS 37 would apply.
- BC6.480 The IASB noted that a significant disadvantage of Alternative 1 is that in many situations in practice (when a financial institution obtains credit protection for an exposure after the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and would therefore not reflect its effect. An advantage of Alternative 1 is that it is less complex than the other alternatives that the IASB considered. By not permitting the election of fair value through profit or loss after initial recognition (or inception of a loan commitment), the difference at later points in time between the carrying amount and the fair value of the financial instrument will not arise.
- BC6.481 In addition to the election of fair value through profit or loss at initial recognition in accordance with Alternative 1, Alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was previously deteriorating and was then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was

protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.

- BC6.482 The IASB noted that when the financial instrument is elected for measurement as at fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and its fair value. This difference is a result of the change in the measurement basis (for example, from amortised cost to fair value for a loan). The IASB considers this type of difference a measurement change adjustment. Alternative 2 proposes to recognise the measurement change adjustment in profit or loss immediately. At the date of discontinuation of fair value through profit or loss accounting, the fair value will be the deemed cost (as in Alternative 1). If the financial instrument is elected again after a previous discontinuation, the measurement change adjustment at that date is also recognised immediately in profit or loss.
- BC6.483 A significant advantage of Alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.
- BC6.484 A disadvantage of Alternative 2 is that it is more complex than Alternative 1. Furthermore, it might appear susceptible to earnings management. An entity can decide at what time to elect fair value through profit or loss accounting for the financial instrument and thus when the difference between the carrying amount and the fair value at that date would be recognised in profit or loss. The accounting impact of immediately recognising the measurement change adjustment in profit or loss may also deter an entity from electing fair value through profit or loss accounting. For example, when an entity decides to take out credit protection at a time when the fair value has already moved below the carrying amount of the loan because of credit concerns in the market, it will immediately recognise a loss if it elects fair value through profit or loss accounting.
- BC6.485 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than Alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as Alternative 2. Consequently, it also allows financial institutions to achieve an accounting outcome that reflects their credit risk management strategy.
- BC6.486 An important difference between Alternatives 2 and 3 is the treatment of the measurement change adjustment (ie the difference that could arise between the carrying amount and the fair value of the financial instrument when fair value through profit or loss accounting is elected after initial recognition of the credit exposure). Alternative 3 proposes that the measurement change adjustment should be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37.

- BC6.487 As in Alternative 2, a significant advantage of Alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives. An advantage of Alternative 3 over Alternative 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.
- BC6.488 However, a disadvantage of Alternative 3 is that it is the most complex of the alternatives. The IASB noted that the measurement change adjustment in accordance with Alternative 3 would have presentation implications. The measurement change adjustment could be presented in the statement of financial position in the following ways:
- (a) as an integral part of the carrying amount of the exposure (ie it could be added to the fair value of the loan); this results in a mixed amount that is neither fair value nor amortised cost;
 - (b) presentation as a separate line item next to the line item that includes the credit exposure; this results in additional line items in the statement of financial position and may easily be confused as a hedging adjustment; or
 - (c) in other comprehensive income.
- BC6.489 The IASB noted that disclosures could make the measurement change adjustment transparent.
- BC6.490 However, in the light of the complexities that these three alternatives would introduce, the IASB decided not to propose allowing elective fair value accounting for hedged credit exposures (such as loans and loan commitments).

The feedback received on the Exposure Draft

- BC6.491 Many respondents to the Exposure Draft were of the view that the IASB should consider how to accommodate hedges of credit risk using credit derivatives under IFRSs. Respondents commented that hedges of credit risk using credit derivatives are becoming an increasingly significant practice issue in the application of IFRSs. They noted that this issue is just as significant as other issues that had been addressed in the Exposure Draft (for example, the time value of options, hedges of aggregated exposures and risk components of non-financial items). They also noted that financial reporting under IFRSs should allow entities to reflect the effects of such activities in the financial statements consistently with the overall hedge accounting objective to better reflect risk management activities.
- BC6.492 Respondents also commented that IFRSs today fail to represent the effect of credit risk management activities and distort the financial performance of financial institutions. They noted that, because of the accounting mismatch between loans and loan commitments on the one hand and the related credit derivatives on the other hand, the profit or loss under IFRSs is significantly more

volatile for financial institutions that hedge their credit risk exposures than for financial institutions that do not hedge.

- BC6.493 Many respondents noted that the objective of hedge accounting would not be met if IFRSs would not provide a way to account for hedges of credit risk so that financial statements can reflect the credit risk management activities of financial institutions.
- BC6.494 Most users of financial statements commented that the IASB should address this issue. Many also noted that the financial statements currently reflect accounting-driven volatility when credit risk is hedged and that those financial statements do not align with those risk management activities.
- BC6.495 Participants in the outreach provided the same feedback. Most of them were also of the view that this is an important practice issue that the IASB should address.
- BC6.496 However, the feedback was mixed on how the IASB should address or resolve this issue. Many respondents were of the view that it was difficult to reliably measure credit risk as a risk component for the purposes of hedge accounting. However, some respondents suggested that for some types of instruments the credit risk component of financial instruments could be reliably measured on the basis of credit default swap (CDS) prices, subject to some adjustments.
- BC6.497 Many agreed that the alternatives set out in the Basis for Conclusions of the Exposure Draft (see paragraph BC6.474) were too complex, although some respondents supported elective fair value through profit or loss accounting as an alternative to hedge accounting. Of the three fair value through profit or loss alternatives, most respondents supported Alternative 3.
- BC6.498 Respondents who supported elective fair value through profit or loss accounting thought that it would be operational and believed that it would be no more complex than the other possible approaches, for example, identifying risk components. Most preferred Alternative 3 as it would align most closely with the dynamic credit risk management approach of many financial institutions. Some users of financial statements supported elective fair value through profit or loss accounting because they thought that the benefits of providing a better depiction of the economics of the risk management activities would outweigh the complexity.

The IASB's redeliberations of the Exposure Draft

- BC6.499 In the light of the feedback received on its Exposure Draft, the IASB decided to specifically address the accounting for hedges of credit risk using credit derivatives. In its redeliberations the IASB explored various accounting alternatives.

Treating credit risk as a risk component

- BC6.500 The IASB noted that for credit risk there are unique differences between how the relevant risk might affect the hedging instrument and the hedged risk exposure when compared to other risk components.

- BC6.501 The IASB also noted that there is sometimes uncertainty about whether voluntary debt restructurings constitute a credit event under a standard credit default swap contract. Whether an event constitutes a credit event is determined by a committee consisting of representatives of banks and fund entities. This can (and in practice did) result in situations in which the fair value of a debt instrument has decreased, reflecting the market view of credit losses on those debt instruments while any payout on credit default swaps for those debt instruments depends on how the difficulties of the debtor will be resolved and what related measures might be considered a credit event. This is a factor that affects credit default swaps in a different way than the actual underlying debt. It is an additional factor inherent in credit default swaps that is not inherent in the debt as such. Hence, there could be scenarios in which, for example, an impairment loss on a loan might not be compensated by a payout from a credit default swap that is linked to the obligor of that debt. Also, market liquidity and the behaviour of speculators trying to close positions and taking gains affect the credit default swap and the debt market in different ways.
- BC6.502 The IASB also noted that when a financial institution enters into a credit default swap to hedge the credit exposure from a loan commitment it might result in a situation in which the reference entity defaults while the loan commitment remains undrawn or partly undrawn. In such situations the financial institution receives compensation from the payout on the credit default swaps without actually incurring a credit loss.
- BC6.503 Furthermore, the IASB considered the implications of the fact that, upon a credit event, the protection buyer receives the notional principal less the fair value of the reference entity's obligation. Hence, the compensation received for credit risk depends on the fair value of the reference instrument. The IASB noted that, for a fixed-rate loan, the fair value of the reference instrument is also affected by changes in market interest rates. In other words, on settlement of the credit default swap, the entity also settles the fair value changes attributable to interest rate risk—and not solely fair value changes attributable to the credit risk of the reference entity. Hence, the way credit default swaps are settled reflects that credit risk inextricably depends on interest rate risk. This in turn reflects that credit risk is an 'overlay' risk that is affected by all other value changes of the hedged exposure because those value changes determine the value of what is lost in case of a default.
- BC6.504 Hence, the IASB considered that credit risk is not a separately identifiable risk component and thus does not qualify for designation as a hedged item on a risk component basis.

Exception to the general risk component criteria

- BC6.505 The IASB then considered whether it should provide an exception to the general risk component criteria specifically for credit risk.
- BC6.506 Some respondents suggested that, as an exception to the general risk component criteria, the IASB should consider an approach that would provide a reasonable approximation of the credit risk. This approach could be based on the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss. Those

respondents noted that if this method of determining own credit risk for such liabilities is acceptable in IFRS 7 and IFRS 9, the IASB should provide the same ‘relief’ for measuring the credit risk component for the purposes of hedge accounting.

- BC6.507 The IASB noted that, in finalising the requirement for the fair value option for financial liabilities in IFRS 9, it retained the default method in the application guidance in IFRS 7 to determine the effects of changes in the liability’s credit risk. The IASB received comments on its Exposure Draft *Fair Value Option for Financial Liabilities* that determining the effects of changes in a liability’s credit risk can be complex, and that it was therefore necessary to allow some flexibility in how a liability’s credit risk could be measured. Respondents to that Exposure Draft, like the IASB, acknowledged that the default method was imprecise but considered the result a reasonable proxy in many cases. Moreover, the IASB noted that respondents to that Exposure Draft did acknowledge that the ‘IFRS 7 method’ did not isolate changes in a liability’s credit risk from other changes in fair value (for example, general changes in the price of credit or changes in liquidity risk). Those respondents said that it was often very difficult or impossible to separate those items.
- BC6.508 The IASB noted that the ‘IFRS 7 method’ (which was incorporated into IFRS 9) involves the use of an observed market price at the beginning and end of the period to determine the change in the effects of credit. That method requires entities to deduct any changes in market conditions from changes in the fair value of the instrument. Any residual amount is deemed to be attributable to changes in credit. The IASB noted that the loans and loan commitments for which the credit risk is hedged very often have no observable market price and that, in order to achieve a close approximation of the credit risk, complex modelling would be involved to arrive at a ‘market price’. Applying the ‘IFRS 7 method’ would then require the deduction of valuations for parts of the instrument and analysing them for changes in market conditions to arrive at a credit risk component. This would also be complex when trying to achieve a close approximation of the credit risk.
- BC6.509 Furthermore, the IASB noted that the loans and loan commitments for which the credit exposure is hedged often have embedded options whose fair value depends on both market and non-market conditions. For example, the exercise of prepayment options could be because of changes in general interest rates (a market condition) while loans are typically refinanced (exercise of the prepayment option) well in advance of the scheduled maturity, irrespective of movements in general interest rates. Hence, in order to achieve a close approximation of the credit risk, isolating the changes for market conditions on those embedded options could involve significant judgement and could become extremely complex.
- BC6.510 The IASB also considered that applying the ‘IFRS 7 method’ in a way that was operational (ie so that the approximation would provide relief) would mean using many of the same simplifications that some had suggested for applying the general risk component criteria to credit risk (for example, using a standardised haircut for prepayment and term-out options, and ignoring immaterial options).

