AASB Exposure Draft

ED 208
December 2010

Hedge Accounting

Comments to the AASB by 18 February 2011

Australian Government

Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 18 February 2011. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 9 March 2011. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org).

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chairman of the AASB agrees to those submissions being treated as confidential. The latter will only occur if the public interest warrants such treatment.

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This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

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ISSN 1030-5882

AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

Submissions play an important role in the decisions that the AASB will make in regard to a Standard. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 18 February 2011. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

Reduced Disclosure Requirements

AASB 1053 *Application of Tiers of Australian Accounting Standards* establishes a differential reporting framework consisting of two tiers of reporting requirements for preparing general purpose financial statements:

(a) Tier 1: Australian Accounting Standards; and

(b) Tier 2: Australian Accounting Standards – Reduced Disclosure Requirements.

Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 and substantially reduced disclosures corresponding to those requirements.

A separate consultative document will be issued for comment shortly after the issue of this Exposure Draft outlining the AASB's Tier 2 disclosure proposals in respect of this Exposure Draft.

AASB Specific Matters for Comment

The AASB would particularly value comments on the following:

1. whether, overall, the proposals would result in financial statements that would be useful to users;
2. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
   (a) not-for-profit entities; and
   (b) public sector entities;
3. whether there are any implications for GAAP/GFS harmonisation;
4. whether the proposals are in the best interests of the Australian and New Zealand economies; and
5. unless already provided in response to specific matters for comment 1 – 4 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

December 2010

Exposure Draft ED/2010/13

Hedge Accounting

Comments to be received by 9 March 2011

IFRS™

Exposure Draft
HEDGE ACCOUNTING

Comments to be received by 9 March 2011

ED/2010/13

This exposure draft *Hedge Accounting* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IFRS 9 *Financial Instruments*. Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **9 March 2011.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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ISBN for this part: 978-1-907026-96-6
ISBN for complete publication (set of two parts): 978-1-907026-95-9

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Introduction and invitation to comment

Reasons for publishing the exposure draft

IN1 The exposure draft *Hedge Accounting* is the third phase of the International Accounting Standards Board's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The other phases are:

(a) Phase 1: Classification and measurement of financial assets and financial liabilities. In November 2009 the Board issued the chapters of IFRS 9 *Financial Instruments* setting out the requirements for the classification and measurement of financial assets. In October 2010 the Board added to IFRS 9 the requirements for the classification and measurement of financial liabilities.

(b) Phase 2: Amortised cost and impairment. In June 2009 the Board published a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. The Board is redeliberating the proposals in the exposure draft to address the comments received from respondents and suggestions made by a panel of credit and risk experts that the Board set up to consider and advise it on the operational issues arising from an expected cash flow approach and views received through various outreach activities.

IN2 The IASB has published this exposure draft to propose significant changes to the general hedge accounting requirements in IAS 39 in order to provide more useful hedge accounting information. Many users and preparers of financial statements describe hedge accounting today as complex and criticise it for not reflecting an entity's risk management activities nor to what extent those activities are successful in meeting the entity's risk management objectives. Many also find the requirements in IAS 39 excessively rule-based, resulting in arbitrary outcomes.

IN3 The proposals in the exposure draft amount to a comprehensive review of hedge accounting requirements (apart from some portfolio hedge accounting requirements, see paragraph IN7), and the proposals in this exposure draft, if confirmed, would:

(a) align hedge accounting more closely with risk management and hence result in more useful information.

(b) establish a more objective-based approach to hedge accounting.

(c) address inconsistencies and weaknesses in the existing hedge accounting model.

IN4 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. As the Board completes each subsequent phase of its project to replace IAS 39, it deletes the relevant portions of IAS 39 and creates chapters in IFRS 9 that replace the requirements in IAS 39.

Contents of this exposure draft

IN5 This exposure draft proposes requirements in the following areas:

(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.

It also proposes application guidance for the proposed hedge accounting model.

IN6 The Board also proposes an objective for hedge accounting that relates to linking accounting with risk management.

IN7 The Board decided not to address open portfolios or macro hedging as part of this exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross position or a net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship). The Board is continuing to discuss proposals for hedge accounting for open portfolios.

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IN8 For the convenience of the reader, the proposals in this exposure draft are presented as a self-contained proposal rather than as an amendment to IFRS 9. However, any finalised requirements would be included in chapter 6 *Hedge accounting* of IFRS 9, apart from any finalised disclosure requirements, which would be included in IFRS 7 *Financial Instruments: Disclosures.*

Invitation to comment

IN9 The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Comments are most helpful if they:

(a) respond to the questions as stated.

(b) indicate the specific paragraph or paragraphs to which the comments relate.

(c) contain a clear rationale.

(d) describe any alternatives the Board should consider.

IN10 Respondents need not comment on all of the questions and are encouraged to comment on any additional matters. However, the Board is not seeking comments on aspects of IFRS 7, IAS 39 or IFRS 9 not addressed in this exposure draft.

IN11 The Board will consider all comments received in writing by 9 March 2011. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

Objective of hedge accounting (paragraphs 1 and BC11–BC16)

IN12 This exposure draft proposes 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 to manage exposures arising from particular risks that could affect profit or loss. This aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.

IN13 The Board believes that an objective would be helpful in setting the scene for hedge accounting and to lay the foundation for a more principle-based approach. An objective also assists the understanding and interpretation of requirements.

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)

IN14 The exposure draft proposes that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss may be eligible for designation as a hedging instrument.

IN15 The Board believes that extending eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. However, the Board believes that extending eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety, would not give rise to the need to change the measurement basis of the financial instrument. The Board also believes that extending eligibility to these financial instruments would align more closely with the classification model of IFRS 9.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)

IN16 The exposure draft proposes that an aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item.

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IN17 The Board believes that an entity is often economically required to enter into transactions that result in, for example, interest rate risk and foreign currency risk. Even though these two exposures can be managed together at the same time and for the entire term, the Board believes that entities often use different risk management strategies for the interest rate risk and foreign currency risk. The Board believes 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 designation of that aggregated exposure as a hedged item.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)

IN18 The exposure draft proposes that an entity may designate all changes in the cash flows or fair value of an item as the hedged item in a hedging relationship. An entity may also designate as the hedged item something other than the entire fair value change or cash flow variability of an item, ie a component. However, the exposure draft proposes that when an entity designates only changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component) that risk component must be separately identifiable and reliably measurable.

IN19 The Board believes that it is not appropriate to limit the eligibility of risk components for designation as hedged items on the basis of whether the risk component is part of a financial or a non-financial item (as is the case in IAS 39). The Board believes that it is more appropriate to permit the designation of risk components as hedged items if they are separately identifiable and reliably measurable—irrespective of whether the item that includes the risk component is a financial or non-financial item. This would also more closely align hedge accounting with risk management. The determination of appropriate risk components requires an evaluation of the relevant facts and circumstances.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)

IN20 The exposure draft proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.

IN21 Hedging a layer of the nominal amount addresses the fact that there may be a level of uncertainty surrounding the hedged item. The Board believes that designating a percentage component of a nominal amount as the hedged item can give rise to an accounting outcome different from designating a layer component of a nominal amount as a hedged item. If the designation of the component of a nominal amount is not aligned with the risk management strategy of the entity, it might result in less useful information to users of financial statements. In the Board's view there might be circumstances in which it is appropriate to designate as a hedged item a layer component of the nominal amount.

IN22 The Board believes 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 hedge effectiveness would be measured).

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Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree 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? Why or why not? If not, what changes do you recommend and why?

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75–BC90)

IN23 The exposure draft proposes that a hedging relationship should meet the hedge effectiveness requirements as one of the requirements to qualify for hedge accounting. Those qualifying criteria are set out in paragraph 19.

IN24 IAS 39 permits hedge accounting only if a hedge is highly effective, both prospectively and retrospectively. IAS 39 regards a hedge as highly effective if the offset is within the range of 80–125 per cent. The Board proposes to eliminate the 80–125 per cent 'bright line' for testing whether a hedging relationship qualifies for hedge accounting. Instead, the Board believes that an objective-based assessment would enhance the link between hedge accounting and an entity's risk management activities. The proposed hedge effectiveness requirements are that a hedging relationship:

(a) meets the objective of the hedge effectiveness assessment (ie to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and

(b) is expected to achieve other than accidental offsetting.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

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Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)

IN25 The exposure draft proposes that when a hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity should rebalance the hedging relationship so that it meets the objective of the hedge effectiveness assessment again. When an entity expects that a hedging relationship might cease to meet the objective of the hedge effectiveness assessment in the future, it may proactively rebalance the hedging relationship.

IN26 The Board believes that there are instances in which, although the risk management objective remains the same, adjustments are required to the existing hedging relationship to maintain the alignment to risk management policies. The adjustments to the hedged item or hedging instrument do not change the original risk management objective as stated in the documentation supporting the designation. The Board believes that in these circumstances the revised hedging relationship should be accounted for as a continuation of an existing hedge rather than as a discontinuation. The Board calls this adjustment rebalancing.

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

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Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)

IN27 The exposure draft proposes that an entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). This may affect the entire hedging relationship or a part of it.

IN28 The Board believes that hedge accounting should reflect an entity's risk management activities. Therefore, an entity should only discontinue hedge accounting when it no longer reflects the risk management strategy. Consequently, the Board believes that it is inappropriate for an entity to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)

IN29 The exposure draft proposes that for fair value hedges, the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income. The ineffective portion of the gain or loss shall be transferred to profit or loss. In addition, the gain or loss on the hedged item shall be presented as a separate line item in the statement of financial position.

IN30 The Board believes that the proposed accounting treatment:

(a) eliminates the mixed measurement for the hedged item (eg an amount that is amortised cost with a partial fair value adjustment);

(b) avoids volatility in other comprehensive income and equity that some consider artificial;

(c) presents in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges); and

(d) provides information in the statement of comprehensive income about the extent of the offsetting achieved by fair value hedges.

IN31 The Board also discussed linked presentation as an alternative for presenting information in the statement of financial position for fair value hedges. Linked presentation is a way to present information together in the statement of financial position to show how a particular asset and liability are related. Linked presentation is not the same as offsetting. This is because linked presentation displays the gross amounts together in the statement of financial position.

IN32 The Board believes that although 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 a liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (eg only currency risk but not credit risk or interest rate risk). Furthermore, the Board does not believe that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affects only one risk but not all risks. Instead, the Board believes

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that disclosures about hedging would be a better alternative to provide information about the relationship between hedged items and hedging instruments that allows users of financial statements to assess the relevance of the information for their own analysis.

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)

IN33 In IAS 39 the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss. The Board believes that this accounting treatment is not aligned with an entity's risk management activities. The Board noted that the time value of an option is a cost of obtaining protection against unfavourable changes of prices or rates.

IN34 The exposure draft proposes that an entity should distinguish the time value of options by the type of hedged item that the option hedges: a transaction related hedged item or a time period related hedged item.

IN35 The exposure draft proposes specific accounting requirements for the time value of an option when an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in the intrinsic value.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)

Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)

IN36 The exposure draft proposes that a group of items is an eligible hedged item only if:

(a) it consists of items (including components of items) that individually are eligible hedged items;

(b) the items in the group are managed together on a group basis for risk management purposes; and

(c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).

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IN37 An individual hedging approach involves an entity entering into one or more hedging instruments to manage the risk exposure attributable to an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, in a group hedge approach an entity seeks to manage the residual 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. An individual hedge approach and a group hedge approach are similar in concept, and so the Board believes that the requirements for qualifying for hedge accounting should also be similar. Consequently, the exposure draft proposes that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions are retained for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different reporting periods.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)

IN38 The exposure draft proposes that for a hedge of a group of items with offsetting hedged risk positions that affect different line items in the statement of comprehensive income (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss shall be presented in a separate line from those affected by the hedged items.

IN39 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items may affect different income statement line items. Consequently, a cash flow hedge of such a group creates a presentation problem when amounts are reclassified from other comprehensive income to profit or loss. This is because the reclassified amounts would need to be grossed up to offset the hedged items effectively. The Board concluded that if it proposed to adjust (gross up) all the affected line items in the income statement the result would be the recognition of gross (partially offsetting) gains or losses that do not exist. This is not consistent with basic accounting principles. Consequently, the exposure draft proposes that amounts that are reclassified from other

comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. The Board believes that this avoids the problem of distorting gains or losses with amounts that do not exist.

> **Question 12**
>
> Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Disclosures (paragraphs 40–52 and BC183–BC208)

IN40 The exposure draft proposes disclosure requirements that provide information about:

(a) an entity's risk management strategy and how it is applied to manage risk;

(b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

IN41 The exposure draft also proposes that in the reconciliation of accumulated other comprehensive income in accordance with IAS 1 *Financial Statement Presentation,* an entity should provide sufficient detail to allow users to identify related amounts disclosed as part of the information to explain the effects of hedge accounting on the statement of comprehensive income. Furthermore, in the reconciliation of accumulated other comprehensive income, an entity should differentiate amounts recognised regarding the time value of options between transaction related hedged items and time period related hedged items.

IN42 The Board believes that the proposed disclosures provide relevant information that enhances the transparency regarding an entity's hedging activities.

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Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)

IN43 The exposure draft proposes that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting shall apply to contracts that can be settled net in cash that 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.

IN44 The Board believes that hedge accounting does not necessarily provide appropriate accounting for hedging relationships that include commodity contracts. Consequently, the Board proposes to amend the scope of IAS 39 to allow a commodity contract to be accounted for as a derivative in appropriate circumstances. The Board believes that this approach combines the purpose for a contract that can be settled net to buy or sell non-financial items (normally commodities) that are 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 and also how they are managed. This better reflects the contract's effect on the entity's financial performance and provides more useful information.

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Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that 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? Why or why not? If not, what changes do you recommend and why?

Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)

IN45 Many financial institutions use credit derivatives to manage credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer to a third party the risk of credit loss on a loan or a loan commitment. Hedges of credit risk might also reduce the regulatory capital requirement for the loan or loan commitment while allowing the financial institution to retain nominal ownership of the loan and the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's overall lending portfolio.

IN46 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a 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, it is operationally difficult to isolate and measure the changes in fair value that are attributable solely to credit risk for the purpose of hedge accounting.

IN47 The Board considered three possible alternative approaches to hedge accounting when credit derivatives are used to hedge credit risk. Because of the complexities involved, the Board decided not to propose an alternative accounting treatment to account for hedges of credit risk using credit derivatives.

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Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

Effective date and transition (paragraphs 53–55 and BC247–BC254)

IN48 The Board proposes that the proposed requirements for hedge accounting be applied prospectively.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Proposals for hedge accounting

Hedge accounting

1 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 to manage exposures arising from particular risks that could affect profit or loss. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.

2 An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 5–18 and B1–B26. An entity shall account for the gain or loss on the hedging instrument and the hedged item in accordance with paragraphs 20–33. When the hedged item is a group of items an entity shall comply with the additional requirements in paragraphs 34–39.

3 For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities an entity shall apply the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114–AG132 of IAS 39) instead of this [draft] IFRS.

4 Hedge accounting shall not be applied to investments in equity instruments designated as at fair value through other comprehensive income.

Hedging instruments

Qualifying instruments

5 A financial asset or a financial liability measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options (see paragraph B4).

6 For a hedge of foreign currency risk, a financial asset or financial liability may be designated as a hedging instrument provided that it is not designated as at fair value through other comprehensive income (see paragraph 4).

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7 For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.

Designation of hedging instruments

8 A hedging instrument must be designated in its entirety in a hedging relationship. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value (see paragraph 33); and

(b) separating the interest element and the spot price of a forward contract and designating as the hedging instrument only the change in the spot element of a forward contract and not the interest element.

9 A percentage of the nominal amount of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

10 An entity may view in combination and jointly designate as the hedging instrument any combination of the following (including those circumstances when the risk or risks arising from some hedging instruments offset those arising from others):

(a) derivatives or a percentage of their nominal amounts.

(b) non-derivatives or a percentage of their nominal amounts.

11 However, a derivative instrument that combines a written option and a purchased option (eg an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option. Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged items

Qualifying items

12 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be:

(a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, or

(b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations (subject to paragraphs 34–39).