- BC6.511 The IASB considered that for exchange-traded bonds for which market prices are readily observable and that do not have embedded options, the 'IFRS 7 method' might result in an approximation or proxy for the credit risk component in some circumstances. However, the IASB was concerned that for loans and loan commitments that are not actively traded, the 'IFRS 7 method' could become a complicated 'circular' pricing exercise and in any case it would very likely result in only a rough approximation or imprecise measurement of the credit risk component.
- BC6.512 The IASB further noted that it had acknowledged the shortcomings of the approach used for IFRS 7 and IFRS 9 and that the approach was only a proxy for measuring credit risk. Hence, the IASB had actively sought to limit the application of this approach by retaining the bifurcation requirement for hybrid financial liabilities, even though bifurcation of financial assets was eliminated. Hence, the approach was only applied to financial liabilities designated as at fair value through profit or loss.
- BC6.513 The IASB acknowledged that in order to ensure that hedge ineffectiveness is recognised the qualifying criteria for risk components use a higher degree of precision than a mere proxy. Also, for the classification and measurement of financial liabilities the IASB sought to minimise the application of this proxy by retaining the separation of embedded derivatives. Consequently, the IASB decided that also using the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss for the purpose of measuring credit risk as a hedged item would be inappropriate.
- BC6.514 The IASB also considered whether it should permit 'residual risks' as an eligible hedged item. Such an approach would allow an entity to designate as the hedged item those changes in cash flows or fair value of an item that are not attributable to a specific risk or risks that meet the separately identifiable and reliably measurable criteria for risk components. For example, an entity could designate as the hedged item the fair value changes of a loan that are attributable to all risks other than interest rate risk.
- BC6.515 The IASB noted that that approach would have the advantage of not requiring an entity to directly measure credit risk. However, the IASB noted that this approach would entail similar complexity as the IFRS 7 method for financial instruments with multiple embedded options. Hence, determining the part of the fair value changes that is attributable to a specific risk (for example, interest rate risk) could be complex.
- BC6.516 The IASB also noted that that approach would have other disadvantages:
- (a) the problem that credit risk inextricably depends on interest rate risk because of the nature of credit risk as an overlay risk (see paragraphs BC6.503–BC6.504) would remain; and
 - (b) entities would struggle with the hedge effectiveness assessment of the new hedge accounting model as it would be difficult to establish and demonstrate a direct economic relationship between the 'residual risk' and the hedging instrument (ie the credit default swap), which gives rise to offset—a requirement to qualify for hedge accounting.

- BC6.517 Consequently, the IASB decided against permitting 'residual risks' as an eligible hedged item.

Applying financial guarantee contract accounting

- BC6.518 The IASB considered whether the accounting for financial guarantee contracts in IFRS 9 could be applied to credit derivatives.

- BC6.519 The IASB noted that credit derivatives, such as credit default swaps, do not typically meet the definition of a financial guarantee contract in IFRS 9 because:

- (a) the credit events that trigger payment on a standardised credit default swap (for example, bankruptcy, repudiation, moratorium or restructuring) might not directly relate to the failure to pay on the particular debt instrument held by an entity; and
- (b) in order to meet the definition of a financial guarantee contract, it must be a precondition for payment that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. However, it is not a precondition for entering into a credit default swap that the holder is exposed to the underlying reference financial instrument (ie an entity can hold a 'naked' position).

- BC6.520 The IASB noted that it would have to broaden the definition of 'financial guarantee contract' in order to include such credit derivatives. The IASB also noted that accounting for credit default swaps as financial guarantee contracts would mean that credit default swaps would not be measured at fair value but at 'cost', ie it would result in applying accrual accounting to a derivative financial instrument.

- BC6.521 The IASB therefore rejected this alternative.

Applying the accounting for the time value of options

- BC6.522 Some respondents to the Exposure Draft suggested that the premium paid on credit default swaps is similar to buying protection under an insurance contract and, accordingly, the premium should be amortised to profit or loss. Those respondents supported applying to credit default swaps the accounting treatment for the time value of options that was proposed in the Exposure Draft. They argued that, from a risk management perspective, changes in the fair value of the derivative during the reporting period were irrelevant, as long as the issuer of the debt was solvent because if there was no credit event the fair value of the credit default swap on maturity would be zero. Hence, those respondents believed that 'interim' fair value changes could be recognised in other comprehensive income similarly to the accounting treatment proposed in the Exposure Draft for the time value of options.

- BC6.523 The IASB noted that in contrast to 'normal' options for which the time value paid is known from the beginning (hence the amount to be amortised or deferred is known), for a credit default swap the premium is contingent on the occurrence of a credit event and hence the total premium that is ultimately paid is not known at the outset. This is because the premium for a credit default swap, or at least a large part of the premium, is paid over time—but only until a

credit event occurs. The IASB noted that in order to apply the same accounting as for the time value of options, the contingent nature of the credit default swap premium would have to be ignored so that the amortisation of the premium to profit or loss could be based on the assumption that no credit event occurs—even though that risk is reflected in the fair value of the credit default swap. The IASB also noted that in substance this would be ‘as-you-go’ accounting for the credit default swap premium (ie recognising it in profit or loss on an accrual basis).

- BC6.524 The IASB also noted that applying to credit default swaps the same accounting treatment as for the time value of options would require splitting the fair value of the credit default swap into an intrinsic value and a time value. This raises the question of whether the credit default swap would only have time value (and hence no intrinsic value) until a credit event occurs, ie whether before a credit event occurs the entire fair value of the credit default swap should be deemed to be its time value.
- BC6.525 The IASB considered that it would be inappropriate to simply attribute the entire fair value of the credit default swap before a credit event to time value. The IASB noted that hedged items such as bonds or loans have ‘intrinsic’ value but not an equivalent to time value. In an effective economic hedge, the changes in the ‘intrinsic’ value in the hedged item would offset the changes in the intrinsic value of the hedging instrument. During times of financial difficulty, but before a credit event (for example, before an actual default), the fair value of the loan would have decreased because of credit deterioration. Also, the fair value of the related credit default swap would increase because of the higher risk of default. Hence, the IASB considered that the increase in fair value of the credit default swap includes some intrinsic value element even though it would be difficult to isolate and separately quantify it.
- BC6.526 The IASB also noted that if the entire fair value on a credit default swap was treated as time value before default, there could be an accounting mismatch when an entity recognised an impairment loss on the loan or loan commitment before default. This is because all fair value changes from the credit default swap would still be recognised in other comprehensive income. One solution might be to recycle the amount recognised as an impairment loss on the loan or loan commitment from other comprehensive income to profit or loss and hence to simply deem the amount of the impairment loss to be the intrinsic value of the credit default swap. The IASB considered that this would give rise to the same problems as other approximations it had discussed when it rejected an exception to the general risk component criteria, namely that any mismatch of economic gains or losses from the hedge would not be recognised as hedge ineffectiveness. Instead, under this approach profit or loss recognition for the credit default swap would be the same as accrual accounting while assuming perfect hedge effectiveness.
- BC6.527 The IASB therefore rejected this alternative.

Applying an ‘insurance approach’

- BC6.528 Some respondents to the Exposure Draft supported an ‘insurance approach’ or accrual accounting for credit derivatives. They argued that such an approach

would best address the accounting mismatch between loans or loan commitments and credit derivatives and would reflect the risk management of financial institutions.

BC6.529 The IASB considered that under an insurance approach the following accounting could be applied to a credit default swap that is used to manage credit exposures:

- (a) any premium paid at the inception of the credit default swap (or its fair value if an existing contract is used) would be amortised over the life of that contract;
- (b) the periodic premium would be expensed as paid each period (including adjustments for premium accruals);
- (c) the fair value of the credit default swap would be disclosed in the notes; and
- (d) in the assessment of impairment, the cash flow that might result from the credit default swap in case of a credit event is treated in the same way as cash flows that might result from the collateral or guarantee of a collateralised or guaranteed financial asset. In other words, the loan or loan commitment for which credit risk is managed using the credit default swap is treated like a collateralised or guaranteed financial asset with the credit default swap accounted for like collateral or a guarantee.

BC6.530 The IASB noted that the insurance approach is a simple and straightforward solution if a credit default swap is used as credit protection for one particular credit exposure with a matching (remaining) maturity. Also, situations in which the maturity of the credit default swap exceeds that of the credit exposure could be addressed by using an 'aligned' credit default swap (similar to the notion of 'aligned' time value that is used for the new accounting treatment for the time value of options; see paragraphs BC6.386–BC6.409). However, the aligned credit default swap would only address maturity mismatches. It would not capture other differences between the actual credit default swap and the hedged credit exposure (for example, that a loan might be prepayable) because the insurance approach only intends to change the accounting for the credit default swap instead of adjusting the credit exposure for value changes that reflect all of its characteristics.

BC6.531 The IASB considered that the insurance approach would have a simple interaction with an impairment model as a result of treating the credit default swap like collateral or a guarantee, which means it would affect the estimate of the recoverable cash flows. Hence, this interaction would be at the most basic level of the information that any impairment model uses so that the effect would not differ by type of impairment model (assuming only credit derivatives with a remaining life equal to, or longer than, the remaining exposure period would qualify for the insurance approach).

BC6.532 However, the IASB noted that difficulties would arise when the insurance approach was discontinued before the credit exposure matures. In such a situation the consequences of using accrual (or 'as-you-go') accounting for the

credit default swap would become obvious, ie it would be necessary to revert from off-balance-sheet accounting to measurement at fair value.

BC6.533 The IASB also noted that under the insurance approach neither the credit derivative nor the loan or loan commitment would be recognised in the statement of financial position at fair value. Hence, any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between loans or loan commitments and the credit derivatives would not be recognised in profit or loss. In addition, it would result in omitting the fair value of the credit default swap from the statement of financial position even though fair value provides important and relevant information about derivative financial instruments.

BC6.534 The IASB therefore rejected this alternative.

Applying a 'deemed credit adjustment approach'

BC6.535 The IASB also considered an approach that would adjust the carrying amount of the hedged credit exposure against profit or loss. The adjustment would be the change in the fair value of a credit default swap that matches the maturity of the hedged credit exposure ('aligned' credit default swap value). The mechanics of this would be similar to how, in a fair value hedge, the gain or loss on the hedged item that is attributable to a risk component adjusts the carrying amount of the hedged item and is recognised in profit or loss. Essentially, the cumulative change in the fair value of the aligned credit default swap would be deemed to be the credit risk component of the exposure in a fair value hedge of credit risk (ie act as a proxy for credit risk—'deemed credit adjustment'). When the deemed credit adjustment approach is discontinued before the credit exposure matures an accounting treatment that is similar to that used for discontinued fair value hedges could be used.

BC6.536 The IASB noted that the deemed credit adjustment approach would retain the measurement of credit default swaps at fair value through profit or loss. Hence, in contrast to the insurance approach (see paragraphs BC6.528–BC6.534), an advantage of this approach would be that the accounting for the credit default swap would not be affected by any switches between periods for which the credit derivative is used and those for which it is not used to manage a particular credit exposure.

BC6.537 However, the IASB was concerned that the interaction between the deemed credit adjustment approach and impairment accounting would be significantly more complex than under the insurance approach because the deemed credit adjustment and the impairment allowance would be 'competing mechanisms' in the accounting for impairment losses. This would also involve the danger of double counting for credit losses. The interaction would depend on the type of impairment model and would be more difficult in conjunction with an expected loss model.

BC6.538 The IASB therefore rejected this alternative.

Allowing entities to elect fair value accounting for the hedged credit exposure

- BC6.539 Because the discussions of those various alternatives did not identify an appropriate solution, the IASB reconsidered the alternatives it had contemplated in its original deliberations leading to the Exposure Draft (see paragraph BC6.474).
- BC6.540 The IASB considered that only Alternatives 2 and 3 of allowing an entity to elect fair value through profit or loss accounting for the hedged credit exposure would be viable. Given that Alternative 1 would be limited to an election only on initial recognition of the credit exposure (or when entering into a loan commitment), the IASB was concerned that, in many situations in practice (when an entity obtains credit protection for an exposure after the initial recognition of that exposure or entering into the loan commitment), this alternative would not be aligned with the credit risk management strategy and would therefore fail to resolve the problem (ie that no useful information is provided).
- BC6.541 The IASB noted that Alternative 3 would involve amortising the measurement change adjustment (ie the difference between the carrying amount, or nil for an unrecognised loan commitment, and the fair value of the financial instrument when it is elected for measurement at fair value through profit or loss after initial recognition or after entering into a loan commitment) over the life of the financial instrument hedged for credit risk. As a consequence, to ensure that the measurement change adjustment is not inappropriately deferred but recognised immediately in profit or loss when impaired, the measurement change adjustment would require an impairment test. This would result in interaction with the impairment model.
- BC6.542 The IASB was concerned that the interaction of Alternative 3 with the impairment model could create a compatibility problem and might be a potential restriction of the impairment phase of its project to replace IAS 39.
- BC6.543 Hence, the IASB reconsidered Alternative 2, noting that:
- (a) the status quo under IAS 39, in which credit default swaps are accounted for at fair value through profit or loss while credit exposures are accounted for at amortised cost or are unrecognised (for example, many loan commitments), does not convey the full picture. It results in the recognition of gains on credit default swaps while the impairment is recognised on a different measurement basis and with a time lag because of the impairment models. Hence, in a situation in which the situation of a lender deteriorates but it has protected itself, gains are shown even though the protection keeps the situation neutral at best.
 - (b) Alternative 2 would use fair value accounting for both the credit default swap and the credit exposure. This would best capture all economic mismatches but would come at the expense of inevitably including in the remeasurement interest rate risk in addition to credit risk. Alternative 2 would have the clearest objective of all the approaches considered (fair value measurement) and, as a result, it would require the least guidance. The IASB noted that under Alternative 2 there could be

concerns about earnings management because on electing fair value accounting the difference to the previous carrying amount of the credit exposure would be immediately recognised in profit or loss. However, the IASB also noted that some would consider that outcome as relevant because it would signal a different approach to managing credit risk and this difference would often be a loss that is a reflection of any lag in the impairment model behind the 'market view'. To be consistent, this should be removed by changing the measurement basis when switching to a fair value-based credit risk management.

- (c) the accounting under Alternative 2 is completely de-linked from the impairment model and consequently has the least interaction with impairment of all approaches considered.
- (d) Alternative 2 is operationally the least complex of the approaches considered.

BC6.544 The IASB considered that, on balance, the advantages of Alternative 2 outweighed its disadvantages and, overall, that it was superior to all other approaches. Hence, the IASB decided to include Alternative 2 in the final requirements.

BC6.545 In response to feedback received on the Exposure Draft, the IASB also decided to align the accounting for the discontinuation of fair value through profit or loss accounting for loan commitments with that for loans (ie use amortisation unless a higher liability is required by IAS 37, instead of simply reverting to that Standard as contemplated during the IASB's initial deliberations—see paragraphs BC6.479 and BC6.482). The IASB's reasons for also using an amortisation approach for loan commitments were that:

- (a) it would prevent an immediate gain from the derecognition of the loan commitment under IAS 37 if the probable threshold is not met when discontinuing fair value through profit or loss accounting. This would reduce concerns about earnings management.
- (b) the amortisation of the carrying amount when discontinuing fair value through profit or loss accounting would use the effective interest method. This would require the entity to assume that a loan had been drawn under the loan commitment in order to determine an amortisation profile. The rationale for this alternative is that a credit loss only results from a loan commitment if that loan commitment gets drawn and the resulting loan is not repaid. Hence, an amortisation on an 'as if drawn' basis would be appropriate for the amortisation of the carrying amount.
- (c) this accounting also provides operational relief for loan commitments that allow repayments and redraws (for example, a revolving facility). It would avoid the need to capitalise any remaining carrying amount into individual drawings to ensure its amortisation, which would be operationally complex.

After paragraph BC7.9E, paragraphs BC7.9F–BC7.9I and their related headings are added.

Effective date and transition (chapter 7)

Requirements added to, and amendments of, IFRS 9 in November 2013

Mandatory effective date of IFRS 9—November 2013

BC7.9F In November 2012 the IASB published the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (Limited Amendments ED). The Limited Amendments ED did not propose to change the mandatory effective date of IFRS 9 and the IASB did not ask a question on that topic. However, as part of the Exposure Draft *Financial Instruments: Expected Credit Losses*, which was published in March 2013, the IASB noted that all phases of IFRS 9 would have the same effective date and asked respondents for feedback on the lead time that would be needed to implement the proposals on expected credit losses and what the resulting mandatory effective date for IFRS 9 should be.

BC7.9G Many respondents to the Limited Amendments ED urged the IASB to confirm as soon as possible that the mandatory effective date of IFRS 9 of 1 January 2015 would be deferred. Respondents noted that the IASB has a practice of allowing a minimum of 18 months between the finalisation of a Standard and the mandatory effective date. They noted that even if the remaining phases of IFRS 9 were completed by the end of 2013, there would not be 18 months remaining until 1 January 2015. The feedback received in response to the Exposure Draft on expected credit losses indicated that entities believed that they would need around three years to implement the proposed impairment model.

BC7.9H In the light of the feedback received, the IASB decided to defer the mandatory effective date of IFRS 9. The IASB decided that it will be able to determine the appropriate mandatory effective date only after it finalises the requirements for impairment and classification and measurement and has considered the lead time that is necessary to implement those new requirements. Consequently, the IASB decided that the mandatory effective date should not be specified in IFRS 9 but will be determined when the outstanding phases are finalised. However, the IASB confirmed that in the meantime application of IFRS 9 is still permitted.

Hedge accounting

BC7.9I The IASB decided that the effective date of the hedge accounting requirements should be aligned with the effective date for the other requirements of IFRS 9 (see paragraph BC7.9H) and confirmed that the hedge accounting requirements cannot be applied prior to the application of the classification and measurement requirements in IFRS 9.

After paragraph BC7.34M, paragraphs BC7.35–BC7.52 and their related headings are added.

Transition related to the requirements added to IFRS 9 in November 2013

Presentation of 'own credit' gains and losses on financial liabilities

- BC7.35 After requirements were added to IFRS 9 in October 2010 to address the effects of changes in own credit risk for liabilities designated under the fair value option, many interested parties requested that the IASB permit an entity to apply those requirements without also applying the other requirements in IFRS 9. That is because markets continued to be volatile and own credit gains or losses remained significant, which accentuated the concerns about the usefulness of presenting gains in profit or loss when an entity is experiencing deterioration in its own credit quality.
- BC7.36 In the Limited Amendments ED, which was published in November 2012, the IASB proposed that six months after the completed version of IFRS 9 is issued, entities would no longer be permitted to newly early apply previous versions of IFRS 9. Therefore, entities wishing to apply the classification and measurement requirements after the completed version of IFRS 9 was issued would have to develop and implement the necessary systems changes for applying the new impairment requirements before they would be able to apply the classification and measurement requirements. In effect, that would have made the availability of the own credit requirements for early application dependent on the implementation of an expected credit loss impairment model.
- BC7.37 Consequently, in order to make the own credit requirements in IFRS 9 available more quickly, the Limited Amendments ED proposed that once the completed version of IFRS 9 was issued, an entity would be permitted to early apply the requirements for presenting in other comprehensive income the 'own credit' gains or losses on financial liabilities designated under the fair value option without early applying the other requirements of IFRS 9. However, at the time, the IASB noted that its decision to incorporate the possibility to apply early only the own credit requirements into the final version of IFRS 9 rather than IFRS 9 (2010) and later versions, was based on the expectation that there would not be a significant delay in the completion of IFRS 9. In other words, the IASB believed that the own credit requirements would be available for early application at roughly the same time under both approaches. However, the IASB noted that by exposing the proposals as part of the Limited Amendments ED, it would be possible to change this approach if necessary.
- BC7.38 Nearly all respondents to the Limited Amendments ED supported the proposal that an entity would be permitted to early apply only the own credit requirements in IFRS 9 without applying any other requirements of IFRS 9 at the same time. However, most of these respondents also asked the IASB to make these requirements available for early application before the IFRS 9 project is completed and the final Standard is issued. Many of these respondents suggested that this could be accomplished by incorporating the own credit

requirements into IAS 39, whereas others suggested incorporating the requirements into IFRS 9 (2010) and later versions.

- BC7.39 During the redeliberations the IASB confirmed the proposal in the Limited Amendments ED that the own credit requirements should be made available for early application without early applying the other requirements of IFRS 9. However, in order to respond to the feedback that the own credit requirements should be made available as soon as possible, the IASB decided to incorporate those requirements into IFRS 9 (2010) and later versions. The IASB also confirmed its previous decision not to incorporate the own credit requirements into IAS 39 because that Standard is being replaced by IFRS 9.
- BC7.40 Although the topic was not within the scope of the Limited Amendments ED, some respondents asked the IASB to reconsider the requirements in IFRS 9 that prohibit an entity from reclassifying (recycling) own credit gains or losses to profit or loss when the financial liability is derecognised. The IASB noted that it is currently discussing the objective of other comprehensive income, including whether amounts should be recycled to profit or loss (and if so, when), in its project on the Conceptual Framework and therefore the IASB noted that it would be inappropriate to reconsider those requirements in IFRS 9 before it completes that work.