A hedged item can also be a component of these items (see paragraph 18).

13 The hedged item must be reliably measurable.

14 If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

15 An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item (see paragraph B9).

16 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the entity can be designated as hedged items. Hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group.

17 However, as an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. In accordance with IAS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in

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consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of hedged items

18 An entity may designate all changes in the cash flows or fair value of an item as the hedged item in a hedging relationship. An entity may also designate as the hedged item something other than the entire fair value change or cash flow variability of an item, ie a component. An entity may designate the following types of components (including combinations) as hedged items:

(a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that the risk component is separately identifiable and reliably measurable (see paragraphs B13–B18); risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or specified rate (ie a 'one-sided' risk).

(b) one or more selected contractual cash flows.

(c) nominal components, ie a specified part of the amount of an item (as set out in paragraphs B19–B23).

Qualifying criteria for hedge accounting

19 A hedging relationship qualifies for hedge accounting only if all the following criteria are met:

(a) The hedging relationship consists only of eligible hedging instruments and hedged items.

(b) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation includes identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

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(c) The hedging relationship meets the hedge effectiveness requirements (see paragraphs B27–B39). A hedging relationship meets the hedge effectiveness requirements if it:

(i) meets the objective of the hedge effectiveness assessment; and

(ii) is expected to achieve other than accidental offsetting.

Accounting for qualifying hedges

20 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 19 (which include the entity's decision to designate the hedging relationship).

21 There are three types of hedging relationships:

(a) *fair value hedge:* a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

(b) *cash flow hedge:* a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and could affect profit or loss.

(c) *hedge of a net investment in a foreign operation* as defined in IAS 21.

22 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

23 If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity shall rebalance the hedging relationship so that it meets the qualifying criteria again (see paragraphs B46–B60). When an entity expects that a hedging relationship might cease to meet the qualifying criteria of hedge accounting in the future, it may proactively rebalance the hedging relationship.

24 An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging

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instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). This might affect the entire hedging relationship or a part of it.

25 An entity shall apply:

(a) paragraph 28 when it discontinues hedge accounting for a fair value hedge for which the hedged item is (or is a component of) a financial instrument measured at amortised cost; and

(b) paragraph 30 when it discontinues hedge accounting for cash flow hedges.

Fair value hedges

26 While a fair value hedge meets the qualifying criteria in paragraph 19 during the hedged period, the hedge relationship shall be accounted for as follows:

(a) The gain or loss from remeasuring the hedging instrument shall be recognised in other comprehensive income.

(b) The hedging gain or loss on the hedged item shall be recognised and presented as a separate line item in the statement of financial position, and be recognised in other comprehensive income. The separate line item shall be presented next to the line item that includes the hedged asset or liability. The separate line item is presented within assets for those reporting periods for which the hedged item is an asset and within liabilities for those reporting periods for which the hedged item is a liability. Amounts included in these line items shall not remain in the statement of financial position when the assets or liabilities to which they relate are derecognised. When a hedged item is an unrecognised firm commitment (or a component thereof), the subsequent cumulative change in the fair value of the hedged item is recognised as an asset or liability with a corresponding gain or loss recognised in other comprehensive income.

(c) The ineffective portion of the gain or loss from remeasuring the hedging instrument and the hedged item shall be transferred from other comprehensive income to profit or loss.

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27 When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire a non-financial asset or assume a non-financial liability, the initial carrying amount of the non-financial asset or non-financial liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position.

28 The separate line item in the statement of financial position described in paragraph 26(b) shall be amortised to profit or loss if the hedged item is a financial instrument (or a component thereof) measured at amortised cost. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the separate line item ceases to be adjusted for changes in the fair value of the hedged item. The amortisation is based on a recalculated effective interest rate at the date amortisation begins (taking into account the carrying amounts of the separate line item and the financial instrument that it relates to).

Cash flow hedges

29 While a cash flow hedge meets the qualifying criteria in paragraph 19, it shall be accounted for as follows:

(a) The separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the change in the hedged expected future cash flows) from inception of the hedge.

(b) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) Any remaining gain or loss (ie hedge ineffectiveness) is recognised in profit or loss.

(d) The amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

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(i) If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is not a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence it does not affect other comprehensive income.

(ii) For cash flow hedges other than those covered by (i) that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

(iii) However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment (see IAS 1) the amount that is not expected to be recovered.

30 When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 24 and 25) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 29(a) as follows:

(a) If the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur. When the future cash flows occur, paragraph 29(d) applies.

(b) If the hedged future cash flows are no longer expected to occur, that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1). A hedged future cash flow that is no longer highly probable of occurring may still be expected to occur.

Hedges of a net investment in a foreign operation

31 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IAS 21), shall be accounted for similarly to cash flow hedges:

(a) The portion of the gain or loss on the hedging instrument that is determined an effective hedge (see paragraph 29) shall be recognised in other comprehensive income.

(b) The ineffective portion shall be recognised in profit or loss.

32 The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the cash flow hedge reserve shall be reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1) in accordance with paragraphs 48–49 of IAS 21 on the disposal or partial disposal of the foreign operation.

Accounting for the time value of options

33 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option (see paragraph 8(a)), it shall account for the time value of the option as follows (see paragraphs B67–B69):

(a) An entity shall distinguish the time value of options by the type of hedged item that the option hedges:

(i) a transaction related hedged item; or

(ii) a time period related hedged item.

(b) The change in fair value of the time value of an option that hedges a transaction related hedged item shall be recognised in other comprehensive income to the extent that it relates to the hedged item. The cumulative change in fair value arising from the time value of the option that has been accumulated in a separate component of equity (the amount) shall be accounted for as follows:

(i) If the hedged item subsequently results in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied, the entity shall remove the amount from the separate component of equity and include it directly in the initial cost or other carrying amount of the asset or liability.

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This is not a reclassification adjustment (see IAS 1) and hence does not affect other comprehensive income.

(ii) For hedging relationships other than those covered by (i), the amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, when a forecast sale occurs).

(iii) However, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered shall be reclassified into profit or loss as a reclassification adjustment (see IAS 1).

(c) The change in fair value of the time value of an option that hedges a time period related hedged item shall be recognised in other comprehensive income to the extent that is relates to the hedged item and be accumulated in a separate component of equity. The original time value paid to the option writer or seller, to the extent that it relates to the hedged item, shall be amortised on a rational basis over the term of the hedging relationship. Hence, in each period the amortisation amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see IAS 1). However, if hedge accounting is discontinued for the hedging relationship that includes the change in intrinsic value of the option as the hedging instrument, the net amount (ie including cumulative amortisation) that has been accumulated in the separate component of equity shall be immediately reclassified into profit or loss as a reclassification adjustment (see IAS 1).

Hedges of a group of items

Eligibility of a group of items as the hedged item

34 A group of items (including a group of items that constitute a net position, see paragraphs B70–B76) is an eligible hedged item only if:

(a) it consists of items (including components of items) that individually are eligible hedged items;

(b) the items in the group are managed together on a group basis for risk management purposes; and

(c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, affect profit or loss in the same and only in that reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).

Designation of a component of a nominal amount

35 A percentage component of an eligible group of items is an eligible hedged item provided that designation is consistent with the entity's risk management objective.

36 A layer component of an overall group of items (eg a bottom layer) is eligible for hedge accounting only if:

(a) it is separately identifiable and reliably measurable;

(b) the risk management objective is to hedge a layer component;

(c) the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not dependent on which items from the overall group form part of the hedged layer);

(d) for a hedge of existing items (eg an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements regarding the accounting for qualifying hedges); and

(e) the items in the group do not contain prepayment options other than those whose fair value is not affected by the hedged risk.

Presentation

37 For a hedge of a group of items with offsetting hedged risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss shall be presented in a separate line from those affected by the hedged items.

38 For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss on the assets and liabilities shall be recognised in the statement of financial position in accordance with paragraph 26(b). The gain or loss shall be presented on a gross basis next to each line item that includes the related asset or liability.

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Nil net positions

39 When the hedged item is a group that is a nil net position (ie the hedged items among themselves fully offset the risk that is managed on a group basis) an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument provided that:

(a) the hedge is part of a rolling net risk hedge strategy for a hedged position that changes in size over time;

(b) over the life of the rolling net risk hedge strategy eligible hedging instruments will be used to hedge the net risk (ie when the net position is not nil);

(c) hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and

(d) not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes as the accounting would not recognise the offsetting risk position that would otherwise be recognised in a hedge of a net position.

Disclosures

40 Hedge accounting disclosures shall provide information about:

(a) an entity's risk management strategy and how it is applied to manage risk;

(b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

41 An entity shall present the required disclosures in a single note or separate section in its financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

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42 When paragraphs 44–52 require the entity to separate by risk category the information disclosed, the entity shall determine each category of risk on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. An entity shall determine risk categories consistently for all hedge accounting disclosures.

43 To meet the objectives in paragraph 40, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need any additional information to evaluate the quantitative information disclosed. However, when an entity determines the level of aggregation or disaggregation, it shall consider the level of aggregation or disaggregation it uses for other disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.

The risk management strategy

44 An entity shall explain its risk management strategy for each category of risk exposure that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate (for example):

(a) how each risk arises.

(b) how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item.

(c) the extent of risk exposures that the entity manages.

The amount, timing and uncertainty of future cash flows

45 For each category of risk exposure, an entity shall disclose quantitative information to enable users of its financial statements to evaluate the types of risk exposures being managed in each risk category, the extent to which each type of risk exposure is hedged and the effect of the hedging strategy on each type of risk exposure.

46 An entity shall provide a breakdown that discloses, for each subsequent period that the hedging relationship is expected to affect profit or loss, the following:

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(a) the monetary amount or other quantity (eg tonnes, cubic metres) to which the entity is exposed for each particular risk (for hedges of groups of items, an entity shall explain the risk exposure in the context of a group or net position);

(b) the amount or quantity of the risk exposure being hedged; and

(c) in quantitative terms, how hedging changes the exposure (ie the exposure profile after hedging such as the average rate at which the entity has hedged that exposure).

47 For each category of risk, an entity shall disclose a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.

48 If other sources of hedge ineffectiveness emerge in a hedging relationship, an entity shall disclose those sources and explain the resulting hedge ineffectiveness.

The effects of hedge accounting on the primary financial statements

49 An entity shall disclose, in a tabular format, the following amounts related to items designated as hedging instruments separately by category of risk for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):

(a) the carrying amount of the hedging instruments (financial assets separately from financial liabilities); and

(b) the notional amounts or other quantity (eg tonnes or cubic metres) related to the hedging instruments.

50 An entity shall disclose, in a tabular format, the following amounts related to hedged items separately by category of risk for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):

(a) for fair value hedges:

(i) the carrying amount of the accumulated gains or losses on the hedged item presented in a separate line item in the statement of financial position, separating assets from liabilities; and

(ii) the balance remaining in the statement of financial position of any hedges for which hedge accounting has been discontinued.

(b) for cash flow hedges and hedges of a net investment in a foreign operation:

(i) the balance in the cash flow hedge reserve for continuing hedges that will be reclassified when the hedged item affects profit or loss; and

(ii) the balance remaining in the cash flow hedge reserve from any hedges for which hedge accounting has been discontinued.

51 An entity shall disclose, in tabular format, the following amounts separately by category of risk for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):

(a) for fair value, cash flow hedges and hedges of a net investment in a foreign operation:

(i) changes in the value of the hedging instrument recognised in other comprehensive income;

(ii) hedge ineffectiveness recognised in profit or loss;

(iii) a description of the line item(s) in the income statement in which hedge ineffectiveness is included.

(b) for fair value hedges, the change in the value of the hedged item.

(c) for cash flow hedges and hedges of a net investment in a foreign operation:

(i) for hedges of net positions, the hedging gains or losses recognised in a separate line item in the income statement (see paragraph 37);

(ii) the amount reclassified from the cash flow hedge reserve into profit or loss as a reclassification adjustment (see IAS 1) (differentiating between amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss); and

(iii) a description of the line item in the income statement affected by the reclassification adjustment (see IAS 1).

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52 An entity shall provide a reconciliation of accumulated other comprehensive income in accordance with IAS 1, either in the statement of changes in equity or in the notes to the financial statements, that:

(a) allows users of its financial statements to identify the amounts that relate to the disclosures in paragraph 51(a)(i), (c)(i) and (c)(ii);

(b) differentiates between amounts associated with the time value of options that hedge transaction related hedged items and amounts associated with the time value of options that hedge time period related hedged items when an entity accounts for the time value of an option in accordance with paragraph 33 (see paragraphs B67–B69).

Effective date and transition

53 An entity shall apply this [draft] IFRS prospectively for annual periods beginning on or after 1 January 2013 with earlier application permitted. The disclosure requirements of this [draft] IFRS need not be applied in comparative information provided for periods before initial application of the [draft] IFRS. However, the hedge accounting requirements in this [draft] IFRS can be applied only if all existing IFRS 9 requirements are adopted at the same time or have already been adopted.

54 To apply hedge accounting from the date of adoption of this [draft] IFRS, all qualifying criteria must be met as at that date.

55 Hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the criteria of this [draft] IFRS (see paragraph 19) shall be regarded as continuing hedging relationships.

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Appendix A
Defined terms

This appendix is an integral part of the IFRS.

The following terms are defined in Appendix A of IFRS 9, paragraph 11 of IAS 32 or paragraph 9 of IAS 39 and are used in this IFRS with the meaning specified in those IFRSs:

(a) derivative

(b) effective interest method

(c) equity instrument

(d) fair value

(e) financial asset

(f) financial instrument

(g) financial liability

firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
forecast transaction	An uncommitted future transaction that is expected.

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Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

Hedging instruments

Qualifying instruments

B1 Derivatives that are embedded in hybrid contracts but are not separately accounted for cannot be designated as hedging instruments.

B2 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

B3 For hedges of foreign currency risk, an entity may designate as the hedging instrument a foreign currency risk component of a non-derivative financial instrument determined in accordance with IAS 21.

Written options

B4 This [draft] IFRS does not restrict the circumstances in which a derivative may be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

Designation of hedging instruments

B5 For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument, it shall designate the non-derivative financial instrument in its entirety.

B6 A single hedging instrument may be designated as a hedging instrument of more than one type of risk provided that the different risk positions are designated as hedged items.

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Hedged items

Qualifying items

B7 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

B8 An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge. This is because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

B9 Paragraph 15 permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative. When designating such a hedged item an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks). In that case the entity may designate the hedged item on the basis of the aggregated exposure. For example:

(a) An entity may hedge a given quantity of expected coffee purchases in two years against price risk (based on US dollars) using a two-year futures contract for coffee. The expected coffee purchases and the futures contract for coffee in combination can be viewed as a two-year fixed amount US dollar foreign currency risk exposure for risk management purposes (ie like any fixed amount US dollar cash outflow in two years' time).

(b) An entity may hedge the foreign currency risk for the entire term of a 10-year fixed rate debt denominated in a foreign currency. However, the entity requires fixed rate exposure in its functional currency only for a 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' interest rate exposure (if the interest level is such that the entity wants to fix

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interest rates). In such a situation it is common for an entity to 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 domestic currency exposure. This is overlaid with a two-year domestic interest rate swap that—on the basis of the domestic 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 domestic 10-year variable rate debt for risk management purposes.

B10 Paragraph 17 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

B11 If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive income in accordance with paragraph 29 shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Designation of hedged items

B12 A component is a hedged item that is something less than the entire item. Therefore, a component reflects only some of the risks of the item of which it is a part or reflects the risks only to some extent (eg when designating a percentage of an item).

Risk components

B13 To be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or non-financial item and the changes in the cash flows or fair value of the item attributable to changes in that risk component must be reliably measurable.

B14 When identifying what risk components are eligible for designation as a hedged item, an entity assesses such risk components in the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market.

B15 When designating risk components as hedged items, an entity considers whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or cash flows of an item of which they are a part (non-contractually specified risk components). Non-contractually specified risk components can relate to items that are not a contract (eg forecast transactions) or contracts that do not explicitly specify the component (eg a firm commitment that includes only one single price instead of a pricing formula that references different underlyings). For example:

(a) Entity A has a long-term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (eg gas oil, fuel oil, and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Hence, because of the type of pricing formula, Entity A concludes that the gas oil price exposure is separately identifiable. At the same time there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable. Therefore, the gas oil price exposure in the

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supply contract is a risk component that is eligible for designation as a hedged item.