Transition related to the hedge accounting requirements

- BC7.41 IAS 8 states that retrospective application results in the most useful information to users of the financial statements. IAS 8 also states that retrospective application is the preferred approach to transition, unless such retrospective application is impracticable. In such a scenario the entity adjusts the comparative information from the earliest date practicable. In conformity with these requirements, the classification and measurement chapters of IFRS 9 require retrospective application (with some relief in particular circumstances).
- BC7.42 The proposals in the Exposure Draft were a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship could be designated only prospectively. Consequently, retrospective application was not applicable. This reflects that retrospective application gives rise to similar concerns about using hindsight as retrospective designation of hedging relationships, which is prohibited.
- BC7.43 In developing the transition requirements proposed in the Exposure Draft, the IASB considered two alternative approaches:
- (a) prospective application only for new hedging relationships; or
 - (b) prospective application for all hedging relationships.
- BC7.44 The IASB rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would have required the current hedge accounting model in IAS 39 to be maintained until hedge accounting is discontinued for the hedging relationships established in accordance with IAS 39. Also, the proposed disclosures would be provided only for the hedging relationships accounted for in accordance with the proposed model. This approach entails the complexity of applying the two models

simultaneously and also involves a set of disclosures that would be inconsistent and difficult to interpret. Because some hedging relationships are long-term, two hedge accounting models would co-exist for a potentially long period. This would make it difficult for users to compare the financial statements of different entities. Comparability would also be difficult when entities apply the old and the new model in the same financial statements, as well as for information provided over time.

- BC7.45 Consequently, the IASB proposed prospective application of the proposed hedge accounting requirements for all hedging relationships, while ensuring that 'qualifying' hedging relationships could be moved from the existing model to the proposed model on the adoption date.
- BC7.46 Almost all respondents agreed with prospective application of the new hedge accounting requirements to all hedging relationships because that would avoid the administrative burden of maintaining both the IAS 39 model and the new hedge accounting model and would also mitigate the risk of hindsight arising from retrospective designation of hedging relationships. Respondents also noted that prospective application is consistent with hedge accounting transition requirements that were used for previous amendments to IAS 39.
- BC7.47 The IASB also received feedback that suggested a general provision, whereby hedging relationships designated under IAS 39 would be automatically 'grandfathered', ie entities could continue applying the requirements of IAS 39 to these hedging relationships. However, consistent with its proposal in the Exposure Draft (see paragraph BC7.44), the IASB decided not to allow the grandfathering of the application of IAS 39. Instead, the IASB retained its original decision that the new hedge accounting requirements are applied to hedging relationships that qualify for hedge accounting in accordance with IAS 39 and this IFRS and that those are treated as continuing hedging relationships.
- BC7.48 Some respondents supported varying forms of retrospective application. However, consistent with previous hedge accounting transition requirements in IAS 39 and the Exposure Draft, the IASB decided not to allow retrospective application in situations that would require retrospective designation because that would involve hindsight.
- BC7.49 Some responses to the Exposure Draft suggested using retrospective application in two particular situations in which the outcomes under IAS 39 and the new hedge accounting model significantly differ but retrospective designation would not be necessary. The particular situations are when an entity under IAS 39 designated as the hedging instrument only changes in the intrinsic value (but not the time value) of an option or changes in the spot element (but not the forward element) of a forward contract. The IASB noted that in both circumstances applying the new requirements for accounting for the time value of options or the forward element of forward contracts would not involve hindsight from retrospective designation but instead use the designation that was previously made under IAS 39. The IASB also noted that in situations in which mismatches between the terms of the hedging instrument and the hedged item exist there might still be some risk of hindsight related to Level 3

fair value measurements when calculating the ‘aligned’ time value of an option and the ‘aligned’ forward element of a forward contract. However, the IASB concluded that such hindsight would be limited because hedge accounting was applied to these hedging relationships under IAS 39, meaning that the changes in the intrinsic value of an option or the changes in the value of the spot element of a forward contract had to have a high degree of offset with the changes in value of the hedged risks. Hence, the valuation inputs used for the calculation of the aligned values could not significantly differ from the valuation inputs for the overall fair value of the hedging instruments, which were known from previously applying IAS 39. The IASB also noted that retrospective application in these cases would significantly improve the usefulness of the information for the reasons that underpinned the IASB’s decisions on accounting for the time value of options and the forward element of forward contracts (see paragraphs BC6.386–BC6.426). Consequently, the IASB decided to provide for those two particular situations an exception to prospective application of the hedge accounting requirements of this IFRS but only for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. For the forward element of forward contracts retrospective application is permitted but not required because unlike the new treatment for time value of options the new treatment for the forward element of forward contracts is an election. However, in order to address the risk of using hindsight, the IASB decided that on transition this election is only available on an ‘all-or-nothing’ basis (ie not a hedge-by-hedge basis). IAS 39 did not allow excluding foreign currency basis spreads from the designation of a financial instrument as the hedging instrument. Consequently, the requirement for the time value of options and the forward element of forward contracts, that an entity excluded the part of the financial instrument that represents costs of hedging from the designation as the hedging instrument under IAS 39, does not apply to foreign currency basis spreads. The restriction that retrospective application is available only on an ‘all-or-nothing’ basis does not apply to foreign currency basis spreads because of the variety of hedging instruments that involve those spreads.

- BC7.50 Some respondents asked the IASB to consider allowing discontinuing at the date of initial application of the new hedge accounting requirements hedging relationships designated under IAS 39 and then designating new hedging relationships in a way that is better aligned with the new hedge accounting requirements.
- BC7.51 The IASB noted that an entity could revoke designations of hedging relationships without any restriction until the last day of applying IAS 39 in accordance with the requirements in that standard. Hence, the IASB considered that any specific transition requirements to address this request were unnecessary. However, in order to address some concerns over potential practical transition issues in the context of prospective application, the IASB decided:
- (a) to allow an entity to consider the moment it initially applies the new hedge accounting requirements and the moment it ceases to apply the hedge accounting requirements of IAS 39 as the same point in time. The IASB noted that this would avoid any time lag between starting the use of

the new hedge accounting model and discontinuing the old hedge accounting model (because the end of the last business day of the previous reporting period often does not coincide with the beginning of the first business day of the next reporting period), which otherwise might involve significant changes in fair values between those points in time and as a result could cause difficulties in applying hedge accounting under the new hedge accounting model for hedging relationships that would otherwise qualify.

- (b) to require that an entity uses the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship (if applicable) and to recognise any related gain or loss in profit or loss. The IASB considered that any change to the hedge ratio that might be required on transition so that a hedging relationship designated under IAS 39 continues to qualify for hedge accounting should not result in an entity having to discontinue that hedging relationship on transition and then newly designating it. The IASB decided to require the recognition of any gain or loss on rebalancing in profit or loss in a broadly similar manner for ongoing hedge accounting under the new model to address any concerns that hedge ineffectiveness might otherwise be recognised as a direct adjustment to retained earnings on transition. The accounting is broadly similar to that for ongoing hedge accounting under the new model in that the hedge ineffectiveness in the context of rebalancing is recognised in profit or loss. However, in contrast to ongoing hedge accounting under the new model, rebalancing on transition applies because a different hedge ratio has already been used for risk management purposes (but did not coincide with the designation of the hedging relationship under IAS 39). In other words, rebalancing does not reflect a concurrent adjustment for risk management purposes but results in aligning the hedge ratio for accounting purposes with a hedge ratio that was already in place for risk management purposes.

BC7.52 The IASB decided not to change the requirements of IFRS 1 for hedging accounting. The IASB noted that a first-time adopter would need to look at the entire population of possible hedging relationships and assess which ones would meet the qualifying criteria of the new hedge accounting model. To the extent that an entity wants to apply hedge accounting, those hedging relationships should be documented on or before the transition date. This is consistent with the transition requirements for existing users of IFRSs and the existing transition requirements of IFRS 1, which state that an entity shall discontinue hedge accounting if it had designated a hedging relationship but that hedging relationship does not meet the qualifying criteria in IAS 39.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 9 and the related amendments to other IFRSs.

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

- BCA1 The footnotes to the reference to 'IAS 39' in paragraphs BC58A, BC63A, BC65, BC66, BC74, BC89 and BC89A and to the heading 'Available-for-sale financial assets' above paragraph BC81 are deleted.
- BCA2 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17(a), and the first references to 'IAS 39' in paragraphs BC20, BC58A, BC63A, BC74, BC81, BC89 and BC89A are footnoted appropriately as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA3 The first references to 'IAS 39' in paragraphs BC65 and BC66 are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.
- BCA4 The term 'available for sale' in paragraph BC63A, the term 'available-for-sale financial assets' in paragraph BC74(b) and the heading 'Available-for-sale financial assets' above paragraph BC81 are footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, with requirements added in October 2010, eliminated the category of available-for-sale financial assets.
- BCA5 The heading 'Hedge accounting' above paragraph BC75 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, as amended in November 2013, replaced the hedge accounting requirements in IAS 39.
- BCA6 Paragraph BC80F is added:
- BC80F In November 2013 the Board amended the examples in the guidance on hedge accounting so that they conformed to IFRS 9, as amended in November 2013, which replaced the hedge accounting requirements in IAS 39.

IFRS 2 *Share-based Payment*

BCA7 The footnote to the reference to 'IAS 39' in the heading above paragraph BC25 is replaced with:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. Paragraphs BC25–BC28 refer to matters relevant when IFRS 2 was issued.

IFRS 3 *Business Combinations*

BCA8 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC185 and the first references to 'IAS 39' in paragraphs BC244, BC256 and BC437(c) are deleted.

BCA9 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC185 and the first references to 'IAS 39' in paragraphs BC246, BC256, BC354, BC434A and BC437(c) are footnoted as follows:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA10 The reference to 'IAS 39' in paragraph BC244 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.

BCA11 The first reference to 'available-for-sale securities' in paragraph BC389 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA12 The second reference to 'IAS 39' in paragraph BC185 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, as amended in November 2013, replaced the hedge accounting requirements in IAS 39.

IFRS 4 *Insurance Contracts*

BCA13 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC11(a), the first references to 'IAS 39' in paragraphs BC22(c), BC28(b), BC40, BC41(b), BC47, BC55, BC73(d), BC82 and BC161, the reference to 'available for sale' in paragraph BC145(b) and the heading above paragraph BC166 are deleted.

BCA14 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC11(a), the first references to 'IAS 39' in paragraphs BC21, BC22(c),

BC28(b), BC40, BC55, BC62, BC73(d), BC82, BC117, BC146 and BC154–BC165 and the heading ‘Issues related to IAS 39’ above paragraph BC166 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA15 The references to ‘IAS 39’ in paragraphs BC47 and BC161 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

BCA16 The term ‘available for sale’ in paragraph BC145(b) and the heading ‘Issues related to IAS 39’ above paragraph BC166 are footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA17 The footnotes to the headings above paragraphs DO7, DO9 and DO18 are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

BCA18 The footnote to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC8(b), the first references to ‘IAS 39’ in paragraphs BC13(a) and BC54(b) and the reference to ‘available-for-sale assets’ in paragraph BC58 are deleted.

BCA19 The reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC8(b) and the reference to ‘IAS 39’ in paragraphs BC13(a), BC54(a) and BC81 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

BCA20 The term ‘held-for-trading financial asset’ in paragraph BC54(b) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-for-trading financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

BCA21 The term ‘available-for-sale assets’ in paragraph BC58 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

IFRS 7 *Financial Instruments: Disclosures*

BCA22 In the rubric below the title a third paragraph is added as follows:

In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments, and IFRS 7 was amended accordingly. The text of this Basis for Conclusions has been amended for consistency with those changes.

BCA23 Paragraphs BC14–BC16 are amended to read as follows:

BC14 Paragraph 8 requires entities to disclose financial assets and financial liabilities by the measurement categories in IFRS 9 *Financial Instruments*. The Board concluded that disclosures for each measurement category would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognised.

BC15 The Board also concluded that separate disclosure of the carrying amounts of financial assets and financial liabilities that are designated upon initial recognition as financial assets and financial liabilities at fair value through profit or loss and those mandatorily measured at fair value is useful because such designation is at the discretion of the entity.

Financial assets or financial liabilities at fair value through profit or loss (paragraphs 9–11, B4 and B5)

BC16 IFRS 9 permits entities to designate a non-derivative financial liability as at fair value through profit or loss, if specified conditions are met. If entities do so, they are required to provide the disclosures in paragraphs 10 and 11. The Board’s reasons for these disclosures are set out in the Basis for Conclusions on IFRS 9, paragraphs BCZ5.29–BCZ5.34.

BCA24 The heading above paragraph BC23 is amended to read as follows and paragraph BC23B is added:

Reclassification (paragraphs 12B–12D)

...

BC23B In November 2009 the Board issued the requirements relating to the reclassification of financial assets in IFRS 9 *Financial Instruments* and revised accordingly the disclosure requirements relating to the reclassification of financial assets.

BCA25 Paragraphs BC33 and BC34 are amended to read as follows:

BC33 Paragraph 20(a) requires disclosure of income statement gains and losses by the measurement classifications in IFRS 9 (which complement the balance sheet disclosure requirement described in paragraph BC14). The

Board concluded that the disclosure is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in IFRS 9.

BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities measured at fair value through profit or loss and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities measured at fair value through profit or loss include interest and dividend income (see Appendix B, paragraph B5(e)).

BCA26 Paragraphs BC35A–BC35S and related headings are added as follows:

Other Disclosures—Hedge Accounting

BC35A The Board divided its project to replace IAS 39 into three phases. As the Board completed each phase, it deleted the relevant portions in IAS 39 and replaced it with chapters in IFRS 9. The third phase of the project to replace IAS 39 related to hedge accounting. As a consequence of the decisions the Board made when it replaced the hedge accounting guidance in IAS 39, the Board also considered changes to the disclosure requirements related to hedge accounting contained in IFRS 7.

BC35B During its deliberations, the Board engaged in outreach activities with users of financial statements. This outreach included soliciting views on presentation and disclosures. The Board used the responses received from those outreach activities to develop the proposed hedge accounting disclosures.

BC35C The Board was told that many users did not find the hedge accounting disclosures in financial statements helpful. Many also think that the hedge accounting disclosures that were originally in IFRS 7 did not provide transparency on an entity's hedging activities.

BC35D To provide relevant information that enhances the transparency on an entity's hedging activities, the Board proposes hedge accounting disclosures that meet particular objectives. Clear disclosure objectives allow an entity to apply its judgement when it provides information that is useful and relevant to users of financial statements.

BC35E The following sub-sections set out the Board's considerations regarding the proposed hedge accounting disclosures.

General considerations

Scope of the hedge accounting disclosures

BC35F An entity might enter into a transaction to manage an exposure to a particular risk that might not qualify for hedge accounting (for various reasons), for example, an item that is not eligible to be designated as a hedged item or hedging instrument. Information on such transactions

might enable users to understand why an entity has entered into a transaction and how it manages the particular risk, even though those transactions do not qualify for hedge accounting.

BC35G However, the Board thought that mandating such disclosures would require it to determine the part of an entity's risk management that was relevant for the purpose of this disclosure and then define that part to make the disclosure requirement operational. The Board did not believe that this would be feasible as part of its hedge accounting project as it requires a much wider scope because the disclosures would not depend on the accounting treatment.

BC35H Furthermore, users of financial statements can often obtain information on an entity's hedging activities from information in management reports and sources outside the financial reporting context. That often gives a reasonable overview of why hedge accounting might be difficult to achieve. Consequently, the Board decided not to propose in its exposure draft *Hedge Accounting* disclosures about hedging when hedge accounting does not apply.

BC35I Most respondents to the exposure draft agreed with the Board's proposed scope for hedge accounting disclosures (ie to provide information about risk exposures that an entity hedges and for which hedge accounting is applied). However, some did raise concerns about the potential lack of information that will be available to users of financial statements about those risk exposures an entity hedges but for which hedge accounting is not applied.

BC35J The Board noted that IFRS 7 requires entities to provide qualitative and quantitative disclosure about the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period and how those risks are being managed. The Board believes that, as part of these disclosures, entities would provide information for users of financial statements to understand how it manages risk exposures for which hedge accounting is not applied.

BC35K Consequently, the Board decided to retain the scope of the hedge accounting disclosures as proposed in the exposure draft, that is, to provide information to users of financial statements on exposures that an entity hedges and for which hedge accounting is applied.

Location of disclosures

BC35L The Board decided that all hedge accounting disclosures should be presented in one location within an entity's financial statements. However, if such information is already presented elsewhere the Board decided that, in order to avoid duplication, an entity should be allowed to incorporate that information by cross-reference, which is similar to the approach used by IFRS 7 for some disclosures that can be incorporated by reference. The Board thinks that the information will be more transparent and easier to understand if it is presented in one location within the entity's financial statements.

Disclosures by risk category

BC35M The Board noted that recognition and measurement requirements allow for only a partial reflection of the economic hedging activities in the financial statements, which results in a limitation of an entity's reporting of its hedging activities. Hence, the Board considered that the transparency of an entity's hedging activities could be enhanced by an approach that considers:

- (a) information that provides a clear picture of those risk management activities of an entity that are captured by hedge accounting (this information is not necessarily provided in the primary financial statements); and
- (b) information that is included in the primary financial statements.

BC35N To provide information that is useful to users of financial statements, there should be a clear link between the hedge accounting information that is outside the primary financial statements and the hedge accounting within those. To provide such a link, the Board decided that an entity should provide hedge accounting disclosures by risk category. Consequently, an entity should disclose by risk category:

- (a) information that is not included in the primary financial statements (see paragraphs BC35P–BC35BB); and
- (b) information that is included in the primary financial statements (see paragraphs BC35CC–BC35SS).

BC35O The Board decided not to prescribe the risk categories by which the disclosures need to be disaggregated. In the Board's view an entity should apply judgement and categorise risks on the basis of how it manages its risks through hedging. For example, an entity manages its floating interest rate risk using interest rate swaps (to change it to a fixed interest rate) for some hedging relationships (cash flow hedges), while it also uses cross-currency interest rate swaps to manage both the floating interest rate and foreign exchange risk of other hedging relationships (cash flow hedges). Consequently, the entity would have one risk category for floating interest rate risk and another risk category for foreign exchange risk combined with floating interest rate risk. However, an entity should apply its risk categories consistently throughout all the proposed hedge accounting disclosures.

The risk management strategy

BC35P Users of financial statements need to understand how an entity's risk management strategy is applied. Understanding an entity's risk management strategy for each risk helps users to understand the accounting information disclosed.

BC35Q Consequently, in its exposure draft, the Board proposed that an entity should provide an explanation of its risk management strategy for each category of risk.

BC35R Most respondents to the exposure draft agreed with this proposal. However, some raised concerns that the exposure draft was not clear enough on how much detail should be provided by entities to comply with the disclosure requirement.

BC35S The Board noted that an entity will identify and ultimately describe their risk management strategies based on how it manages risk. Because entities manage risk in different ways, the Board did not think that users of financial statements would necessarily understand an entity's risk management strategy if it required a specific list of information to be disclosed. Instead, the Board decided to add additional guidance on the type of information that should be included in a risk management description.

The amount, timing and uncertainty of future cash flows

BC35T The Board decided that, in order to meet the objectives of hedge accounting disclosures, an entity would have to provide sufficient quantitative information to help users of financial statements understand how its risk management strategy for each particular risk affects the amount, timing and uncertainty of future cash flows. In this context, risk exposure refers only to risks that the entity has decided to hedge and for which hedge accounting is applied.

BC35U Consequently, in its exposure draft, the Board proposed that an entity should provide:

- (a) quantitative information on the risk exposure that the entity manages and the extent to which the entity hedges that exposure; and
- (b) a breakdown of that information for each future period that a hedging relationship (which exists at the reporting date) covers.

BC35V The Board also proposed that an entity should disclose information about the sources of hedge ineffectiveness of hedging relationships for each particular risk category. In the Board's view this would assist users in identifying the reasons for hedge ineffectiveness that is recognised in profit or loss. It would also help users to determine how hedging relationships will affect profit or loss.

BC35W Most respondents disagreed with the Board's proposal to require entities to disclose information on the risk exposure and the hedged rate. They commented that this would result in the disclosure of commercially sensitive information (ie the risk exposure and the hedged rate). They believed that those who do not elect to apply hedge accounting would potentially have an unfair advantage because although they do not have to disclose anything, they could nonetheless gain insight into their competitor's hedge positions. Commercial sensitivity was also of concern to those entities whose competitors are not listed companies or who do not report under IFRSs.

BC35X The Board noted that the proposal in the exposure draft focused on the hedged risk (ie the hedged item). Consequently, it would result in disclosures about forward looking information and the rates at which future transactions are hedged. The Board acknowledged that this would potentially provide competitors with insight into an entity's costing structure. Consequently, the Board decided not to require information to be disclosed about the total risk exposure because of the potential forward looking nature of this information. The Board also decided to change the focus of the proposed disclosure from the hedged item to the hedging instrument. In other words, the disclosure would require information on some of the terms and conditions of the hedging instrument to be provided. The Board believes that this information will still be relevant and useful for users of financial statements in inferring the exposure that an entity is exposed to and what the effects will be on future cash flows as a result of how the entity manages the particular risk.

BC35Y The Board also discussed situations in which an entity uses a 'dynamic' hedging process, ie a situation in which entities assess their overall exposure to a particular risk and then designate hedging relationships for constantly evolving exposures that require frequent discontinuations and restarts of hedging relationships. This is particularly the case for hedges of open portfolios. The Board noted that, because the general hedge accounting model allows hedge accounting for hedges of groups and net positions in relation to closed portfolios, entities need to use a 'dynamic' hedging process for an open portfolio. This means that entities designate hedging relationships for an open portfolio as if it were a closed portfolio for a short period and at the end of that period look at the open portfolio as the next closed portfolio for another short period. The dynamic nature of this process involves frequent discontinuations and restarts of hedging relationships.

BC35Z The Board considered that, in those circumstances, providing information about the terms and conditions of the hedging instruments would not be useful given that the hedging instruments are part of a particular hedging relationship for only a short period at a time and are then designated into a new hedging relationship or left undesignated. In contrast, the disclosure requirement related to the terms and conditions of the hedging instrument was designed to provide information for situations in which an entity hedges a risk that remains broadly the same over the entire hedged period. Consequently, the Board decided to exempt entities from the requirement to disclose the terms and conditions of the hedging instruments in situations in which they use a 'dynamic' hedging process that involves frequent discontinuations and restarts of hedging relationships.