(b) Entity B hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the coverage volume over time. Entity B hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity B uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity B uses gas oil derivatives because they are sufficiently liquid. For time horizons up to 6 months Entity B uses jet fuel contracts. On the basis of its analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances, Entity B concludes that although crude oil and gas oil are not specified in any contractual arrangement there is a relationship between their prices and the jet fuel prices. This relationship results from different refining margins (also known as cracking spreads) that allow the entity to look at the hedging relationship as a 'building block'. Therefore, Entity B is exposed to two different risks: the crude oil price and the refining margins for different types of distillates. Entity B concludes that these are two risk components that are separately identifiable and reliably measurable even though they are not contractually specified. Therefore, Entity B may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil).

B16 When designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. For example, the hedging relationship must meet the hedge effectiveness requirements, including determining a hedge ratio so that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness, and any hedge ineffectiveness must be measured and recognised.

B17 An entity can also designate only 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). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast

commodity purchase. In such a situation, the entity designates only cash flow losses that result from an increase in the price above the specified level. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss.

B18 Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified. A contractually specified inflation component of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation component.

Components of a nominal amount

B19 There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a percentage component of a nominal amount or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.

B20 An example of a percentage component of a nominal amount is 50 per cent of the contractual cash flows of a loan.

B21 A layer component may be specified from a defined, but open, population or from a defined nominal amount. Examples include:

(a) a part of a monetary transaction volume, eg the next FC10[*] cash flows from sales denominated in a foreign currency after the first CU20[*] in March 201X;

(b) a part of a physical volume, eg 50,000 cubic metres of the natural gas stored in location XYZ;

(c) a part of a physical or other transaction volume, eg the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or

(d) a layer of the nominal amount of the hedged item, eg the last CU80 million of a CU100 million firm commitment or the bottom layer

* In this [draft] IFRS monetary amounts are denominated in 'currency units (CU)' and 'foreign currency units (FC)'.

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of CU20 million of a CU100 million fixed rate bond (the defined nominal amount is CU100 million).

B22 If a layer component is designated in a fair value hedge, an entity shall specify it from a defined nominal amount. To comply with the requirements for qualifying fair value hedges, an entity shall remeasure the hedged item for fair value changes (ie remeasure the item for fair value changes attributable to the hedged risk). The change in fair value of the hedged item is recognised as a separate asset or liability. It must be recognised in profit or loss no later than when the item ceases to exist or is transferred and derecognised. Therefore, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal component from which it is defined. For example in paragraph B21(d), the total fixed rate bond must be tracked in order to track the bottom layer of CU20 million.

B23 A layer component of a contract that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.

Relationship between components and the total cash flows of an item

B24 If a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or equal to the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate

(a) a component of the liability equal to the principal amount plus interest at LIBOR; and

(b) a negative residual component.

B25 However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the change in the value of the cash flows of that entire liability (ie principal plus interest at LIBOR minus 100 basis points) that is attributable to changes in LIBOR. The entity would choose a hedge ratio that meets the objective of the hedge effectiveness assessment (see paragraph B29).

B26 If a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. For example, assume that an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates the related LIBOR interest rate risk as the hedged item, the effective yield of the asset based on its then fair value of CU90 would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR component of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie CU90) and the amount repayable on maturity (ie CU100).

Qualifying criteria for hedge accounting

Hedge effectiveness

B27 Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item (eg when the hedged item is a risk component the change in fair value or cash flows of an item attributable to the hedged risk). Hedge ineffectiveness is the extent to which there is no such offset or the changes in the fair value or cash flows of the hedging instrument more than offset those on the hedged item.

B28 When designating a hedging relationship and on an ongoing basis, an entity shall analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates in accordance with paragraph B60 arising from rebalancing a hedging relationship) is the basis for the entity's expectations of hedge ineffectiveness for the hedging relationship.

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Objective and extent of offset

B29 The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness. This means an entity has 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 such that they would produce a biased result. However, this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting.

B30 An entity considers the relationship between the weightings of the hedging instrument and the hedged item (the hedge ratio) when assessing whether the hedging relationship will minimise the expected ineffectiveness. For example, an entity wants to hedge a forecast purchase of 100 tonnes of a commodity of a particular grade in Location A and that commodity usually trades at about 90 per cent of the price for the exchange-traded benchmark grade of the same commodity in Location B. If the entity wants to hedge the forecast purchase of 100 tonnes with exchange-traded forward contracts then a forward contract volume to purchase 90 tonnes of the benchmark grade of the commodity in Location B would be expected to offset best the entity's exposure to changes in the cash flows for the hedged purchase. Hence, a hedge ratio of 1.11:1 would minimise expected hedge effectiveness.

B31 An entity also assesses whether the expected offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is other than accidental by analysing the economic relationship between the hedged item and the hedging instrument. This includes an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. Hence, for example, a statistical correlation between two variables that have no substantive economic relationship would not support a valid expectation of other than accidental offsetting. Another example of a lack of a valid expectation of other than accidental offsetting is when the relationship between the changes in the value of the hedging instrument and the hedged item breaks down. For example, an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, any offsetting between the change in the fair value of the

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hedging instrument and the hedged item's fair value or cash flows might become accidental. This is because the effect of the changes in the credit standing of the counterparty is unrelated to the hedged commodity price risk and affects only the hedging instrument. Hence, that effect might outweigh the effect of changes in the commodity price, which affects both the hedging instrument and the hedged item.

Frequency of assessing whether the hedge effectiveness requirements are met

B32 An entity shall assess at the inception of the hedging relationship and on an ongoing basis whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge ineffectiveness and offsetting and therefore is only forward-looking.

Methods for assessing whether the hedge effectiveness requirements are met

B33 This [draft] IFRS does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements, including determining the hedge ratio. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors the method can be a qualitative or a quantitative assessment.

B34 For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging relationship will probably achieve systematic offset and that the hedge ineffectiveness, if any, would not be expected to produce a biased result. This qualitative assessment might also allow the entity to determine an appropriate hedge ratio (eg 1:1 or as determined by simple ratio calculation) and also support an expectation that that hedge ratio would minimise any hedge ineffectiveness.

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B35 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether the hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.

B36 Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty regarding the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that the hedging relationship is likely to achieve systematic offset and that the hedge ineffectiveness would not be expected to produce a biased result. Similarly, the entity might also need a quantitative assessment to determine an appropriate hedge ratio (eg determined by regression analysis or on the basis of a long-term average ratio between variables) and to support an expectation that that hedge ratio would minimise any hedge ineffectiveness. An entity can use the same or different methods for the different purposes (eg to determine the hedge ratio and to ascertain whether the hedging relationship is expected to achieve other than accidental offsetting).

B37 If there are changes in circumstances that affect hedge effectiveness, an entity might have to change the method for assessing whether a hedging relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness are still captured.

B38 An entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets the hedge effectiveness requirements. This means management information (or analysis) used for decision-making purposes can be used as a basis to assess whether a hedging relationship meets the hedge effectiveness requirements.

B39 An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements including the method or methods used.

Accounting for qualifying hedges

B40 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument arising from changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

B41 An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction in which the future cash flows being hedged are the future interest payments).

B42 A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, in accordance with paragraph 22 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Measurement of hedge ineffectiveness

B43 When measuring hedge ineffectiveness, an entity shall consider the time value of money. Hence, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

B44 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item and would be at the money at the time of designation of the hedging relationship (this is commonly referred to as a 'hypothetical derivative'). This is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach.

B45 The change in the value of the hedged item determined using a hypothetical derivative may also be used for the purpose of assessing whether a hedging relationship meets the hedge effectiveness requirements.

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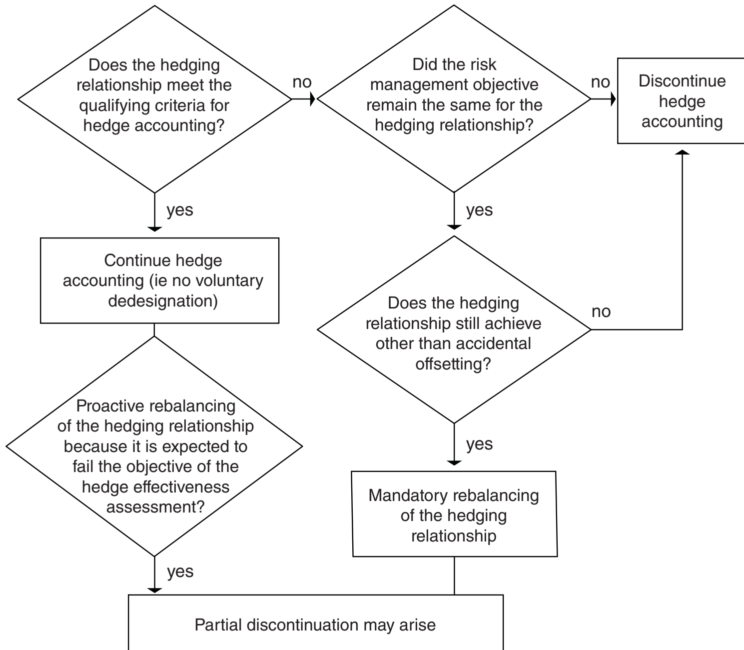
Rebalancing the hedging relationship and changes to the hedge ratio

B46 The following flow chart illustrates the evaluation when a hedging relationship is rebalanced.



B47 If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so, an entity determines whether the risk management objective for that hedging relationship remains unaltered. If so, the hedging relationship is adjusted so that the new hedge ratio again meets, or is no longer expected to cease to meet, the objective of the hedge effectiveness assessment (rebalancing). Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B48–B60. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship.

B48 Adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item arising from their underlyings or risk variables. For example, a hedging relationship in which the hedging instrument and the hedged item have different but related underlyings changes in response to a change in basis risk that affects the relationship between these two underlyings (eg different but related reference indices, rates or prices). Hence, rebalancing allows continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.

B49 For example, an entity hedges an exposure to foreign currency A using a currency derivative that references foreign currency B and currencies A and B are pegged (ie their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the exchange rate between currencies A and B were changed (ie a new band or rate was set) rebalancing the hedging relationship to reflect the new exchange rate would ensure that the hedging relationship meets the objective of the hedge effectiveness assessment in the new circumstances. In contrast, if there were a default on the currency derivative changing the hedge ratio could not ensure that the hedging relationship meets the objective of the hedge effectiveness assessment. Hence, rebalancing does not facilitate continuing a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.

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B50 Not every change in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows constitutes a change in the relationship between the hedging instrument and the hedged item. An entity analyses the sources of hedge ineffectiveness that it expected to affect the hedging relationship during its term and evaluates whether changes in the extent of offset are:

(a) fluctuations around the hedge ratio that remains valid (ie continues to appropriately reflect the relationship between the hedging instrument and the hedged item); or

(b) an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

An entity performs this evaluation against the objective of the hedge effectiveness assessment, ie whether the hedge ratio still ensures that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Hence, this evaluation requires judgement.

B51 Fluctuation around a constant hedge ratio (and hence the related hedge ineffectiveness) cannot be minimised by adjusting the hedge ratio in response to each particular outcome. Hence, in such circumstances, the change in the extent of offset is a matter of measuring and recognising hedge ineffectiveness but not of adjusting the hedge ratio, ie it does not result in rebalancing.

B52 Conversely, if changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio, hedge ineffectiveness can be minimised by adjusting the hedge ratio whereas retaining the hedge ratio would increasingly produce a biased result and hedge ineffectiveness. Hence, in such circumstances, the change in the extent of offset is a matter of adjusting the hedge ratio and therefore requires rebalancing the hedging relationship. In addition, it is also a matter of measuring and recognising hedge ineffectiveness because, on rebalancing, the hedge ineffectiveness of the hedging relationship must be determined and recognised in profit or loss immediately before adjusting the hedging relationship in accordance with paragraph B47.

B53 If the risk management objective for a hedging relationship has changed rebalancing does not apply. Instead, hedge accounting for that hedging relationship shall be discontinued (notwithstanding that an entity might designate a new hedging relationship that involves the hedging instrument or hedged item of the previous hedging relationship as described in paragraph B66).

B54 If a hedging relationship is rebalanced the adjustment of the hedge ratio can be effected in different ways:

(a) The weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:

 (i) increasing the volume of the hedged item; or

 (ii) decreasing the volume of the hedging instrument.

(b) The weighting of the hedging instrument can be increased (which at the same time reduces the weighting of the hedged item) by:

 (i) increasing the volume of the hedging instrument; or

 (ii) decreasing the volume of the hedged item.

Changes in volume refer to the quantities that are part of the hedging relationship. Hence, decreases in volumes do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur but that they are not part of the hedging relationship. For example, decreasing the volume of the hedging instrument can result in the entity retaining a derivative but only part of it might remain a hedging instrument of the hedging relationship. This could occur if the rebalancing could be effected only by reducing the volume of the hedging instrument in the hedging relationship, but the change in the volume is such that it does not allow the entity to unwind the part of the hedging instrument that is no longer needed (eg because of the minimum lot size of a standardised derivative contract). In that case the undesignated part of the derivative would be accounted for at fair value through profit or loss (unless it was designated as a hedging instrument in a different hedging relationship).

B55 Adjusting the hedge ratio by increasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedged item also include the change in the value of the additional volume of the hedged item. These changes are measured

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starting from and by reference to the date of rebalancing rather than the date on which the hedging relationship was designated. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 (the forward price at inception of the hedging relationship) and added a volume of 10 tonnes on rebalancing when the forward price was CU90, the hedged item after rebalancing would comprise two layers: 100 tonnes hedged at CU80 and 10 tonnes hedged at CU90.

B56 Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and reduces that volume by 10 tonnes on rebalancing, a notional amount of 90 tonnes of the hedging instrument volume would remain (see paragraph B54 regarding the consequences for decreasing the derivative volume (ie the 10 tonnes) that is no longer a part of the hedging relationship).

B57 Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedging instrument also include the change in the value of the additional volume of the hedging instrument. The changes are measured starting from and by reference to the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and added a volume of 10 tonnes on rebalancing, the hedging instrument after rebalancing would comprise a total derivative volume of 110 tonnes. The change in the fair value of the hedging instrument is the total change in fair value of the derivatives that make up the total volume of 110 tonnes. These derivatives could (and probably would) have different critical terms, such as their forward rates, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition).

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B58 Adjusting the hedge ratio by decreasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item regarding the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price CU80 and reduces that volume by 10 tonnes on rebalancing, the hedged item after rebalancing would be 90 tonnes hedged at CU80. The 10 tonnes of the hedged item that are no longer part of the hedging relationship would be accounted for in accordance with the requirements for discontinuation of hedge accounting (see paragraphs 23, 24, 30 and B61–B66).

B59 An entity may rebalance a hedging relationship if it aims to ensure that the hedging relationship will continue to meet the objective of the hedge effectiveness assessment (ie the adjustment aims at reducing the likelihood of ceasing to meet the objective in the future). For example, an entity might expect that a hedging relationship will cease to meet the objective of the hedge effectiveness assessment at a future date. The entity observes changes in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows that follow an unusual pattern. The entity considers that the pattern might still reflect fluctuations around the currently used hedge ratio but that it might also signal that a trend is emerging that leads away from the currently used hedge ratio. The entity uses its judgement and decides that although the hedging relationship still meets the objective of the hedge effectiveness assessment adjusting the hedge ratio would reduce the likelihood of ceasing to meet the objective in the medium term. Hence, the entity is permitted to rebalance the hedging relationship.

B60 When rebalancing a hedging relationship, an entity shall update its analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its (remaining) term (see paragraph B28). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of hedge accounting

B61 Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.

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B62 An entity shall not de-designate and thereby discontinue a hedging relationship that:

(a) still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (ie the entity still pursues that risk management objective and strategy); and

(b) continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

B63 The discontinuation of hedge accounting can affect:

(a) a hedging relationship in its entirety; or

(b) a part of a hedging relationship (which means hedge accounting continues for the remainder of the hedging relationship).

B64 A hedging relationship is discontinued in its entirety when as a whole it ceases to meet the qualifying criteria. For example:

(a) The hedging relationship no longer meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective and strategy).

(b) The hedging instrument or instruments have been sold or terminated (regarding the entire volume that was part of the hedging relationship).

(c) The offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is no longer expected to be other than accidental (eg when the hedging instrument experiences a severe credit deterioration).

B65 A part of a hedging relationship is discontinued (and hedge accounting continues for its remainder) when only a part of the hedging relationship ceases to meet the qualifying criteria. For example:

(a) On rebalancing of the hedging relationship, the hedge ratio might be adjusted such that some of the volume of the hedged item is no longer part of the hedging relationship (see paragraph B58); hence, hedge accounting is discontinued only for the volume of the hedged item that is no longer part of the hedging relationship.

(b) When the occurrence of some of the volume of the hedged item that is (or is a component of) a forecast transaction is no longer highly probable, hedge accounting is discontinued only for the volume of the hedged item whose occurrence is no longer highly

probable. However, if an entity has a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur, the entity's ability to predict forecast transactions accurately is called into question when predicting similar forecast transactions. This affects the assessment whether similar forecast transactions are highly probable (see paragraph 14) and hence whether they are eligible as hedged items.

B66 An entity can designate a new hedging relationship that involves the hedging instrument or hedged item of a previous hedging relationship for which hedge accounting was (in part or in its entirety) discontinued. This does not constitute a continuation of a hedging relationship but is a restart. For example:

(a) A hedging instrument experiences such a severe credit deterioration that the entity replaces it with a new hedging instrument. This means the original hedging relationship failed to achieve the risk management objective and is hence discontinued in its entirety. The new hedging instrument is designated as the hedge of the same exposure that was hedged previously and forms a new hedging relationship. Hence, the changes in the fair value or cash flows of the hedged item are measured starting from and by reference to the date of designation of the new hedging relationship instead of the date on which the original hedging relationship was designated.

(b) A hedging relationship is discontinued before the end of its term. The item that was the hedging instrument in that hedging relationship can be designated as the hedging instrument in another hedging relationship (eg when adjusting the hedge ratio on rebalancing by increasing the volume of the hedging instrument or when designating a whole new hedging relationship).

Accounting for the time value of options

B67 An entity shall assess the type of hedged item (see paragraph 33(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

(a) The time value of an option relates to a transaction related hedged item if the nature of the hedged item is that of transaction costs. An example is when the time value of an option relates to a hedged item that results in the recognition of an item whose initial

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measurement includes transaction costs (eg an entity hedges a commodity purchase, whether it is a forecast transaction or a firm commitment, against commodity price risk and includes the transaction costs in the initial measurement of the inventory). Similarly, an entity that hedges a sale of a commodity, whether it is a forecast transaction or a firm commitment, would include the time value of the option as part of the cost related to that sale (hence, the time value would be recognised in profit or loss in the same period as the revenue from the hedged sale).

(b) The time value of an option relates to a time period related hedged item if the nature of the hedged item is that of the cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of transaction cost in accordance with (a). For example, if a commodity inventory is hedged for six months using a commodity option with a corresponding life, the time value of the option would be allocated to profit or loss (ie amortised on a rational basis) over that six-month period.

B68 The accounting for the time value of options in accordance with paragraph 33 applies only to the extent that the time value relates to the hedged item (aligned time value). The time value of an option relates to the hedged item if the critical terms of the option (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the option and the hedged item are not fully aligned an entity shall determine the aligned time value, ie how much of the time value included in the premium paid (actual time value) relates to the hedged item (and therefore should be treated in accordance with paragraph 33). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

B69 If the actual time value and the aligned time value differ an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 33 as follows:

(a) If, at inception of the hedging relationship, the actual time value is higher than the aligned time value the entity shall:

(i) determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and

(ii) account for the differences in the fair value changes between the two time values in profit or loss.

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(b) If, at inception of the hedging relationship, the actual time value is lower than the aligned time value the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:

(i) the actual time value; and

(ii) the aligned time value.

Any remainder of the change in fair value of the actual time value shall be recognised in profit or loss.

Hedge of a group of items

B70 A net position is eligible for hedge accounting only if an entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact (not only of assertion or documentation). Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy. Normally this would be approved by key management personnel as defined in IAS 24 *Related Party Disclosures*.

B71 For example, Entity A, whose functional currency is its local currency has a firm commitment to pay FC150,000 for advertising expenses in nine months' time and a firm commitment to sell finished goods for FC150,000 in 15 months' time. Entity A enters into a foreign currency derivative that settles in nine months' time under which it receives FC100 and pays CU70. Entity A has no other exposures to FC. Entity A does not manage foreign currency risk on a net basis. Hence, Entity A cannot apply hedge accounting for a hedging relationship between the foreign currency derivative and a net position of FC100 (consisting of FC150,000 of the firm purchase commitment—ie advertising services—and FC149,900 (of the FC150,000) of the firm sale commitment) for a nine-month period.

B72 If Entity A did manage foreign currency risk on a net basis and did not enter into the foreign currency derivative (because it increases its foreign currency risk exposure instead of reducing it) then the entity would be in a natural hedged position for nine months. Normally this hedged position would not be reflected in the financial statements because the transactions are recognised in different reporting periods in the future. The nil net position would be eligible for hedge accounting only if the conditions in paragraph 39 are met.

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B73 When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. The entity cannot designate an abstract amount of a net position up to FC20. Instead, it must designate a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position. An entity shall designate gross positions that give rise to the net position so that the entity is able to comply with the requirements for the accounting for qualifying hedges.

Cash flow hedges of groups of items that constitute a net position

B74 When an entity hedges a group of items with offsetting risks (eg a net position) that affect profit or loss in *different* reporting periods, the eligibility for hedge accounting depends on the type of hedge. If the hedge is a fair value hedge then the net position may be eligible as a hedged item. If, however, the hedge is a cash flow hedge then the net position is not eligible as a hedged item.

B75 Offsetting value changes in a group of hedged items in a cash flow hedge will naturally offset in net profit or loss if they are recognised in the same reporting period. If, however, the offsetting risk positions affect profit or loss in different reporting periods, then this natural offset is not achieved. An entity cannot gross up net hedging instrument gains or losses for recognition in different periods, nor can it defer value changes from one hedged item to match the later recognition of another hedged item. As a result, cash flow hedge accounting is not permitted for groups of items with offsetting cash flows that affect profit or loss in different reporting periods.

B76 For example, an entity has a net position of FC50 consisting of forecast sales of FC100 in 12 months' time and forecast purchases of FC150 in 20 months' time. This could be hedged for 12 months using a forward foreign exchange contract under which the entity receives FC50 and pays CU25 (ie a 2:1 forward exchange rate). When the sale is recognised in profit or loss it will be measured at the spot exchange rate in accordance with IAS 21. Reclassifying, into profit or loss when the sale is recognised, any amount of the gain or loss deferred in other comprehensive income from the hedging instrument would exaggerate any variability in profit or loss arising from changes in the exchange rate over the 12-month period. This

is because the entity receives foreign currency in accordance with both the sale and the forward foreign exchange contract. To mitigate the variability arising in profit or loss from the sale, it would be necessary to defer some of the value change on the sale in other comprehensive income to match the later recognition of the purchase. This deferral of value changes is not permitted.

Layers of groups of items designated as the hedged item

B77 For the same reasons noted in paragraph B22, designating layer components of groups of existing items requires the specific identification of the nominal amount of the group of items from which the hedged layer component is defined.

B78 A hedging relationship can include layers from multiple different groups of items. For example, in a net position hedge of a group of assets and a group of liabilities, the hedging relationship can comprise, in combination, a layer component of the group of assets and a layer component of the group of liabilities.

Presentation of hedging instrument gains or losses

B79 If items are hedged together as a group in a cash flow hedge, the items might affect different line items in the income statement. The presentation in the income statement of the hedging instrument gains or losses reclassified from other comprehensive income will depend on the group of items.

B80 If the group of items does not have any offsetting hedged risk positions (eg a group of foreign currency expenses that affect different line items in the income statement, hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment should be done on a rational basis and should not result in the grossing up of the net gains or losses arising from a single hedging instrument.

B81 If the group of items does have offsetting risk positions (eg a group of sales and expenses denominated in a foreign currency hedged together for foreign currency risk) then an entity shall present the reclassified hedging instrument gains or losses in a separate line item in the income statement. For example, consider a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency

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expenses of FC80 using a forward exchange contract for FC20. The gain or loss reclassified from other comprehensive income to profit or loss (when the net position affects profit or loss) shall be presented in a separate line item.

B82 For some types of fair value hedges the objective of the hedge is not primarily to offset the fair value change of the hedged item but rather to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in profit or loss. In case of a net position hedge (eg a net position of a fixed rate asset and a fixed rate liability), this net interest accrual must be presented in a separate line item in the income statement. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising them in different line items (eg this avoids grossing up a net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense).

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Appendix C
[Draft] Amendments to other IFRSs

The amendments [outlined] in this [draft] appendix shall be applied for annual periods beginning on or after January 2013. If an entity applies the [draft] amendments for an earlier period, it shall apply the amendments in this [draft] appendix for that earlier period.

Standard	Description of amendment
• IAS 32 *Financial Instruments: Presentation*	• Amend paragraph 8 of the scope of IAS 32. The amendment would change the scope for a contract that was entered into and continues 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. An entity would account for such a contract as a derivative financial instrument if that accounting is in accordance with the entity's underlying business model and how the contracts are managed. That would be the case for a fair value-based risk management strategy, ie the entire business is managed on a fair value basis and the net exposure is maintained close to nil.
• IAS 39 *Financial Instruments: Recognition and Measurement*	• Retain the hedge requirements in IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk.
	• Amend paragraph 5 of the scope of IAS 39. This would be similar to the amendment proposed for paragraph 8 of IAS 32.
• IFRS 7 *Financial Instruments: Disclosures*	• Delete the disclosure requirements in paragraphs 22, 23(a), 23(c)–(e) and 24.
• IFRS 9 *Financial Instruments*	• Amend references to hedge accounting in IFRS 9 in chapters other than chapter 6 *Hedge accounting* (for example paragraph 5.4.1).

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Approval by the Board of *Hedge Accounting* published in December 2010

The exposure draft *Hedge Accounting* was approved for publication by fourteen of the fifteen members of the International Accounting Standards Board. Mr Smith voted against its publication. His alternative view is set out after the Basis for Conclusions.

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December 2010

Basis for Conclusions and Illustrative Examples
Exposure Draft ED/2010/13

Hedge Accounting

Comments to be received by 9 March 2011

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Exposure Draft
HEDGE ACCOUNTING

Basis for Conclusions and illustrative examples

Comments to be received by 9 March 2011

ED/2010/13

This Basis for Conclusions and illustrative examples accompany the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Hedge Accounting* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **9 March 2011.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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ISBN for this part: 978-1-907026-97-3
ISBN for complete publication (set of two parts): 978-1-907026-95-9

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Basis for Conclusions on the exposure draft *Hedge Accounting*

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

Introduction

BC1 The International Accounting Standards Board has long acknowledged the need to improve the accounting requirements for financial instruments. In the light of the global financial crisis and the urgent need to improve the accounting for financial instruments, the Board proposed to replace IAS 39 *Financial Instruments: Recognition and Measurement* in three phases. The exposure draft *Hedge Accounting* is part of the third phase.

BC2 This Basis for Conclusions summarises the Board's considerations in developing the proposals in the exposure draft. Individual Board members gave greater weight to some factors than to others.

Background

The project to replace IAS 39

BC3 IAS 39 set out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The Board inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.

BC4 Many users of financial statements and other interested parties told the Board that the requirements in IAS 39 were difficult to understand, apply and interpret. They urged the Board to develop a new standard for the reporting of financial instruments that is principle-based and less complex. Although the Board amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it had not previously undertaken a fundamental reconsideration of reporting for financial instruments.

BC5 In April 2009, in response to the input received on its work in responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the Board announced an accelerated timetable for replacing IAS 39.

BC6 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the Board divided its project to replace IAS 39 into three main phases. As the Board completes each phase, it deletes the relevant portions of IAS 39 and creates chapters in IFRS 9 that replace the requirements in IAS 39.

BC7 The exposure draft *Hedge Accounting* is part of the third phase of the Board's project to replace IAS 39. The other phases are:

(a) Phase 1: Classification and measurement of financial assets and financial liabilities. In November 2009 the Board issued the chapters of IFRS 9 setting out requirements for the classification and measurement of financial assets. In October 2010 the Board added to IFRS 9 the requirements for the classification and measurement of financial liabilities.

(b) Phase 2: Amortised cost and impairment. In June 2009 the Board published a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. The Board also set up a panel of credit and risk experts to consider and advise it on the operational issues arising from an expected cash flow approach. The Board is redeliberating the proposals in the exposure draft to address the comments received from respondents, and suggestions from the expert advisory panel and from other outreach activities.

Replacing the hedge accounting requirements in IAS 39

BC8 The Board used the responses to its discussion paper *Reducing Complexity in Reporting Financial Instruments* as a basis for deliberations on the exposure draft *Hedge Accounting.* During its deliberations the Board also approached preparers, auditors and users of financial statements for views on the hedge accounting requirements in IAS 39. The objective of the Board's outreach was to gain insight into how interested parties viewed the hedge accounting requirements in IAS 39 and to obtain information on common practice issues. A particular effort was made to gain an overall understanding of how users view hedging and how an entity's hedging activities affect their analysis and decisions.

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BC9 Users of financial statements told the Board that hedge accounting should be more closely aligned to an entity's risk management activities. Furthermore, the response to the Board's outreach activities indicated that a comprehensive review of hedge accounting was needed. In particular:

(a) *Eligibility of hedged items and hedging instruments*—Many think that the restrictions in IAS 39 of what is eligible for hedge accounting unduly hinders an entity's ability to reflect its risk management practices.

(b) *Groups of items and net positions*—Many think that an entity should be permitted to apply hedge accounting for situations other than a relationship between a single hedging instrument and a single hedged item. For example, they think that an entity should be permitted to apply hedge accounting to groups of items beyond the restrictions in IAS 39 (ie not only in the narrow circumstances in which individual items have fair value changes that are approximately proportional to the overall change for the group), and to hedges of net positions.

(c) *Effectiveness qualification*—Many think that the existing requirements for assessing hedge effectiveness are onerous and result in misleading accounting outcomes because they are too restrictive and based on arbitrary 'bright lines'.

(d) *De-designation and designation*—Some think that IAS 39 impairs comparability because hedge accounting is an option that can be discontinued at will at any time.

(e) *Fair value hedge accounting mechanics*—Some think that the different accounting mechanics in IAS 39 for cash flow hedges and fair value hedges add complexity.

(f) *Presentation and disclosure*—Some think that the current disclosure requirements do not provide sufficient information in the financial statements about an entity's risk management activities and focus too strongly on accounting, which limits their understandability and usefulness.

BC10 The Board expects to complete this and the second phase of the project to replace IAS 39 in the first half of 2011.

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The objective and scope of hedge accounting

The objective of hedge accounting

BC11 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRSs. For example, the hedge accounting guidance in IAS 39 permits:

(a) recognition of items that would otherwise not be recognised (eg a firm commitment);

(b) measurement of an item on a basis that is different from its normally required measurement basis (eg adjusting the measurement of a hedged item in a fair value hedge); and

(c) deferral of the changes in fair value of a hedging instrument for a cash flow hedge in other comprehensive income. These changes in fair value would otherwise have been recognised in profit or loss (eg hedging of a highly probable forecast transaction).

BC12 The Board noted that although hedge accounting was an exception, it was also an indication that in many situations the information that resulted from the normal requirements without applying hedge accounting did not provide useful information or omitted important information. Hence, the Board concluded that hedge accounting should be retained.

BC13 In the Board's view, consistent application of hedge accounting 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).

BC14 During its deliberations the Board 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

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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.

BC15 However, the Board rejected both objectives. The Board 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 Board 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.