- BC35AA The Board was of the view that it was more important for users to understand why entities use hedge accounting in the context of ‘dynamic’ hedging processes than to provide users with information about the terms and conditions of a hedging instrument that is part of a hedging relationship for only a short period at a time (and the designation of which changes frequently). Consequently, the Board decided that, in such circumstances, an entity should expand its discussion of the risk management strategy by providing the following information about how the entity uses hedge accounting to reflect its risk management strategy:
- (a) information about what the ultimate risk management strategy is (for the dynamic hedging process);
 - (b) a description of how it reflects its risk management strategy by using hedge accounting and designating the particular hedging relationships; and
 - (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic hedging process.
- BC35BB The Board also noted that, because the designated hedging relationships change frequently, the specific relationships at the reporting date might not be representative of the normal volumes during the period. The Board therefore decided to require entities to disclose when the volumes at the reporting date are unrepresentative of normal volumes during the period (similar to the disclosure requirement on sensitivity analyses for market risk in paragraph 42).
- BC35CC One function of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures should therefore increase the transparency of how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the entity’s statement of profit or loss and other comprehensive income and statement of financial position.

The effects of hedge accounting on financial position and performance

- BC35DD To provide information on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the Board proposed disclosures that should be presented in a tabular format that separates the information by risk category and by type of hedge. Providing disclosures in a tabular format allows users to identify clearly the relevant numbers and their effects on the entity's statement of profit or loss and other comprehensive income and statement of financial position.
- BC35EE During the Board's initial outreach, users said that they do not analyse an entity's hedging activities by type of hedging relationship (for example, a cash flow hedge or a fair value hedge). They said that it is more important to understand the risks that the entity manages and the results after hedging. However, to provide information effectively on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (for example, cash flow hedge accounting or fair value hedge accounting). The Board believed that if the proposed table is prepared by risk category and by type of hedge, the table would provide sufficient links between the accounting information and the risk management information.
- BC35FF The Board did not propose prescribing levels of aggregation or disaggregation for the information that should be disclosed in a tabular format. An entity should apply judgement when it determines the appropriate level of aggregation or disaggregation. However, the Board proposed that an entity should consider other disclosure requirements in IFRS 7 when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to take amounts that are disclosed and measured at fair value and make comparisons between the fair value disclosures and the proposed hedge accounting disclosures.

- BC35GG Cash flow hedge accounting requires an entity to defer gains or losses on the hedging instrument in other comprehensive income. The deferred amounts are reflected in the statement of changes in equity in the cash flow hedge reserve. IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. In conformity with its objectives for hedge accounting disclosures, the Board proposed that the reconciliation required by IAS 1 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 other comprehensive income. The Board also proposed that the reconciliation should be by type of risk. The Board considered that such a disclosure would allow users of financial statements to evaluate the effects of hedge accounting on equity and the statement of profit or loss and other comprehensive income.
- BC35HH Many respondents to the exposure draft agreed with the Board's proposal to explain the effects of hedge accounting disclosures using a tabular disclosure format. However, some respondents raised concerns that the proposal seems too prescriptive. Some also commented that they did not think that the tabular disclosure, as proposed, provided a clear enough link between hedged items and hedging instruments for the purpose of explaining hedge ineffectiveness. A few respondents also commented that the disclosures did not allow them to differentiate between financial instruments that have been designated as hedging instruments and those that have not. These respondents believe that it is helpful to understand the purpose and effect of financial instruments if their designation is made clear through disclosures.
- BC35II The Board thinks that providing a tabular disclosure format separated by type of hedge (ie fair value hedges or cash flow hedge), risk category and by risk management strategy provides a sufficient link between the accounting information and the risk management information.
- BC35JJ The Board did not propose any more specific format other than requiring information to be disclosed in a tabular format. The Board thought that entities should have the freedom to present the disclosures that require a tabular format however they feel is best in order to provide users with the most useful information.

- BC35KK While the exposure draft on hedge accounting was open for public comment, the Board issued IFRS 13 *Fair Value Measurement*. As a consequence of issuing that standard, the Board moved the fair value disclosures in IFRS 7 to IFRS 13. To improve the usefulness of the hedge accounting disclosures, the Board decided to require entities to use the same level of aggregation or disaggregation it used for other IFRS 7 or IFRS 13 disclosures related to the same underlying information.
- BC35LL In its redeliberations of the exposure draft, the Board also considered a disclosure that would allow understanding how the hedge ineffectiveness that is recognised in the statement of comprehensive income relates to the changes in the values of the hedging instruments and the hedged items. The Board decided to require disclosure of the change in fair value of the hedging instruments and the change in the value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of comprehensive income. Those are the changes in value during the period (after taking into account the effect of the 'lower of test for cash flow hedges and hedges of a net investment in a foreign operation). This means that the difference between the amount included in the table for hedged items and the amount included in the table for hedging instruments equals the hedge ineffectiveness recognised in the statement of comprehensive income.
- BC35MM The Board also did not think that it was necessary to provide a specific disclosure that indicates which financial instruments have been designated as hedging instruments and which have not. The Board thought that such a disclosure would provide potentially misleading information to users of financial statements. This is because users of financial statements might think that all financial instruments not designated as hedging instruments might be held for speculative purposes. This is not necessarily the case. Entities might hold financial instruments for hedging purposes but may decide not to elect hedge accounting. In addition to this, the Board thought that, because entities need to provide the information that requires a tabular format based on the same level of aggregation or disaggregation as in IFRS 13, users of financial statements should be able to identify the financial instruments not designated as hedging instruments by simply comparing the disclosures with each other. In addition, users should be able to understand how an entity manages the risks it is exposed to as a result of financial instruments using the disclosure requirements in IFRS 7 that are not related to the hedge accounting disclosures.

Time value of options accumulated through other comprehensive income

- BC35NN The Board proposed accounting requirements that involve other comprehensive income for the time value of an option when an entity elects to separate the time value of the option and designate (as the hedging instrument) only its intrinsic value. Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.
- BC35OO The Board noted that IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. Consequently, as a result of IAS 1, an entity would disclose the amounts in relation to the time value of options that would be accumulated in other comprehensive income and the movements in that balance.
- BC35PP However, in its Exposure Draft, the Board proposed that an entity should differentiate between transaction related hedged items and time-period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.
- BC35QQ Most respondents agreed with the Board's proposal and consequently, the Board decided to retain the proposal from its Exposure Draft. However, as a consequence of the Board's decision to also allow an alternative accounting treatment for forward elements and foreign currency basis spreads, the Board also required that for the purpose of the IAS 1, amounts recognised in accumulated other comprehensive income that relate to forward elements and foreign currency basis spreads should be reconciled separately from amounts in relation to time value of options.

Hedging credit risk using credit derivatives

- BC35RR For situations in which entities hedge credit risk using credit derivatives the Board decided to mitigate accounting mismatches in relation to credit derivatives accounted for at fair value through profit or loss by also using fair value through profit or loss accounting for the hedged credit exposure. Consequently, the Board also considered disclosures to provide transparency when entities apply that accounting.

BC35SS The Board considered that the following information would be useful for understanding the accounting in such situations:

- (a) a reconciliation of amounts at the beginning and end of the period for the nominal amount and for the fair value of the credit derivatives;
- (b) the gain or loss recognised in profit or loss as a result of changing the accounting for a credit exposure to fair value through profit or loss; and
- (c) when an entity discontinues fair value through profit or loss accounting for credit exposures, the fair value that becomes the new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

BCA27 Paragraphs BC39 and BC39B–BC39E are amended to read as follows:

BC39 Paragraph 28 requires disclosure about the difference that arises if the transaction price differs from the fair value of a financial instrument that is determined in accordance with paragraph B5.4.8 of IFRS 9. Those disclosures relate to matters addressed in the December 2004 amendment to IAS 39 *Transition and Initial Recognition of Financial Assets and Financial Liabilities*. That amendment does not specify how entities should account for those initial differences in subsequent periods. The disclosures required by paragraph 28 inform users about the amount of gain or loss that will be recognised in profit or loss in future periods. The Board noted that the information required to provide these disclosures would be readily available to the entities affected.

BC39B Because its own fair value measurement project was not yet completed, the Board decided not to propose a fair value hierarchy for measurement but only for disclosures. The fair value hierarchy for disclosures is the same as that in SFAS 157 but uses IFRS language pending completion of the fair value measurement project. Although the implicit fair value hierarchy for measurement in IFRS 9 is different from the fair value hierarchy in SFAS 157, the Board recognised the importance of using a three-level hierarchy for disclosures that is the same as that in SFAS 157.

BC39C The Board noted the following three-level measurement hierarchy implicit in IFRS 9:

- (a) financial instruments quoted in an active market;
- (b) financial instruments whose fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets; and
- (c) financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market

transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data.

BC39D For example, the Board acknowledged that some financial instruments that, for measurement purposes, are considered to have an active market in accordance with paragraphs B5.4.3–B5.4.5 of IFRS 9 might be in Level 2 for disclosure purposes. Also, the application of paragraph B5.4.9 of IFRS 9 might result in no gain or loss being recognised on the initial recognition of a financial instrument that is in Level 2 for disclosure purposes⁴.

BC39E The introduction of the fair value disclosure hierarchy does not affect any measurement or recognition requirements of other standards. In particular, the Board noted that the recognition of gains or losses at inception of a financial instrument (as required by paragraph B5.4.8 of IFRS 9) would not change as a result of the fair value disclosure hierarchy.

BCA28 Paragraph BC73(b) is amended to read as follows:

BC73 The main changes to the proposals in ED 7 are:

- (a) ...
- (b) a requirement has been added for disclosures about the difference between the transaction price at initial recognition (used as fair value in accordance with paragraph B5.4.8 of IFRS 9) and the results of a valuation technique that will be used for subsequent measurement.
- (c) ...

BCA29 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17 and the reference to 'IAS 39' in paragraph BC23A are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.

BCA29A The reference to 'IAS 39' in paragraph BC65A is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

⁴ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence paragraphs B5.4.3–B5.4.5 of IFRS 9 have been deleted and paragraph B5.4.9 of IFRS 9 has been relocated to paragraphs B5.1.2A and B5.2.2A.

IFRS 9 *Financial Instruments* (issued November 2009)

BCA30 Paragraph BC95F and a related heading are added as follows:

Mandatory effective date of IFRS 9—November 2013

BC95F In the light of the feedback it had received on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) published in November 2012, the IASB decided to defer the mandatory effective date of IFRS 9. The IASB decided that it will be able to determine the appropriate mandatory effective date only after it finalises the requirements for impairment and classification and measurement and has considered the lead time that is necessary to implement those new requirements. Consequently, the IASB decided that the mandatory effective date should not be specified in IFRS 9 until the outstanding phases are finalised. However, the IASB confirmed that in the meantime application of IFRS 9 is still permitted.