BC16 Consequently, the Board decided to use an objective that combines elements of the two objectives. The Board thinks that the proposed objective of hedge accounting reflects 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 provides for a focus on the statement of financial position and the statement of comprehensive income reflecting the effects of the individual assets and liabilities associated with the risk management activities.

Open portfolios

BC17 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 (eg two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to the hedged portfolio and other exposures are removed from it.

BC18 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 de-designation of the previous closed portfolio of items and redesignation of a revised closed portfolio of items). However, this gives rise to complexities regarding tracking, amortisation of hedge adjustments and 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 (eg daily).

BC19 Closed hedged portfolios are hedged portfolios in which items cannot be added to, removed from or substituted within the portfolio without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies the hedged items that form that particular hedging relationship.

BC20 The Board decided not to address open portfolios or 'macro' hedging (ie hedging at the level that aggregates portfolios) as part of the exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross or net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship). See paragraphs BC156–BC182. The Board is continuing to discuss proposals for hedge accounting for open portfolios.

BC21 Consequently, the exposure draft does not propose to replace the requirements in IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk.

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

BC22 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 instruments are not reclassified to profit or loss. However, IAS 39 defines a hedging relationship as one in which the exposure to be hedged could affect profit or loss. Consequently, an entity cannot apply hedge accounting if the hedged exposure affects 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.

BC23 The Board 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, rather than always profit or loss. However, the Board had practical concerns. These related to the matching of 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 Board was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the Board considered alternative approaches.

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BC24 The Board 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 Board's decision in IFRS 9 that 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.

BC25 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.

BC26 The Board decided to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it cannot be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the Board 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).

BC27 The Board noted that dividends from 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).

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Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

BC28 IAS 39 requires the separation of non-closely related derivatives embedded in hybrid financial assets and liabilities (bifurcation). In accordance with IAS 39, the separated derivative is 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.

BC29 In the light of the decision that it made on IFRS 9, the Board considered whether derivatives embedded in financial assets should be eligible for designation as hedging instruments. The Board 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.

BC30 The Board rejected both alternatives. Consequently, the Board proposes 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 BC40). The reasons for the Board's decision are summarised below.

BC31 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 Board noted that the underlying rationale for separating embedded derivatives in IAS 39 is not to reflect risk management activities, but rather to prevent an entity from circumventing the requirements for recognition and measurement of derivatives. Hence, the Board considered that reintroducing the separation of embedded derivatives for hybrid financial assets would not be an appropriate means to address any hedge accounting concerns because this notion does not target hedge accounting considerations.

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BC32 The Board also noted that designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 is not very common in practice. Consequently, the Board did not think it was appropriate to re-create the complexity associated with separating embedded derivatives when all it could achieve was an approach that was neither targeted nor applicable for situations that are not common in practice.

BC33 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 Board 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 regarding non-financial items (eg non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with currency or commodity risk elements). The Board 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 involve a review of other standards and could significantly delay the project.

Non-derivative financial instruments

BC34 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.

BC35 IAS 39 permits non-derivative financial assets and non-derivative financial liabilities (eg 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 is 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 does not require separate, additional requirements for risk components within the hedge accounting model.

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BC36 Not allowing the disaggregation into components of a non-derivative financial instrument 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. Hence, in most scenarios, hedging relationships will not achieve other than accidental offsetting and therefore will fail the qualifying criteria for hedge accounting.

BC37 In the light of this consequence, the Board 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 Board 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 BC33 the Board decided not to explore such an approach.

BC38 The Board also considered two alternatives to the requirements of IAS 39 that limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk. The Board considered whether to extend the eligibility to non-derivative financial instruments classified as at fair value through profit or loss or alternatively other categories of IFRS 9 for hedges of all types of risk (ie not limited to hedges of foreign currency risk).

BC39 The Board 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 and be inconsistent with its decision not to allow the application of hedge accounting to investments in equity instruments designated as at fair value through other comprehensive income (see paragraph BC26).

BC40 However, the Board 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 risk components), would not give rise to the need to change the measurement basis of the financial instrument. The Board also noted that extending the eligibility to these financial instruments would align more closely with the classification model of IFRS 9 and make the new hedge accounting model better able to address hedging strategies that could evolve in the future. Consequently, the Board proposes that those non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments in their entirety (in addition to hedges of foreign currency risk on a risk components basis—see paragraph BC35).

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Internal derivatives as hedging instruments

BC41 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 these two approaches.

BC42 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 is primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align risk management and accounting, the Board considered whether internal derivatives should be eligible for designation as hedging instruments. However, the Board noted that the eligibility of internal derivatives as hedging instruments is not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge is how to make hedge accounting operational for groups of items and net positions.

BC43 The Board noted that 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.

BC44 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 (rather than 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).

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BC45 Consequently, the Board proposes that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting entity (eg 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 means the related requirements in IAS 39 would be retained.

Intragroup monetary items as hedging instruments

BC46 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 can be eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.

BC47 The Board noted that IAS 21 requires the recognition of a gain or loss when translating an intragroup monetary item in the consolidated statement of comprehensive income. Consequently, in the Board'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 Board noted that it does not have a project on foreign currency translation on its agenda. Hence, it decided that it should not address this issue as part of its project on hedge accounting. Consequently, the Board proposes not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).

Hedged items

Qualifying items

Designation of derivatives

BC48 The guidance on implementing IAS 39 states that derivatives can be designated only as hedging instruments, 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 allows 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) do not qualify as hedged items. The implementation guidance accompanying IAS 39 provides the rationale for not permitting derivatives (or aggregated exposures that include a

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derivative) to be designated as hedged items. It states that derivative instruments are 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.

BC49 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 about the prohibition of designating derivatives as hedged items in response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*.

BC50 The Board noted that an entity is sometimes economically required to enter into transactions that result in, for example, interest rate risk and foreign currency risk. While these two exposures can be managed together at the same time and for the entire term, the Board 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 it is common to 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 domestic currency exposure. This is then overlaid with a two-year domestic interest rate swap that—on the basis of the domestic 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 domestic 10-year variable rate debt for risk management purposes.

BC51 Consequently, the Board 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 designation of that aggregated exposure as a hedged item.

Designation of hedged items

Designation of a risk component

BC52 IAS 39 distinguishes the availability of risk components for designation as the hedged item by the type of item that includes the component:

(a) for financial items, an entity can designate a risk component if that risk component is separately identifiable and reliably measurable; however,

(b) for non-financial items, an entity can designate as a risk component only foreign currency risk.

BC53 Risk components of non-financial items, even when they are contractually specified, are not eligible risk components in accordance with IAS 39. 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.

BC54 The hedge accounting model in IAS 39 uses the entire item as the default unit of account and then sets out rules that govern what risk components of that entire item are available for designation in hedging relationships. This has resulted in a misalignment of many risk management strategies and the hedge accounting requirements. The outcome has been that the normal approach for risk management purposes is treated as the exception by the hedge accounting requirements.

BC55 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 Board's outreach activities.

BC56 The Board noted that the conclusion in IAS 39, that permitting risk components of non-financial assets and non-financial liabilities to be eligible for designation as hedged items 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 Board considered whether risk components should be eligible for designation as hedged items when they are:

(a) contractually specified; and

(b) not contractually specified.

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BC57 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 Board also noted that many pricing formulas that use a reference to, for example, benchmark commodity prices are designed in that way to ensure 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).

BC58 However, in many situations risk components are not an explicit part of a fair value or a cash flow. Nonetheless, many hedging strategies involve hedging of components even if they are not contractually specified. There are different rationales 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 (eg because an active market exists for the risk components, but not for the entire item).

(c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (eg because one of the risk components is particularly volatile and therefore it justifies the hedging cost).

BC59 The Board learned from its outreach activities that entities are able to identify and measure with sufficient reliability many risk components (other than foreign currency risk) of non-financial items. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure regarding 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 Board noted that as a result there is no ‘bright line’ to determine eligible risk components of non-financial items.

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BC60 The Board therefore proposes that risk components (both contractually specified and those 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.

Designation of 'one-sided' risk components

BC61 IAS 39 permits 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). For example, an entity might hedge an exposure to a specific type of risk of a financial instrument (eg interest rates) above a predetermined level (eg above 5 per cent) using an interest rate cap. In this situation an entity hedges some parts of a specific type of risk (ie interest exposure above 5 per cent).

BC62 Furthermore, the Board noted that hedging one-sided risk exposures is a common risk management activity. The Board 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 Board proposes to permit the designation of one-sided risk components as hedged items, as in IAS 39, but also decided to reconsider the accounting for the time value of options (see paragraphs BC143–BC155).

Designation of a percentage component of a nominal amount

BC63 The Board noted that components of nominal amounts are typically identifiable (they are some quantifiable nominal part of the total cash flows of the instrument). For example, a percentage component of a known amount, such as 50 per cent of the nominal value 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.

BC64 The Board noted that a percentage component of a nominal amount forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The Board concluded that, if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a percentage component of a nominal amount as a hedged item (as in IAS 39).

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Designation of a layer component of a nominal amount

BC65 IAS 39 requires an entity to identify and document anticipated (ie forecast) transactions 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 permits forecast transactions to be identified as a 'layer' component of a nominal amount. For example, the first 100 barrels of the 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 regarding 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).

BC66 The Board considered whether similar considerations also apply to a hedge of an existing transaction in some situations. For example, a firm commitment might also have uncertainty attached to it:

(a) a contract with an early termination option might be terminated before maturity; or

(b) a contract might be cancelled for breach of contract (ie non-performance).

BC67 Because there is uncertainty for both anticipated transactions and existing transactions, the Board decided not to distinguish between such transactions for the purposes of designating a layer component of a nominal amount.

BC68 The Board noted that designating a percentage component of a nominal amount as the hedged item can give rise to a different accounting outcome when compared with designating a layer component of a nominal amount as a hedged item. If the designation of the component of a nominal amount is not aligned with the risk management strategy of the entity, it might result in profit or loss providing misleading or less useful information to users of financial statements.

BC69 In the Board's view there might be circumstances when it is appropriate to designate a hedged item as a layer component of the nominal. Consequently, the Board proposes to permit the designation of a layer component of a nominal amount as the hedged item (for anticipated and existing transactions). The Board also decided that a layer component of a contract that includes a prepayment option is not 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 Board noted that if the prepayment option's fair

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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 hedge effectiveness would be measured).

Relationship between components and the total cash flows of an item

BC70 IAS 39 allows 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 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).

BC71 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing an 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 where 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) an instrument for all homogeneous groups of transactions that are priced sub-LIBOR. Consequently, such an entity uses instruments that have LIBOR as their underlying.

BC72 Comments received during the Board's outreach activities (see paragraph BC8) showed that some believe that the designation of a risk component that assumes cash flows that would exceed the actual cash flows of the instrument also reflects risk management in situations where the hedged item has a negative spread to the benchmark rate. Those constituents believe that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argue that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.

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BC73 The Board noted that, for risk management purposes, an entity normally does not try to hedge the effective interest rate of the 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 interest rate risk is managed and that the margin is locked over time provided that LIBOR is not below the absolute of the negative spread. This risk management strategy provides offsetting changes regarding the LIBOR-related interest rate risk similar to situations where the spread above LIBOR is zero or positive. However, if LIBOR falls below the absolute of that negative spread it would result in 'negative' interest, or cost of funding inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The Board noted that these outcomes are inconsistent with the economic phenomenon to which they relate.

BC74 To avoid these outcomes, the Board proposes to retain the restriction in IAS 39 regarding the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the Board 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 BC70).

Qualifying criteria for hedge accounting

Effectiveness assessment

BC75 To qualify for hedge accounting in accordance with IAS 39, a hedge must be highly effective, both prospectively and retrospectively. Consequently, an entity must perform two effectiveness assessments for each hedging relationship. The prospective assessment supports the expectation that the hedging relationship will be effective in the future. The retrospective assessment determines that the hedging relationship has been effective in the reporting period. All retrospective effectiveness assessments are required to be performed using quantitative methods. However, IAS 39 does not specify a particular method for testing hedge effectiveness.

BC76 The term 'highly effective' refers to the degree to which the hedging relationship achieves 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. IAS 39 regards a hedge as highly effective if the offset is within the range of 80-125 per cent.

BC77 During its outreach activities (see paragraph BC8), the Board learned that:

(a) many found the hedge effectiveness assessment in IAS 39 arbitrary, onerous and difficult to apply;

(b) as a result, there is often little or no link between hedge accounting and the risk management strategy; and

(c) because hedge accounting is not achieved if the hedge effectiveness is outside the 80-125 per cent range, it makes hedge accounting difficult to understand in the context of the risk management strategy of the entity.

The objective of the hedge effectiveness assessment

BC78 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The Board noted that this has resulted in hedge accounting that is arbitrary and onerous. Furthermore, the arbitrary 'bright line' of 80-125 per cent has disconnected hedge accounting and risk management. Consequently, it makes it difficult to explain the results of hedge accounting to users of financial statements. To address these concerns, the Board decided that it would propose an objective-based model for testing hedge effectiveness instead of the 80-125 per cent bright line in IAS 39.

BC79 During its deliberations, the Board initially considered an objective-based assessment to determine which hedging relationships qualify for hedge accounting. The Board's intention was that the assessment should not be based on a particular level of hedge effectiveness. The Board 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. In the Board's view, the objective of the hedge effectiveness assessment should reflect that hedge accounting is based on the notion of offset.

BC80 In accordance with the Board's initially considered approach, the effectiveness assessment aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment is based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. The Board believes that the proposed approach therefore strengthens the relationship between hedge accounting and risk management practice.

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BC81 However, the Board was concerned that this initially considered approach might not be rigorous enough. This is 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 Board noted that the bright line of 80-125 per cent in IAS 39 created a trade-off when an entity chooses 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 Board noted that the 80-125 per cent range would be eliminated by its proposals. Therefore, the Board decided to extend its initial objective of the effectiveness assessment so that it focuses on the hedge ratio. Consequently, the objective of assessing the effectiveness of a hedging relationship is that the entity designates the hedging relationship so that it gives an unbiased result and minimises expected ineffectiveness.

BC82 The Board noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of basis risk that the entity accepts in order to achieve a cost-effective hedging relationship. Consequently, 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, 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.

Frequency of assessing whether the hedge effectiveness requirements are met

BC83 As a consequence of the Board's proposed hedge effectiveness requirements, the Board considered how frequently an entity should assess whether the hedge effectiveness requirements are met. The Board decided that an entity should perform this assessment at the inception of the hedging relationship. At inception of the hedging relationship, an entity should demonstrate that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness and that the expected offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is other than accidental.

BC84 Furthermore, the Board considered that an entity should assess on an ongoing basis whether the hedge effectiveness requirements are (still) met. This is because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship.

BC85 A further consequence of the proposed hedge effectiveness requirements is that if there are changes in circumstances the hedging relationship might require an adjustment in order to continue to meet the objective of the hedge effectiveness assessment (see paragraphs BC106–BC111). Hence, the Board 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.

Method of assessing hedge effectiveness

BC86 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 Board considered whether the effectiveness of a hedging relationship should be assessed on either a qualitative or a quantitative basis.

BC87 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 regarding the degree of offset and so the effectiveness of the hedge during its term is more difficult to evaluate.

BC88 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 Board believes that in the context of an objective-based effectiveness assessment 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.

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BC89 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 Board believes that a quantitative assessment would be more suitable in such situations.

BC90 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The Board noted that selecting the appropriate tool or technique will depend upon 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 depends on the relevant characteristics of the hedging relationship. Consequently, the Board proposes 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 Board decided not to propose prescribing any specific method of assessing hedge effectiveness.

Accounting for qualifying hedges

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

BC91 The Board considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows (managed on a contractual cash flow basis, as described in IFRS 9). The Board focused on fair value hedges of interest rate risk because other risks (for example, credit risk and foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seems appropriate. More specifically, the Board was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the instrument is managed on a contractual cash flow basis. When an instrument is managed on a contractual cash flow basis, the objective of 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 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 these investments and not in changes in fair value.

BC92 The Board discussed several situations in which a fair value hedge of interest rate risk does not contradict that a financial instrument is managed on a contractual cash flow basis. One example is an entity that seeks to invest in a particular credit quality variable rate asset, but could obtain only a fixed rate asset of the desired credit quality. That entity could create the cash flow profile of a variable rate asset 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 Board noted that the 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 Board considered that a fair value hedge of interest rate risk in itself would not contradict the assertion that a financial instrument is managed on a contractual cash flow basis.

BC93 The Board 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 managed on a contractual cash flow basis. Therefore, the Board proposes that fair value hedge accounting should be available for financial instruments that are managed on a contractual cash flow basis.

Hedge of a foreign currency risk of a firm commitment

BC94 IAS 39 allows an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. The Board considered whether it should continue to allow this choice.

BC95 The Board observed 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 BC119 and BC120). The Board 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).

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BC96 However, the Board also observed 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 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.

BC97 The Board 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.

BC98 Hence, the Board proposes 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.

Measuring the ineffectiveness of a hedging relationship

BC99 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the Board proposes that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).

Time value of money

BC100 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).

BC101 The Board noted that hedging instruments are subject to a measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts compared with the changes in the value of the hedging instrument must also be determined on a present value basis. The Board noted that hedge accounting does not change the measurement of the hedging instrument, but 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 in profit or loss.

BC102 Consequently, the Board proposes that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.

Hypothetical derivatives

BC103 The Board considered the use of a 'hypothetical derivative', which is a derivative that would have critical terms that exactly match those of a hedged item and would be at the money at the time of designation of the hedging relationship. The Board 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.

BC104 The Board 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 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 measure ineffectiveness.

BC105 Hence, the Board proposes 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 Board noted that this notion of a hypothetical derivative means it is one possible way of determining 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.

Rebalancing the hedging relationship

BC106 IAS 39 does not allow adjustments that were not envisaged (documented) at the inception of the hedge to be treated as adjustments to an existing hedging relationship. IAS 39 treats 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 Board 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.

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BC107 The Board noted that there are instances where, although the risk management objective remains the same, there are adjustments to an existing hedging relationship because of changes in circumstances. For example, these adjustments are often required to re-align the hedging relationship with risk management policies in view of the changed circumstances. Hence, these 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 Board considered that in these situations the revised hedging relationship should be accounted for as a continuation of the existing hedging relationship rather than as a discontinuation, which would result in accounting for a new hedging relationship in order to achieve hedge accounting. The Board referred to such adjustments of hedging relationships as rebalancing.

BC108 The Board also considered the ramifications of the new objective-based hedge effectiveness assessment, which aims to ensure that a hedging relationship is designated in such a way that it will produce an unbiased result and minimise expected hedge ineffectiveness. The Board noted that for some changes in circumstances this new hedge effectiveness assessment would create the need for an adjustment to the hedging relationship in order to ensure that the hedge effectiveness assessment would continue to be met. An example is a change in basis risk that changes the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid that the hedging relationship will produce a biased result (which would arise when using the original hedge ratio in the new circumstances).

BC109 The Board concluded that in such situations, if the original risk management objective remains unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the Board proposes that an adjustment to a hedging relationship is treated as a rebalancing when the adjustment changes the hedge ratio in response to the new circumstances and risk management continues to hedge the original exposure using the original hedge cover (including modifications to its volume).

BC110 However, if the adjustment represents an overhaul of the existing hedging relationship, the Board considered that treating the adjustment as a rebalancing would not be appropriate. Instead, the Board 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.

BC111 The Board also considered whether an entity should be allowed to rebalance a hedging relationship voluntarily. An entity might want to rebalance a hedging relationship because it expects that owing to changes in circumstances that relationship might fail to meet the objective of the hedge effectiveness assessment. The Board noted that the proactive use of rebalancing would allow an entity to adjust hedging relationships on a timely basis and at the same time would strengthen the link between hedge accounting and risk management. The Board therefore proposes to permit voluntary rebalancing that aims to ensure that the hedging relationship will continue to qualify for hedge accounting (ie the adjustment aims at reducing the likelihood of failing the qualifying criteria). The Board noted that such a proactive adjustment is consistent with the objective-based hedge effectiveness assessment, particularly regarding the determination of the hedge ratio.

Discontinuation of hedge accounting

BC112 In accordance with IAS 39, an entity must discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria (including when the hedging instrument no longer exists or has been sold). However, in accordance with IAS 39, an entity may also voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).

BC113 The Board noted that entities voluntarily discontinue hedge accounting often because of how the effectiveness assessment in IAS 39 works. For example, entities revoke the designation of a hedging relationship and redesignate 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 will be a better fit). Another example is entities revoking the designation of a hedging relationship because they want 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 basis risk). The hedging relationship is then redesignated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The Board noted that in these situations the hedging relationship is discontinued and then restarted even though the risk management objective of the entity has not changed. In the Board's view these outcomes create a disconnection between the hedge accounting model in IAS 39 and hedging from a risk management perspective.

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BC114 The Board 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 adjustment of the hedge ratio as part of a continuing hedging relationship.

BC115 The Board also noted that sometimes a hedging relationship is 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—the layer). Under IAS 39 this has resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the layer in its entirety. The Board 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 Board decided 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 Board's view, this would more closely align hedge accounting with risk management.

BC116 However, the Board 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 Board decided 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.

BC117 In view of its aim to better link hedge accounting to risk management, the Board also discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship. The Board considered that the choice to revoke the designation of a hedging relationship (and hence discontinue hedge accounting) at will does not result in useful information. The Board noted that this would allow discontinuing hedge

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

BC118 The Board 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 Board noted that this is a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.

Fair value hedges

Accounting for fair value hedges

BC119 The Board 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 remeasuring the hedged item. The Board considered such an approach because it would:

(a) improve the usefulness of the reported information for users. 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

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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.

BC120 However, during its outreach activities the Board received mixed views on that approach. Some supported the approach for the reasons the Board had considered, which was consistent with the feedback received on the discussion paper *Reducing Complexity in Reporting Financial Instruments*. However, some 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). Therefore, 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 where 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.

BC121 In the light of the views received, the Board decided to propose a different approach. The Board proposes to continue to account for fair value hedges differently from cash flow hedges. However, the Board proposes some changes to the presentation and mechanics of fair value hedge accounting:

(a) *Gain or loss on remeasuring the hedging instrument*—IAS 39 requires the gain or loss to be recognised in profit or loss. The Board proposes to require recognising the gain or loss in other comprehensive income.

(b) *Gain or loss on the hedged item*—IAS 39 requires 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 Board proposes 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 is presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).

BC122 The Board noted that the separate line item represents measurement adjustments to the hedged items rather than separate assets or liabilities in their own right. The Board 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 Board noted that this approach is more complex than the approach initially considered, which would have eliminated fair value hedge accounting.

BC123 However, the Board decided to propose these changes because they would:

(a) eliminate the mixed measurement for the hedged item (eg 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.

Linked presentation for fair value hedges

BC124 During its outreach activities, the Board was alerted to the financial reporting effect 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 Board 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

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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).

BC125 That 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 (or asset) and the firm commitment asset (or 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 reduced risk.

BC126 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.

BC127 Moreover, that industry argued that a firm commitment is recognised in the statement of financial position only when fair value hedge accounting is applied. Therefore, 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 these items.

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BC128 The Board 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 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 (eg only currency risk but not credit risk or interest rate risk). Furthermore, the Board 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 Board believes that disclosures about hedging would be a better alternative to provide information that allows users of financial statements to assess the relevance of the information for their own analysis.

BC129 Consequently, the Board decided not to propose the use of linked presentation for the purposes of hedge accounting.

Cash flow hedges

The 'lower of' test

BC130 When a hedge accounting relationship is fully effective, the fair value changes in the hedging instrument perfectly offset the value changes in the hedged item. Hedge ineffectiveness arises when the changes of the hedging instrument exceed that of the hedged item, or when the changes of the hedging instrument are less than those of the hedged item.

BC131 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 these 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 Board noted that this would be conceptually questionable as well as a counter-intuitive outcome.

BC132 IAS 39 requires a 'lower of' test for determining the amounts that are recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensures that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not

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recognised in profit or loss. In contrast, the 'lower of' test does 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.

BC133 The Board 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 Board noted that the two requirements could be aligned by applying the 'lower of' test also to fair value hedges or by eliminating it for cash flow hedges. In the Board's view, aligning the requirements would reduce complexity. However, the Board 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. Hence, the Board proposes that the 'lower of' test is retained for cash flow hedges.

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

BC134 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 permits an entity as 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 is commonly referred to as basis adjustment.

BC135 The Board considered whether to continue to allow this accounting policy choice. The Board noted that if an entity is precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging relationship has ended) and to match them to the period or periods in which the non-financial item that results from the hedged transaction affects profit or loss. The entity would also need to consider whether or not the

remaining amount in other comprehensive income is recoverable in one or more future periods. In contrast, if an entity applies a basis adjustment, the hedging gain or loss is included in the carrying amount of the non-financial item and the hedging gain or loss is automatically recognised in profit or loss in the period in which the related non-financial item affects profit or loss (eg through depreciation expense for items of property, plant and equipment or cost of sales for inventories) and it would also be automatically considered when an entity tests a non-financial asset for impairment. The Board 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).

BC136 The Board acknowledged that there are different views on whether a basis adjustment achieves or impairs comparability. One view is 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 impair comparability.

BC137 The other view is that basis adjustments allow identical assets for which the acquisitions are subject to the same risk to be measured so that they have 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 exchange rate movements. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract thus, in effect, fixing 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.

BC138 The Board 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 BC94–BC98). The Board 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

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hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for these firm commitments is tantamount to a basis adjustment. The Board thought that in this context basis adjustments would also enhance comparability.

BC139 Consequently, the Board decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The Board proposes that when the entity removes the associated gain or loss that was recognised in other comprehensive income in order to include them 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 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. The Board 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 the period in which the non-financial item is recognised (in other comprehensive income); and

(b) then again in the later periods when the non-financial item affects profit or loss (eg through depreciation expense or cost of sales).

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

BC140 The Board 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 Board 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 Board concluded that, on balance, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect on the total period of not using a reclassification adjustment.

Hedges of a net investment in a foreign operation

BC141 The Board decided not to address a hedge of a net investment in a foreign operation as part of the third phase of the project to replace IAS 39. The Board noted that a net investment in a foreign operation is determined and accounted for in accordance with IAS 21. The Board noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similarly to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC47) the Board considered that addressing this type of hedge comprehensively would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements. The Board also noted that IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (issued in July 2008) provided further guidance on that type of hedge accounting. The Board did not think it was appropriate to change the requirements so soon after issuing the Interpretation.

BC142 Consequently, the Board decided to retain the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

Accounting for the time value of options

BC143 IAS 39 allows 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.

BC144 The Board noted that under the IAS 39 hedge accounting model entities typically designate option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option is treated as held for trading and is accounted for as at fair value through profit or loss, which can give rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from risk management. For risk management purposes 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.

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BC145 Against this background, the Board 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 Board noted that the standard-setting debate about accounting for the time value of options has 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 Board concluded that, unless the time value of the option was excluded from the designation as the hedging instrument, hedge ineffectiveness would arise.

BC146 However, the Board 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).

BC147 The Board 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 similarly 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 costs of using this hedging strategy.

BC148 The Board 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 Board noted that under IFRSs some costs of insuring risks are treated as transaction costs that are capitalised into the costs of the insured asset (eg 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 are recognised as expenses over the period for which the entity is insured (eg fire insurance for a building). Hence, the Board 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 think about the issue.

BC149 The Board took the view that, like the distinction of the different types 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 transaction related (eg the forecast purchase of a commodity) or time period related (eg hedging existing commodity inventory regarding commodity price changes). The Board 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 similarly to the requirements for cash flow hedges. In the Board's view, this would best reflect the character of transaction costs (like those capitalised for inventory or property, plant and equipment).

BC150 In contrast, the Board 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 Board considered that the cost of obtaining the protection should be allocated over the relevant period on a rational basis. The Board 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 paid by transferring each period an amount to profit or loss. The Board considered that the amortisation pattern should be determined on a rational basis to reflect principle-based standard-setting best.

BC151 The Board also considered situations when the option used has critical terms (such as the nominal amount, life and underlying) that do not match the hedged item. This raises the following questions:

(a) How much of the time value included in the premium paid 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?

BC152 The Board proposes 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 (eg with the same underlying, maturity and notional amount). The Board 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).

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BC153 The Board noted that the accounting for the time value of the option would need to differentiate 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 Board 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 what reflects costs of hedging. Hence, the Board 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.

BC154 Conversely, the Board 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 Board considered that in this situation, in order to avoid accounting for more 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.

BC155 The Board also considered whether the balances accumulated in other comprehensive income would require an impairment test. The Board 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 Board considered that the part of the option's time value that has not been amortised 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 Board noted that when the hedged item is impaired, the criteria for qualifying hedges are no longer met and hence result in an impairment loss for the remaining unamortised balance of the time value of the option.

Hedges of a group of items

BC156 IAS 39 restricts the application of hedge accounting for groups of items. For example, hedged items that together constitute a net position cannot be designated into a hedging relationship with that net position as the hedged item. Other groups are eligible if the individual items within that group have similar risk characteristics and share the risk exposure that is designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group must be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of these restrictions is that a group will generally qualify only if the hedged items in a group would qualify for hedge accounting for the same hedged risk on an individual basis.

BC157 In response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to hedge account for groups of items, including net positions, has resulted in a hedge accounting model that is 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 Board's outreach activities for its hedge accounting project.

BC158 In practice, most entities hedge their risk exposures using different approaches. These approaches result in hedges of:

(a) individual items;

(b) groups of items that form a gross position; or

(c) groups of (partially) offsetting items that result in a net position.

BC159 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 the risks in the group 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.

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(c) the expediency (cost, practicality etc) of entering 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).

(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.

BC160 The restrictions in IAS 39 prevent 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 (that matures in two years' time). Such an entity cannot designate the net position of sales and expenses as the hedged item. Instead, if it wants to apply hedge accounting it must designate a gross position that best matches its hedging instrument. However, the Board noted there are a number of reasons why this would not give rise to useful information. 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 two-year 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 (eg 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.

BC161 Consequently, the Board proposes that groups of items (including net positions) should be eligible for hedge accounting. However, the Board also proposes to limit the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC168–BC173).

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BC162 The following subsections set out the Board's considerations regarding 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

BC163 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.

BC164 An individual hedge approach and a group hedge approach are similar in concept. Hence, the Board decided that the requirements for qualifying for hedge accounting should also be similar. Consequently, the Board proposes 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 for which the offsetting risk positions affect profit or loss in different reporting periods (see paragraphs BC168–BC173).

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

BC165 As part of the proposals in this exposure draft, the Board proposes that an entity can designate a layer component of a nominal amount (a layer) of a single item in a hedging relationship (see paragraph B21 of the exposure draft). The Board also considered whether it would be appropriate to extend that decision on single items to groups of multiple items and hence allow designating a layer of a group in a hedging relationship.

BC166 The Board decided that the benefits of identifying a layer component of a nominal amount of a group of items are similar to the benefits it considered for layer components of single items (see paragraphs BC65–BC69). However, the Board also noted additional reasons that support the use of components for groups of items:

(a) Uncertainties such as breach (or cancellation) of contracts, or prepayment, can be better modelled when considering a group of items.

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(b) In practice, hedging layers of groups of items (eg a bottom layer) is a common risk management strategy.

(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 fair value hedged and therefore have fair value hedge adjustments attached to them).

BC167 The Board 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 impossible. The Board decided that it is not appropriate to define the cases where the conditions in paragraph 36 of the exposure draft are satisfied because it will depend on the specific facts and circumstances. The Board believes a criteria-based approach would be more operational and appropriate. This would allow hedge accounting to be applied in situations where it is easy to meet the criteria as well as in cases where it is more challenging, but 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.

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

BC168 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred through other comprehensive income to be reclassified later from other comprehensive income to profit or loss when the hedged item affects profit or loss (see paragraphs 29 and 30). For net position hedges, 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 effective part of the cumulative change in value (from the inception of the hedge) of some

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forecast transactions must be deferred through 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 (or used as a basis adjustment) in the later phase when the last hedged item in the net position occurs.