IFRS 9 *Financial Instruments* (issued October 2010)

BCA31 Paragraph BC7.9F and paragraph BC7.34N and related headings are added as follows:

Mandatory effective date of IFRS 9—November 2013

BC7.9F In the light of the feedback it had received on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (Limited Amendments ED) published in November 2012, the IASB decided to defer the mandatory effective date of IFRS 9. The IASB decided that it will be able to determine the appropriate mandatory effective date only after it finalises the requirements for impairment and classification and measurement and has considered the lead time that is necessary to implement those new requirements. Consequently, the IASB decided that the mandatory effective date should not be specified in IFRS 9 until the outstanding phases are finalised. However, the IASB confirmed that in the meantime application of IFRS 9 is still permitted.

Transition related to the presentation of 'own credit' gains and losses on financial liabilities added to IFRS 9 in November 2013

BC7.34N During the redeliberations of the Limited Amendments ED, the IASB confirmed the proposal in that Exposure Draft that the requirements in relation to gains and losses arising from changes in own credit risk should be made available for early application without applying any other requirements of IFRS 9 at the same time. However, in order to respond to the feedback that the own credit requirements should be made available as soon as possible, the IASB decided to incorporate those requirements into IFRS 9 (2010) and later versions. The IASB also confirmed its previous decision not to incorporate the own credit requirements into IAS 39 because that Standard is being replaced by IFRS 9.

IAS 1 *Presentation of Financial Statements*

BCA32 The footnotes to the references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC38A and to 'IAS 39' in paragraph BC38B are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued.

BCA33 The references to 'available-for-sale' in paragraphs BC49 and BC69 are replaced as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

BCA34 The term 'held-to-maturity investments' in paragraph BC77 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-to-maturity financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

IAS 17 *Leases*

BCA35 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC21 is replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 17 was issued.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

BCA36 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the first reference to 'IAS 39' in paragraph BC3 are footnoted as follows:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 20 was amended in 2008.

IAS 27 *Separate Financial Statements*

BCA37 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC9 is replaced with:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA38 The reference to the term 'available-for-sale' in paragraph BC9 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009, and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA39 In the dissenting opinions on the amendments to IFRS 1 and IAS 27 issued in May 2008 the footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph DO3 is replaced with:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 28 *Investments in Associates and Joint Ventures*

BCA40 The term 'available-for-sale equity instrument' in paragraph BCZ44 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IAS 32 *Financial Instruments: Presentation*

BCA41 After paragraph BC3A a heading and paragraph BC3B are added as follows:

Scope

BC3B In November 2013 the Board amended the scope of IAS 32 so that it conformed to the scope of IAS 39 as amended in November 2013 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).

BCA42 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and to the first reference to 'IAS 39' in paragraph BC26 replaced with:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA43 The footnote to the first reference to 'IAS 39' in paragraph BC25 is replaced with:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. The requirements of paragraph 43 of IAS 39 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9.

BCA44 In the dissenting opinion on the issue of IAS 32 in December 2003, the reference to 'IAS 39' in paragraph DO2 is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 36 *Impairment of Assets*

BCA45 The footnote to the reference to 'IAS 39' in paragraph BCZ15(d) is replaced with:

* The IASB's project to revise IAS 32 and IAS 39 in 2003 resulted in the relocation of the requirements on fair value measurement from IAS 32 to IAS 39. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. In 2011 the IASB's project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.

IAS 39 *Financial Instruments: Recognition and Measurement*

BCA46 The following paragraphs are added to the rubric:

In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of financial assets within the scope of IAS 39 and relocated them to IFRS 9

Financial Instruments. Accordingly, the following were deleted: paragraphs BC13 and BC14, the heading above paragraph BC25 and paragraphs BC25–BC29, paragraph BC70, the heading above paragraph BC104A and paragraphs BC104A–BC104E, the headings above paragraphs BC125, BC127 and BC129 and paragraphs BC125–BC130, the heading above paragraph BC221 and that paragraph and the heading above paragraph BC222 and that paragraph.

In October 2010 the Board relocated to IFRS 9 the requirements of IAS 39 relating to classification and measurement of financial liabilities and derecognition of financial assets and financial liabilities. The Board did not reconsider most of those requirements. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC37–BC79A and BC85–BC104.

BCA47 Paragraphs BC11C, BC11E, BC11F, BC13, BC14, BC25–BC29, BC37–BC104E, BC105–BC107, BC125–BC130, BC221 and BC222 and the headings above BC25, BC37, BC104A, BC105 ('Impairment of investments in equity instruments (paragraph 61)' only), BC221 and BC222 are deleted.

BCA48 Paragraph BC20A is amended to read as follows:

BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on loan commitments from the scope section to the section on subsequent measurement. The purpose of this change was to rationalise the presentation of this material without making substantive changes.

BCA49 The headings above paragraphs BC15, BC21 and BC24 are amended to read as follows:

Loan commitments

Financial guarantee contracts

Contracts to buy or sell a non-financial item

BCA50 Paragraphs BC24A–BC24E are renumbered as paragraphs BC24U–BC24Y. After paragraph BC24 a heading and paragraphs BC24A–BC24T are added as follows:

Accounting for a contract to buy or sell a non-financial item as a derivative

BC24A In the third phase of its project to replace IAS 39, the Board considered replacing the hedge accounting requirements in IAS 39. As part of those deliberations, the Board considered the accounting for executory contracts that gives rise to accounting mismatches in some situations. The Board's decision is discussed in more detail below.

BC24B Contracts accounted for in accordance with IAS 39 include those 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), as if the contracts were financial instruments. In addition, IAS 39 specifies that there are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. For example, a contract is considered to be settleable net in cash

even if it is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash.

- BC24C However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39. The 'own use' scope exception in IAS 39 mostly applies to contracts for commodity purchases or sales.
- BC24D It is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative. Many commodity contracts meet the criteria for net settlement in cash because in many instances commodities are readily convertible to cash. When such a contract is accounted for as a derivative, it is measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the change in the fair value of the commodity contract, that derivative is also measured at fair value with changes in fair value recognised in profit or loss. Because the changes in the fair value of the commodity contract and the derivative are recognised in profit or loss, an entity does not need hedge accounting.
- BC24E However, in situations in which a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sale or purchase contract ('executory contract'). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value arising from a commodity supply contract that is not within the scope of IAS 39, an accounting mismatch is created. This is because the change in the fair value of the derivative is recognised in profit or loss while the change in the fair value of the commodity supply contract is not recognised (unless the contract is onerous).
- BC24F To eliminate this accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as a hedged item in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the fair value changes would offset the changes in the fair value of the derivative instruments (to the extent that those are effective hedges). However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts and some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. That net position as a whole is then managed using derivatives to achieve a net position (after hedging) of nil (or close to nil). The net position is typically monitored, managed and adjusted daily. Because of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil by using

derivatives, an entity would have to adjust the fair value hedge relationships frequently if the entity were to apply hedge accounting.

BC24G The Board noted that in such situations hedge accounting would not be an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Consequently, the Board considered amending the scope of IAS 39 so that it would allow a commodity contract to be accounted for as a derivative in such situations. The Board considered two alternatives for amending the scope of IAS 39:

- (a) allowing an entity to elect to account for commodity contracts as derivatives (ie a free choice); or
- (b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair value-based risk management strategy.

BC24H The Board noted that giving an entity the choice to account for commodity contracts as derivatives would be tantamount to an elective 'own use' scope exception, which would have outcomes that would be similar to the accounting treatment in US generally accepted accounting principles (GAAP). This approach would, in effect, allow an entity to elect the 'own use' scope exception instead of derivative accounting at inception or a later date. Once the entity had elected to apply the scope exception it would not be able to change its election and switch to derivative accounting.

BC24I However, the Board noted that such an approach would not be consistent with the approach in IAS 39 because:

- (a) the accounting treatment in accordance with IAS 39 is dependent on, and reflects, the purpose (ie whether it is for 'own use') for which the contracts to buy or sell non-financial items are entered into and continue to be held for. This is different from a free choice, which would allow, but not require, the accounting treatment to reflect the purpose of the contract.
- (b) in accordance with IAS 39, if similar contracts have been settled net, a contract to buy or sell non-financial items that can be settled net in cash must be accounted for as a derivative. Hence, a free choice would allow an entity to account for a commodity contract as a derivative regardless of whether similar contracts have been settled net in cash.

Consequently, in its Exposure Draft, the Board decided not to propose that entities can elect to account for commodity contracts as derivatives.

BC24J Alternatively, the Board considered applying derivative accounting to commodity contracts if that is in accordance with the entity's underlying business model and how the contracts are managed. Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would consider not only the purpose (based solely on

the actual type of settlement) but also how the contracts are managed. As a result, if an entity's underlying business model changes and the entity no longer manages its commodity contracts on a fair value basis, the contracts would revert to the 'own use' scope exception. This would be consistent with the criteria for using the fair value option for financial instruments (ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis).

BC24K Consequently, the Board proposed that derivative accounting would apply to contracts that would otherwise meet the 'own use' scope exception if that is in accordance with the entity's fair value-based risk management strategy. The Board believed that this approach would faithfully represent the financial position and the performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.

BC24L Most respondents to the Exposure Draft supported the Board's approach of using fair value accounting for resolving the accounting mismatch that arises when a commodity contract that is outside the scope of IAS 39 is hedged with a derivative. Those who supported the proposal thought that it would facilitate a better presentation of the overall economic effects of entering into such hedging transactions.

BC24M However, some respondents were concerned that the proposal would have unintended consequences by creating an accounting mismatch for some entities. They argued that in scenarios in which there are other items that are managed within a fair value-based risk management strategy and those other items are not measured at fair value under IFRSs, applying derivative accounting to 'own use contracts' would introduce (instead of eliminate) an accounting mismatch. For example, in the electricity industry the risk management for some power plants and the related electricity sales is on a fair value basis. If these entities had to apply derivative accounting for customer sales contracts it would create an accounting mismatch. This accounting mismatch would result in artificial profit or loss volatility if the power plant is measured at cost under IAS 16 *Property, Plant and Equipment*. Another example raised by respondents was that of entities risk-managing the own use contracts, inventory and derivatives on a fair value basis. An accounting mismatch would arise if the inventory is measured in accordance with IAS 2 *Inventories* at the lower of cost and net realisable value while the own use contracts are measured at fair value.

BC24N Some respondents also requested that the Board remove the precondition that an entity achieves a nil or close to nil net risk position in order to qualify for accounting for executory contracts as derivatives. They argued that if the condition was not removed it would limit the benefits of the proposal. This is because some entities, while generally seeking to maintain a net risk position close to nil, may sometimes take an open position depending on market conditions. These respondents noted that, from an entity's perspective, whether it takes a position or

manages its exposure close to nil, it is still employing a fair value-based risk management strategy and that the financial statements should reflect the nature of its risk management activities.

BC24O Some also requested that the Board clarify whether the proposal required that a fair value-based risk management strategy is adopted at an entity level or whether the business model can be assessed at a level lower than the entity level. These respondents commented that within an entity, a part of the business may be risk-managed on a fair value basis while other businesses within the entity may be managed differently.

BC24P In the light of the arguments raised by respondents to the Exposure Draft, the Board discussed whether an alternative would be extending the fair value option in IFRS 9 (for situations in which it eliminates or significantly reduces an accounting mismatch) to contracts that meet the 'own use' scope exception. The Board noted that because the fair value option would be an election by the entity, it would address the concerns raised about creating unintended accounting mismatches (see paragraph BC24M) while still providing an efficient solution to the problem that the Board wanted to address through its Exposure Draft.