BC169 However, forecast transactions that constitute a hedged net position might affect profit or loss in different accounting periods. For example, sales and unrelated expenditure hedged for foreign currency risk may affect profit or loss in different reporting periods. When the hedged items affect profit or loss in different periods, 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 through other comprehensive income. This is required in order to ensure that the sales recognised in profit or loss are measured at the hedged exchange rate.

BC170 Hence, the Board noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in other comprehensive income of cumulative gains and losses on some forecast transactions from the time they occur until some other forecast transactions occur in later periods. The Board considered that this would be tantamount to measuring the transactions that occur 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 are expected to occur in the future that would have an offsetting gain or loss. When those other transactions occur, their measurement would be adjusted for the amounts deferred in other comprehensive income on forecast transactions that occurred earlier.

BC171 The Board acknowledged that this approach would not result in recognising gains and losses on items that do not yet exist but instead defer gains and losses on some forecast transactions as they occur. However, the Board considered that this approach would be a significant departure from general IFRSs regarding the items that result from the forecast transactions. The Board further considered that this departure would affect the forecast transactions:

(a) that occur in the early phases of the hedging relationship, ie those for which gains and losses are deferred when the transaction occurs; and

(b) those that occur in the later phases of the hedging relationship and are adjusted for the gains or losses deferred on the forecast

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transactions as they occurred in the early phases of the hedging relationship.

BC172 The Board noted that the accounting for the forecast transactions that occur in the later phases of the hedging relationship is comparable to that of forecast transactions that are hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occur in the early phases of the hedging relationship would be more similar to that of a hedging instrument than a hedged item. The Board concluded that this would be a significant departure from general IFRS requirements and the requirements of the hedge accounting model for hedging instruments.

BC173 Consequently, the Board proposes that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting cash flows would affect profit or loss in different periods. The Board noted that when the offsetting cash flows affect profit or loss in the same period those concerns would not apply in the same way as no deferral in other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the Board proposes that such net positions should be eligible as hedged items.

Presentation when the group of items in the net position affects profit or loss in the same period

BC174 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items might affect different income statement line items. Consequently, for a cash flow hedge of such a group, when amounts are reclassified from other comprehensive income to profit or loss that raises the question of how they should be presented. The Board noted that the reclassified amounts would need to be grossed up to offset each of the hedged items individually.

BC175 The Board noted that if it proposed to adjust (gross up) all the affected line items in the income statement it would result in the recognition of gross (partially offsetting) gains or losses that do not exist, and that this would not be consistent with general accounting principles. Consequently, the Board decided not to propose to adjust (gross up) all affected income statement line items.

BC176 Instead, the Board proposes that amounts that are reclassified from other comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. This avoids the problem of distorting gains or losses with amounts that

do not exist. However, the Board acknowledged that this results in additional disaggregation of information in the income statement. This would also result in hedges of net positions being presented differently from hedges of gross positions.

BC177 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 other comprehensive income. Any difference, which is the hedge ineffectiveness, is transferred to profit or loss (see paragraph 28(c)). Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the Board does not believe it is necessary to propose any changes to the fair value hedge accounting mechanics to accommodate net positions. However, in cases where some hedging instrument gains or losses are recognised in profit or loss (eg the net interest accrual on an interest rate swap), those gains or losses should be presented in a separate line when the hedged item is a net position for the same reasons that the Board considered for cash flow hedges in relation to their presentation in the income statement.

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

BC178 The Board considered how an entity that applies net position hedge accounting should identify the hedged item. The Board 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 Board decided 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.

Hedges of a group of items that constitutes a net position resulting in a net position of nil

BC179 When an entity manages and hedges risks on a net basis, the net risk from hedged items may be designated in a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the Board acknowledged that there might be circumstances where by coincidence the net position of hedged items for a particular period is nil.

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BC180 The Board 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.

BC181 However, the Board 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 hedges (with eligible hedging instruments) and applies hedge accounting on a net basis. For example:

(a) in periods where hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument) the transactions would reflect an overall hedged rate or price; whereas

(b) in periods where hedge accounting would not be permitted (because the net position is nil), transactions would be recorded at prevailing spot rates or prices.

BC182 Consequently, the Board proposes that nil net positions should qualify for hedge accounting. However, the Board notes that such situations would be coincidental and hence it expects that nil net positions would be rare in practice.

Disclosures

BC183 The Board considered disclosure requirements in the context of hedging relationships that qualify for hedge accounting. Consequently, if an entity does not apply hedge accounting the proposed hedge accounting disclosures would not apply. When these requirements are finalised, the disclosures will be incorporated into IFRS 7 *Financial Instruments: Disclosures*.

BC184 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.

BC185 The Board was told that many users do not find the hedge accounting disclosures in financial statements helpful. Many also think that the hedge accounting disclosures in IFRS 7 do not provide transparency on an entity's hedging activities.

BC186 To provide relevant information that enhances the transparency on an entity's hedging activities, the Board proposes hedge accounting disclosures that meet particular objectives (see paragraph 40). Clear disclosure objectives allow an entity to apply its judgement when it provides information that is useful and relevant to users of financial statements.

BC187 The following subsections set out the Board's considerations regarding the proposed hedge accounting disclosures.

General considerations

Location of disclosures

BC188 The Board proposes 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.

Disclosures by risk category

BC189 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 included in the primary financial statements.

BC190 To provide information that is useful to users of financial statements, there should be a clear link between the hedge accounting information included in the primary financial statements and the hedge accounting information that is not included in the primary financial statements. To provide such a link, the Board proposes that an entity should provide hedge accounting disclosures by risk category. Consequently, an entity should disclose by risk category:

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(a) information not included in the primary financial statements (see paragraphs BC192–BC196); and

(b) information included in the primary financial statements (see paragraphs BC197–BC204).

BC191 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. However, an entity should apply its risk categories consistently throughout all the proposed hedge accounting disclosures.

The risk management strategy

BC192 Users of financial statements need to understand how an entity's risk management strategy is applied to manage risk. Understanding an entity's risk management strategy for each risk helps users to understand the accounting information disclosed.

BC193 Consequently, the Board proposes that an entity should provide an explanation of its risk management strategy for each category of risk. The risk management strategy disclosure would relate to only those risks that an entity has decided to hedge and for which hedge accounting is applied.

The amount, timing and uncertainty of future cash flows

BC194 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.

BC195 Consequently, the Board proposes that an entity should provide:

(a) quantitative information on the risk exposure 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) is expected to affect profit or loss.

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BC196 The Board also proposes 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 assist users in determining how hedging relationships will affect profit or loss.

The effects of hedge accounting on the primary financial statements

BC197 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 comprehensive income and statement of financial position.

BC198 To provide information on the effects of hedge accounting on the statement of comprehensive income and the statement of financial position, the Board proposes 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 comprehensive income and statement of financial position.

BC199 During the Board's outreach activities, users said that they do not analyse an entity's hedging activities by type of hedging relationship (eg cash flow hedge or 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 comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (eg cash flow hedge accounting or fair value hedge accounting). The Board believes 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.

BC200 The Board does 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 proposes that an entity should consider other disclosure requirements

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(for example, fair value disclosures in IFRS 7) when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to compare amounts that are disclosed and measured at fair value between the fair value disclosures and the proposed hedge accounting disclosures.

BC201 Cash flow hedge accounting requires an entity to defer in other comprehensive income gains or losses on the hedging instrument (see paragraph 31 of the exposure draft). 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 proposes 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 comprehensive income. The Board also proposes 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 comprehensive income.

Time value of options accumulated through other comprehensive income

BC202 The Board proposes 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 (see paragraph 8(a)). Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.

BC203 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.

BC204 However, the Board proposes 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.

Other considerations

BC205 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, it is 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.

BC206 However, the Board thought that mandating such disclosures would require it to determine which part of an entity's risk management was relevant for the purpose of this disclosure and then define this part to make the disclosure requirement operational. The Board did not believe that this was feasible as part of its hedge accounting project but would have a much wider, generic scope.

BC207 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. Hence, the Board decided not to propose disclosures about hedging when hedge accounting does not apply.

Accounting alternatives to hedge accounting

BC208 One of the functions of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for the hedging instrument and the accounting for the hedged item. The Board considered two situations where it could change the recognition and measurement requirements for items, rather than requiring an entity to mitigate the recognition and measurement anomaly through hedge accounting. The Board considered changing the recognition and measurement requirements in the context of:

(a) accounting for a contract for a non-financial item; and

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(b) accounting for hedges of credit risk using credit derivatives.

Accounting for a contract for a non-financial item as a derivative

BC209 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 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 settled 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.

BC210 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.

BC211 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 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 will also be 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.

BC212 However, in situations where a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sales or purchase contract (executory contract). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value or cash flow exposures arising from a commodity supply contract that is not within the scope of IAS 39, it creates an accounting mismatch. 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).

BC213 To eliminate the 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 changes would offset the changes in fair value of the derivative instruments (to the extent that they are effective). 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 within the large volume of contracts 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. 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, an entity would have to adjust the fair value hedge relationship frequently if the entity were to apply hedge accounting.

BC214 The Board noted that in such situations hedge accounting is not an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Hence, 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.

BC215 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. This approach in effect would allow an entity to elect the 'own use' scope exception or derivative accounting at inception or a later date. Once the entity had elected to apply the scope exception it would not be able change its election and switch to derivative accounting.

BC216 However, the Board noted that such an approach would not be consistent with the approach in IAS 39 because:

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(a) the accounting treatment in accordance with IAS 39 is dependent on the purpose (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 not depend on 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, the Board decided not to propose that entities can elect to account for commodity contracts as derivatives.

BC217 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 not consider 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).

BC218 Hence, the Board proposes 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 (see Appendix C regarding amendments to other IFRSs). The Board believes that this approach would faithfully represent the financial position and 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.

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Hedging credit risk using credit derivatives

BC219 Many financial institutions frequently 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 (eg a facility for a particular client) or the bank's overall lending portfolio.

BC220 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a 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, it is operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk.

BC221 Some believe that credit default swap prices are the best measure of the credit risk component of a financial asset. However, the Board noted that using credit default swap pricing to measure the credit risk component of a financial instrument (eg a bond) might be conceptually flawed, at least because of the following structural differences between a credit default swap and a debt instrument:

(a) funding—a credit default swap is a synthetic instrument and does not require funding, whereas a debt instrument is a cash instrument that requires initial cash outlay;

(b) coupon accrual on default—a defaulted debt instrument does not pay the coupon accruals between the last coupon date and the date of default whereas a credit default swap protection buyer pays the accrued premium until the date of default;

(c) counterparty credit risk—a protection buyer of a credit default swap has the risk that the protection seller will default on the credit default swap contract; and

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(d) defined credit event—events that trigger the payout of the credit default swap may not necessarily be a default.

BC222 Other aspects that give rise to differences between the value of a credit default swap and the credit risk inherent in the reference obligation are:

(a) features such as 'cheapest to deliver' options;

(b) differences in liquidity between the credit default swap and debt markets;

(c) the effect of auction processes when credit default swaps are settled as a result of a credit event; and

(d) the interpretation of the 'restructuring' credit event (and any related uncertainty about that interpretation).

BC223 When the requirements for hedge accounting are not met, IFRS 9 and IAS 39 permit an entity to designate as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of the 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 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 to instruments that are within the scope of IAS 39. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37 rather than IAS 39. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of its restrictions and scope.

BC224 As a result, financial institutions that use credit default swaps to hedge 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 IAS 39). The changes in fair value of the credit default swaps are recognised in profit or loss every period (as for a trading book). The accounting outcome is a '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 Board's outreach programme, many users pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.

BC225 In the exposure draft, the Board proposes that a risk component should be separately identifiable and reliably measurable (see paragraph 18) 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 hedge accounting for hedges of credit risk, a different hedge accounting requirement specifically for this type of risk component would have to be developed, or the proposed hedge accounting requirements would have to be significantly modified (eg in relation to eligible hedged items and effectiveness testing).

BC226 The Board considered three alternative approaches to address situations in which credit risk is hedged by credit derivatives. These alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (eg 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 fair value is recognised immediately in profit or loss);

(ii) to designate a component of nominal amounts; and

(iii) to discontinue of 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 fair value is amortised or deferred);

(ii) to designate a component of nominal amounts; and

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(iii) to discontinue fair value through profit or loss accounting.

BC227 The fair value through profit or loss election would be available for a financial instrument that is managed in such a way that an economic relationship with credit derivatives on the basis of the same credit risk exists that causes offsetting changes in fair value of the financial instrument and the credit derivatives. However, this would also apply to loan commitments that fall outside the scope of IAS 39 and IFRS 9 if additional qualification criteria are met. The Board considered the following qualifying criteria for electing fair value through profit or loss:

(a) a clearly defined set of links between the financial instrument and the credit derivative can be established through matching of the name (ie the borrower or holder of the loan commitment matches the reference entity of the credit derivative); and

(b) the seniority (ie the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative).

BC228 The qualification criteria above 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 measured. The qualification criteria above are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions.

BC229 For discontinuation, the Board considered the following criteria:

(a) an accounting mismatch no longer exists because the credit derivative expires or is sold, terminated or settled; or

(b) the credit exposure of the financial instrument is no longer managed on a fair value basis using credit derivatives because of, for example:

(i) improvements in the credit quality of the borrower; or

(ii) changes to capital requirements imposed on the financial institution.

BC230 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 above are met, because that would ensure alignment with how the exposure is managed (ie the credit risk is no longer managed on a fair value basis). The Board noted that in the

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 Board considered it would be logical to make discontinuation of fair value through profit or loss mandatory (rather than optional) if the discontinuation criteria are fulfilled.

BC231 Alternative 1 permits electing fair value through profit or loss for a part of the nominal amount of the financial instrument (nominal component) 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 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 measurement and recognition criteria of IAS 37 would apply.

BC232 Alternative 1 permits an election for a nominal component. The Board noted that when IAS 39 was issued there were concerns that allowing the designation of a component of nominal amounts could provide an incentive for earnings management. This was the reason why IAS 39 prohibits the designation of such a component. However, the Board noted that:

(a) for the purpose of hedging credit risk, the business model is about holding the loan (or loan commitment). This is because:

  (i) investment-grade bank loans are largely illiquid instruments and are therefore not frequently sold.

  (ii) many of such loans result from lines of credit (loan commitments) that the holder of the commitment would not consent to be transferred to potential secondary investors (because the credit standing of the facility provider is crucial for the line of credit).

  (iii) these instruments are typically used by banks to form an anchor relationship with clients that generates business opportunities for other services and products (cross-selling).

(b) for financial instruments within the scope of IFRS 9, the accounting mismatch arises only for instruments that are not classified as fair value through profit or loss. Loans that are classified as amortised cost are subject to the business model test,

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which means that they are held in a business model with the objective of collecting contractual cash flows. The Board addressed the issue of earnings management in this context by way of requiring information on the gains or losses from derecognising assets measured at amortised cost. This information allows users of financial statements to understand the extent and frequency of selling and the associated gains and losses.

(c) for loan commitments outside the scope of IFRS 9, because of the business model (see (a) above), the sale of loan commitments is less likely than for loans. Moreover, loan commitments that can be settled net in cash or for which the resulting loans are sold are within the scope of IFRS 9 and therefore mandatory classification as at fair value through profit or loss applies. Consequently, the considerations above that apply to loans also apply to loan commitments (assuming that equivalent disclosure of information would be required).

BC233 The Board 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 subsequently to the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and therefore would not reflect its effect. An advantage of alternative 1 is that it is less complex than the other alternatives that the Board 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.

BC234 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.

BC235 The Board noted that when the financial instrument is elected for measurement as fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and fair value. This difference is a result of the change in the measurement basis (eg from amortised cost to fair value for a loan). The Board 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.

BC236 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.

BC237 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 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.

BC238 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 facilitates an accounting outcome that reflects the credit risk management strategy of financial institutions.

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BC239 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 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.