BC24Q The Board considered that the disadvantage of providing an election (ie different accounting outcomes as the result of the entity's choice) by extending the fair value option in IFRS 9 was outweighed by the benefits of this alternative because:

- (a) it is consistent with the Board's objective to represent more faithfully the financial position and performance of entities that risk-manage an entire business on a fair value basis;
- (b) it provides operational relief for entities that risk-manage an entire business on a dynamic fair value basis (ie it is less onerous than applying hedge accounting); and
- (c) it does not have the unintended consequences of creating an accounting mismatch in some situations.

BC24R The Board also considered whether specific transition requirements were needed for this amendment. Without those, the amendment would, by default, apply retrospectively. However, the Board noted that because the decision to be made at inception of a contract, the transition to the amended scope of IAS 39 would in effect be prospective in that the election would not be available for contracts that already exist on the date on which an entity applies the amendment for the first time.

BC24S The Board considered that this transition would detrimentally affect financial statements because of the co-existence of two different accounting treatments (derivative and executory contract accounting) for similar contracts until all own use contracts that existed on transition would have matured. The Board also noted that this effect may create a practical disincentive that would dissuade entities from making the election for new contracts. This could result in a failure to achieve the benefit of reducing accounting mismatches that the changes were designed to address.

BC24T Consequently, the Board decided to provide entities with an option to elect accounting as at fair value through profit or loss for own use contracts that already exist on the date on which an entity applies the amendment for the first time. The Board decided that that option would apply on an 'all-or-none basis' for all similar contracts in order to prevent selective use of this option for similar contracts. The Board also noted that because these contracts would previously have been outside the scope of IFRS 7, entities would not have measured the fair value of these contracts for measurement or disclosure purposes. Consequently, restating comparatives would be impracticable because it would involve hindsight.

BCA51 The footnotes to the references to 'IAS 39' in paragraphs BC185(d), BC186, BC189(a), BC201(f) and BC203 are deleted. The following footnotes are amended to read as follows and added:

To the reference to 'IAS 39' in paragraph BC12	In November 2009 the Board amended the requirements of IAS 39 relating to the classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 <i>Financial Instruments</i> . In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39. In 2011 the Board's project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.
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To the heading above paragraph BC15	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
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At the end of paragraph BC16	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.
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To the heading above paragraphs BC21 and BC24	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
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	To the reference to 'loans and receivables' in paragraph BC111	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.
	At the end of paragraph BC185(d) and to the references to 'required to be paid' in paragraphs BC186 and BC189(a)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
	To the reference to 'held-to-maturity' in paragraph BC201(f)	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
	At the end of paragraph BC203(b)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
BCA52	The dissenting opinions from the issue of IAS 39 in December 2003, <i>The Fair Value Option</i> in June 2005 and <i>Reclassification of Financial Assets</i> in October 2008 are deleted.	

IAS 40 Investment Property

BCA53	The footnotes to the reference to 'IAS 39 <i>Financial Instruments: Recognition and Measurement</i> ' in paragraph BC8 is replaced with:	
	*	In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 <i>Financial Instruments</i> . IFRS 9 applies to all items within the scope of IAS 39. Paragraph BC8 refers to matters relevant when IAS 40 was issued.
BCA54	The reference to 'IAS 39 <i>Financial Instruments: Recognition and Measurement</i> ' in paragraph B2 and the references to 'IAS 39' in paragraphs B46(b), B54 and B63(d) are footnoted as follows:	
	*	In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 <i>Financial Instruments</i> . IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.
BCA55	The reference to 'IAS 39' in paragraph B35 is replaced with:	
	*	IFRS 9 <i>Financial Instruments</i> , issued in November 2009 and amended in October 2010, eliminated the held-to-maturity category. This paragraph discusses matters relevant when IAS 40 was issued.

BCA56 The footnote to the reference to ‘available-for-sale’ in paragraph B63(a) is replaced with:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA57 In paragraph B67(a)(i) the footnote to ‘IAS 39’ is amended to read as follows:

- * Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. In 2009 paragraph 46 of IAS 39 was deleted by IFRS 9 *Financial Instruments*.

IAS 41 Agriculture

BCA58 The footnotes to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph B48 and to the reference to ‘IAS 39’ in paragraph B54 are replaced with:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 2 Members’ Shares in Co-operative Entities and Similar Instruments

BCA59 In paragraph BC18 the reference to ‘IAS 39’ is footnoted as follows:

- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. Paragraph 49 of IAS 39 was relocated to paragraph 5.4.3 of IFRS 9. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

IFRIC 4 Determining whether an Arrangement contains a Lease

BCA60 The footnote to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC14 is replaced with:

- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

BCA61 The footnotes to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC6 and to the references to ‘IAS 39’ in paragraphs BC20 and BC24 are replaced with:

- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA62 The footnotes to the references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraphs BC11(a) and BC12 are deleted.

BCA63 The first reference to 'IAS 39' in paragraphs BC8(c), BC27 and the heading above paragraph BC11 are footnoted as follows:

- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The term 'available-for-sale financial asset' in paragraph BC11 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the categories of available-for-sale and held-to-maturity financial assets.

IFRIC 10 *Interim Financial Reporting and Impairment*

BCA64 The footnotes to the references to 'IAS 39' in paragraphs BC2 and BC9 are replaced with:

- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 12 *Service Concession Arrangements*

BCA65 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC43(a) is footnoted as follows:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA66 The footnotes to the reference to 'IAS 39' in paragraph BC59 and to the heading above paragraph BC60 are replaced with:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*

BCA67 The reference to IAS 39 in paragraph BC11 is footnoted as follows:

- * IFRS 9 *Financial Instruments*, as amended in November 2013, replaced the hedge accounting requirements in IAS 39. However, the requirements regarding hedges of a net investment in a foreign operation were retained from IAS 39 and relocated to IFRS 9.

IFRIC 17 Distributions of Non-cash Assets to Owners

- BCA68 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22, to the last sentence of paragraph BC28(a), to the reference to 'AG81' in paragraph BC29, to the reference to 'IAS 39' in paragraph BC32 and to the reference to 'available-for-sale' in paragraph BC47(e) are deleted.
- BCA69 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the references to 'IAS 39' in paragraphs BC37 and BC50 are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA70 The reference to 'IAS 39' in paragraph BC28(a) is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, requires all investments in equity instruments to be measured at fair value.
- BCA71 The reference to 'AG81' in paragraph BC29 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, amended paragraphs AG80 and AG81 of IAS 39 so that they apply only to derivatives on unquoted equity instruments. IFRS 9, issued in October 2010, deleted paragraphs AG80 and AG81 of IAS 39. IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 and IFRS 9 refer to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.
- BCA72 The reference to 'IAS 39' in paragraph BC32 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the requirement in IAS 39 for some assets to be measured using a historical cost basis.
- BCA73 The term 'available-for-sale investment' in paragraph BC47(e) is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA74 The reference to 'IAS 39' in paragraph BC47(f) is footnoted as follows:
- * IFRS 9 *Financial Instruments*, as amended in November 2013 replaced the hedge accounting requirements in IAS 39.

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

BCA75 The references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the references to 'IAS 39' in paragraphs BC10, BC20, BC24, BC31 and BC34(c) are footnoted as follows:

- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

SIC Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

BCA76 The rubric '[The original text ... struck through]' is deleted and replaced with the following rubric:

[In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments. To avoid confusion with earlier amendments marked up on the original text to reflect the revision of IAS 39 in 2003 and the subsequent issue of IFRS 4, paragraphs 14 and 15 have been amended for consistency with IFRS 9 as issued in 2010.]

BCA77 Paragraphs 14 and 15 are amended to read as follows:

- 14 When an Entity does not control the assets that will be used to satisfy the lease payment obligations, and is not obligated to pay the lease payments, it does not recognise the assets and lease payment obligations, because the definitions of an asset and a liability have not been met. This is different from the circumstance when an Entity controls the assets, is obligated to pay the lease payments, and then later transfers assets to a third party (including a trust). In that circumstance, the transfer of assets (sometimes called an 'in-substance' defeasance) does not by itself relieve the Entity of its primary obligation, in the absence of legal release. A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs 3.2.1–3.2.23, 3.3.1–3.3.4, B3.2.1–B3.2.17 and B3.3.1–B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an 'underlying') are subject to IAS 39.*
 - * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

Dissenting opinion

Dissent of Patrick Finnegan from the issue in November 2013 of IFRS 9 *Financial Instruments* ('IFRS 9 (2013)')

- DO1 Mr Finnegan dissents from the issue of the amendments to IFRS 9 (2013) due to the addition of the requirements related to hedge accounting (Chapter 6 of IFRS 9).
- DO2 Mr Finnegan dissents because he disagrees with the decision to provide entities with an accounting policy choice between applying the new hedge accounting requirements of IFRS 9 and retaining the existing hedge accounting requirements in IAS 39 until the completion of the project on the accounting for macro hedging. He believes that such an accounting policy choice combined with the existing approach of replacing IAS 39 in phases creates an unacceptable level of complexity and cost for both preparers and users of financial statements when accounting for financial instruments.
- DO3 Mr Finnegan believes that a principal reason for the Board creating an option was to address the concerns of entities who believe that 'proxy hedging' (the use of designations of hedging relationships that do not exactly represent an entity's risk management) would be prohibited under IFRS 9. The Board has made it clear that this is not the case and, therefore, an option to continue to apply the hedge accounting requirements of IAS 39 creates the potential for the misunderstanding and misapplication of the new requirements in IFRS 9.
- DO4 Mr Finnegan is concerned that the duration of the option to apply the new hedge accounting requirements is open-ended because it depends on the Board's ability to complete its project on the accounting for macro hedging. Consequently, the length of time that preparers and users of financial statements would be dealing with a variety of complex alternatives related to the accounting for financial instruments is also open-ended. Mr Finnegan believes that this outcome conflicts with the Board's stated goal of making timely improvements to simplify such accounting.
- DO5 Mr Finnegan believes that the original goal of the Board to replace IAS 39 in phases was sound, given the initial expectation that a new comprehensive Standard would be completed expeditiously. However, the process of completing the three phases dealing with classification and measurement, impairment, and hedge accounting has proved to be thorny because of many complex and interrelated issues as well as its interaction with the project to create a new Standard for insurance contracts. In the light of that experience, Mr Finnegan believes that preparers and users of financial statements are better served by adopting a new IFRS dealing with all three phases simultaneously because it would involve substantially less cost and complexity and provide more useful information for users of financial statements.
- DO6 Mr Finnegan believes that a principal reason for undertaking a fresh examination of the accounting for financial instruments was to achieve converged accounting with US GAAP. The IASB and the FASB are still examining ways of achieving convergence of the accounting for classification and

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measurement as well as impairment. Mr Finnegan believes that when a classification and measurement model is completed, a reporting entity may need to modify its application of the new requirements for hedge accounting, which would create unnecessary costs for such entities and additional complexity for users of financial statements in their analysis and use of financial statements.