BC240 More specifically, alternative 3 proposes the following in relation to the measurement change adjustment:

(a) for loans within the scope of IFRS 9:

(i) the measurement change adjustment is amortised over the life of the instrument;

(ii) when the measurement change adjustment plus the fair value is greater than the carrying amount if the loan had been continued to be measured at amortised cost, the amount above amortised cost is recognised as an impairment (to the extent of the unamortised measurement change adjustment); and

(iii) any unamortised measurement change adjustment at the date of discontinuation is added to the fair value of the financial instrument as its new deemed cost.

(b) for loan commitments within the scope of IAS 37, the measurement change adjustment is deferred until the earlier of:

(i) the discontinuation of fair value through profit or loss accounting; and

(ii) recognition of a provision in accordance with IAS 37 (ie when the 'probable' threshold is met).

BC241 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 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.

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BC242 However, a disadvantage of alternative 3 is that it is the most complex of the alternatives. The Board 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 balance sheet (statement of financial position) and may easily be confused as a hedging adjustment.

(c) in other comprehensive income.

BC243 The periodic charge for the amortisation of the measurement change adjustment for loans could be presented in the statement of comprehensive income as:

(a) (part of) interest revenue: however, the Board noted that the financial instrument that the amortisation relates to would no longer be measured at amortised cost (given the election to apply fair value through profit or loss accounting) and hence this presentation would be inconsistent with requirements regarding interest revenue recognition.

(b) other gains or losses.

BC244 The Board noted that disclosures could provide transparency on the measurement change adjustment. The Board considered a reconciliation of changes in the measurement change adjustment balance during the period that would include, for example, the following reconciling items:

(a) additions as a result of electing fair value through profit or loss accounting;

(b) releases:

    (i) amortisation

    (ii) impairment

    (iii) discontinuation

    (iv) transfers to allowance account for credit losses; and

(c) the effect of foreign exchange rate changes.

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BC245 The Board also considered a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for fair value through profit or loss accounting.

BC246 However, in the light of the complexities that the three alternatives that the Board considered would introduce, the Board proposes not to allow elective fair value accounting for part of the nominal amount of hedged credit exposures (such as loans and loan commitments).

Effective date and transition

BC247 To be consistent with the effective date for IFRS 9, the Board proposes an effective date for accounting periods beginning on or after 1 January 2013. Earlier application would be permitted. However, in conformity with earlier decisions, an entity would be able to apply the proposed hedge accounting requirements only if it has adopted all of the existing IFRS 9 requirements, or will adopt them at the same time as the proposed hedge accounting requirements are adopted.

BC248 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users. 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, IFRS 9 requires retrospective application (with some relief in particular circumstances).

BC249 The proposals in the exposure draft are a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship can be designated only prospectively. Consequently, retrospective application is not applicable.

BC250 The Board considered two alternative approaches:

(a) prospective application only for new hedging relationships; or

(b) prospective application to all hedging relationships.

BC251 The Board rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would require 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 coexist for a potentially long period. Consequently, for users of financial statements this raises comparability concerns between entities.

BC252 Consequently, the Board proposes the prospective application of the proposed hedge accounting requirements for all hedging relationships. This approach would resolve the problem of having to apply two models simultaneously. This approach would allow some one-off transitional provisions to ensure that 'qualifying' hedging relationships could be moved from the existing model to the proposed model and would therefore be subject to the proposed requirements from the adoption date.

BC253 The Board does not propose to amend IFRS 1 *First-time Adoption of International Financial Reporting Standards.* This is because a first-time adopter would need to look at the entire population of possible hedging relationships as defined by risk management and assess which ones are in compliance with the qualifying criteria in accordance with the proposed model. These should be documented on or before the transition date. This is consistent with the Board's proposed transition provisions for existing users of IFRSs. The proposed approach is also consistent with the current transition requirements of IFRS 1, which state that if an entity had designated a transaction as a hedge but the hedge does not meet the qualifying criteria in IAS 39 the entity shall discontinue hedge accounting.

BC254 The Board recently published the request for views *Effective Dates and Transition Methods*. That document was issued to obtain views on the expected time and effort involved in properly adapting to the new financial reporting requirements and on the implementation timetable and sequence of adoption that facilitates cost-effective management of the changes. The Board will take into consideration the comments received on that document and on the transition proposals in the exposure draft when finalising the transition requirements for hedge accounting.

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Alternative view of John T Smith

AV1 Mr Smith does not support the publication of the exposure draft, *Hedge Accounting,* because he believes that, if confirmed, its proposals would not improve financial reporting. While he agrees with the objective of reducing complexity and eliminating artificial barriers that preclude hedge accounting, he believes that many of the provisions in the exposure draft are not operational, lack rigour and would produce unintended consequences. He is particularly concerned that certain provisions undermine the fundamental principle that hedge ineffectiveness should be identified and recognised in profit or loss and the fundamental qualifying condition that there should be a high expectation that changes in the value of the hedging instrument will substantially offset the changes in the value of the hedged item. Mr Smith also believes that the proposals would inappropriately expand the use of hedge accounting, provide a virtually free choice to change the measurement attribute of assets and liabilities and specified portions thereof otherwise carried at cost or amortised cost, are incompatible with and would provide a means of circumventing the existing provisions of IFRS 9 *Financial Instruments* and would reduce comparability.

Differentiating basis risk and unhedged portions

AV2 Mr Smith agrees that management should be able to designate a portion of either a financial asset or a non-financial asset as a hedged item. Accordingly, he supports the elimination of the qualifying condition in IAS 39 *Financial Instruments: Recognition and Measurement* that prohibits a portion of a non-financial asset from being a hedged item. He disagrees, however, with the method in which the hedged portion can be determined under the provisions in the exposure draft because it has the effect of characterising basis risk as an unhedged residual portion. The exposure draft specifies that a portion of an item can be designated as a hedged risk if it is separately identifiable and measurable. Mr Smith believes that this condition is substantially undermined and will have little utility because other guidance specifies that a hedged item can be a portion that is not contractually specified or a portion that is inferred. He also believes that the example in paragraph B16(b) further undermines this condition because the inferred risk in the price of jet fuel cannot be both gas oil and crude oil depending on the life of the contract. Mr Smith is also concerned that in identifying the portion being hedged there is no consideration of the residual portion, the portion of the whole that is not the subject of the hedge. He believes that it should

not be permissible for a portion to be separated from the whole if there is interdependence between it and the residual portion. Similarly it should not be permissible for a portion that is not contractually specified to be separated from the whole if it and the remaining residual portion cannot be separately priced with the sum of those prices being equal to the price of the whole. Without a requirement to ensure that the prices of each portion can be isolated and measured separately with the sum equal to the price of the whole, any basis difference giving rise to ineffectiveness will not be recognised. Mr Smith believes that the above-mentioned provisions in the exposure draft provide a means of treating basis risk as an unhedged residual portion, thereby substantially eliminating recognition of ineffectiveness in a hedging relationship for both non-financial items and financial instruments and obscuring real ineffectiveness.

Elimination of the 80–125 per cent test

AV3 Mr Smith agrees with the elimination of the 80−125 per cent effectiveness test because it was required to be applied retrospectively and required a discontinuation of hedge accounting when the test was failed, thereby precluding the recognition of any change in value of the hedged item that offset the change in value of the hedging instrument. However, Mr Smith believes that the ongoing effectiveness test specified in the exposure draft is not sufficiently rigorous to provide a basis for hedge accounting because it does not attempt to ensure that the hedging relationship will be highly effective. The exposure draft requires the hedging relationship to be neutral so as to ensure that an entity is not purposefully overhedging or underhedging. The neutrality requirement, however, does not ensure any level of precision. The exposure draft also requires that the expectation for achieving offset is other than accidental. Mr Smith believes that this condition does not ensure that the hedging results will be highly effective. In his view the other than accidental offset condition is an extremely low threshold for qualifying for hedge accounting. He believes that the elimination of the condition that the hedge will be highly effective would unduly expand hedge accounting, thereby allowing considerable free choice to change the normal recognition and measurement requirements in other IFRSs.

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Reliance on risk management

AV4 Mr Smith agrees with the Board in characterising hedge accounting as an exception to the normal recognition and measurement requirements in IFRSs. Accordingly, he believes that there should be a rigorous set of qualifying criteria to provide for the exception. However, he is concerned that the exposure draft would treat hedge accounting as the norm and not the exception because it unduly relies on risk management as the basis for hedge accounting and would inappropriately expand the use of hedge accounting to accommodate all forms of risk management activities.

AV5 Mr Smith supported reliance on the business model as a basis for classification and measurement in IFRS 9 because a particular business model was specified, namely to hold assets in order to collect contractual cash flows. Mr Smith does not support the substantial reliance on risk management in the exposure draft as a basis for hedge accounting because risk management is not defined, it has no boundaries and is not applied uniformly. Risk management activities involve assessing risk and taking risk positions. Risk can be assessed in different ways on the basis of individual items, portfolios or groups and on a local or entity-wide basis. Risk positions are arbitrary and can be changed according to an entity's tolerance of risk, its expectations for the future and its assessment of the cost and benefits of entering into risk management activities. More important, it is not possible to determine whether risk has been increased or decreased because risk management activities involve exchanging one type of risk for another. Risk management policies are often specified at a general level and often seek to reduce earnings volatility. Accordingly, Mr Smith believes that reliance on risk management provides little rigour because policies can be written in any manner to permit an entity to move in and out of hedge accounting freely as a function of how it evaluates risk and documents its risk management policy. Mr Smith believes that the exposure draft inappropriately proposes to expand the use of hedge accounting to accommodate any risk management activity.

Hedge accounting for net positions

AV6 The exposure draft proposes to expand the use of hedge accounting to permit net positions to be designated in a hedging relationship. It would also permit net offsetting positions involving only cash instruments to be accounted for as a hedge to accommodate circumstances that the Board considers rare. Mr Smith believes that the qualifying condition based on

risk management for establishing a hedge relationship for a net position has little rigour and essentially provides a free choice because it can be met when an entity documents that it manages risk on a net basis. He observes that a good risk manager would always consider offsetting positions in evaluating risk. He also believes that hedge accounting for net positions can easily be terminated because an entity can change the specified tolerance for risk any time on the basis of many different factors.

AV7 Mr Smith is concerned that, without other qualifying criteria, two or more combinations of cash instruments that happen to coexist in the normal course of operations can be designated in a hedging relationship just because there is some offsetting risk. Accordingly, this proposal would have the effect of overriding the requirements of IFRS 9 relating to the fair value option when an accounting mismatch exists. Whenever there is an accounting mismatch, instead of electing the fair value option at inception for the life of the instrument and for the entire fair value as required by IFRS 9, an entity could circumvent those requirements by designating a hedging relationship after inception, for a period of time and for a portion of the risk. Mr Smith observes that even if there is no accounting mismatch, such as when the offsetting cash instruments are carried at amortised cost, a hedging relationship could be established and the measurement attribute changed. Accordingly, Mr Smith believes that the exposure draft provides an option to change the measurement attribute of any cash instrument or portion thereof whenever it offsets another instrument or portion thereof, thereby permitting the change in value to be recognised for any period of time and for any portion of risk that is being offset. This would have the effect of eliminating all volatility in earnings to the extent there is anything on the balance sheet that can be identified to offset another position. Mr Smith is also concerned that the ability to designate a net cash position as hedged items may be motivated by a desire to avoid volatility in earnings when there is a real economic mismatch as in the case in which two items carried at cost or amortised cost offset each other but one of them is designated in a hedging relationship to offset a third item carried at fair value.

AV8 Mr Smith is also concerned that hedging results might not be comparable because an entity could choose to designate the net position or the portion of the gross exposure equal to the net exposure as the hedged position, or not to designate the relationship. Each of these designation choices gives rise to a potentially different presentation and impedes comparability.

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Financial assets carried at fair value as hedging instruments

AV9 The exposure draft proposes to expand the use of hedge accounting to permit financial assets and liabilities carried at fair value to be designated as hedging instruments to make the new hedge accounting model more future-proof as hedging strategies develop. Mr Smith believes that this change should not be made unless warranted by a particular practice problem that is known to exist. He also believes it might have unintended consequences by providing a means for structuring to permit the recognition in other comprehensive income of fair value changes that would otherwise be recognised in profit or loss.

Hedging aggregated exposures

AV10 The exposure draft proposes to expand the use of hedge accounting to permit an aggregated exposure that is a combination of another exposure and a derivative to be accounted for as a hedged item and justifies this expansion by analogising to the exception in IAS 39 that permits a purchased option, which is a derivative, to be designated as a hedged item. Mr Smith is concerned that the only condition necessary to permit an aggregated exposure to be a hedged instrument is designation. Mr Smith believes that without other limiting conditions, this provision might have unintended consequences by providing a means for structuring to permit the recognition in other comprehensive income of fair value changes that would otherwise be recognised in profit or loss and to permit the bifurcation of derivatives.

Capitalising the time value of an option premium

AV11 Mr Smith agrees that the time value of a purchased option is a cost for the protection it provides when the intrinsic value of the option is effective in offsetting a risk in a hedging relationship. He disagrees with the recognition of the time value of an option as a basis adjustment of a hedged item when the transaction results in the recognition of a non-financial asset because it does not offset a cash flow of the hedged item, is not a required part of the purchase price and does not enhance the value of the item purchased. It has the effect of spreading the cost into future periods for which protection is not provided. Mr Smith is also concerned that the three different methods described in paragraph 33 for recognising the time value of an option and changes therein depending on the nature of the hedged item adds complexity and diminishes comparability.

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Separate line item presentation

AV12 Mr Smith does not support the separate line item presentation of changes in the value of hedged items in the statement of financial position. The line item amount is not an asset or liability in its own right and it changes over time because of hedging activity, amortisation and derecognition of the underlying asset or liability. He believes that it would only confuse users and make it difficult for them to understand value changes. He is particularly concerned that the exposure draft does not provide any guidance to require the items constituting the separate line item to be tracked with and specifically linked to the hedged items to which they relate. He believes that without such a requirement there exists considerable freedom to decide how to associate the line item amount with assets and liabilities that are derecognised or are no longer being hedged.

User considerations

AV13 Mr Smith does not believe that investors would find the relaxation of the effectiveness test together with the expansion of hedge accounting in reliance on risk management as proposed in the exposure draft an improvement to financial reporting. He understands that investors support accounting that is consistent with risk management. However, investors typically reject free-choice accounting because it diminishes consistency and comparability. Mr Smith believes that the significant effort to link hedge accounting to risk management decreases complexity for preparers but increases it for users because it results in considerable free-choice accounting to change recognition and measurement requirements in other IFRSs.

AV14 Mr Smith recognises that investors have difficulty understanding, and preparers have difficulty explaining, the volatility in profit or loss from the recognition of ineffectiveness under IAS 39 when hedge accounting cannot be applied or ineffectiveness resulting from basis differences is recognised. However, he believes it provided information that will no longer be available to users to serve as a starting point in a discussion with management or to allow them to make a conscious decision to ignore the amount of ineffectiveness reported in the financial statements.

AV15 Mr Smith believes that, given the substantial freedom to change normal recognition and measurement requirements, it would be impossible for users to understand the effects of risk management activities without extensive disclosures of the fair values and changes in fair values in their

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entirety and the carrying amount and changes therein for assets and liabilities and firm commitments that were the subject of any hedge accounting. He believes such comparative analysis would be necessary to be used as a surrogate for identifying basis risk that would be suppressed under the proposals in the exposure draft.

Unintended consequences

AV16 Mr Smith understands that the changes being proposed in the exposure draft are intended to provide a better link between risk management practices and accounting and to reduce complexity. However, he is concerned that in resolving the various practice issues relating to hedge accounting that have been identified, little if any consideration was given to the ensuing operational problems created by these changes and no evaluation was made to consider the interaction of these changes comprehensively. Mr Smith believes that in combination the proposed changes create operational problems and will be shown to have significant unintended consequences. Mr Smith believes that in combination these proposed changes undermine the principles in IFRS 9 relating to classification and measurement, recognition and presentation and provide a means of circumventing its requirements.

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Hedge accounting
[Draft] Illustrative examples

The [draft] examples accompany, but are not part, of the [draft] IFRS.

Disclosures

IE1 Paragraph 50 of the exposure draft proposes that specific amounts related to items designated as hedging instruments should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

	Notional amount of the hedging instrument	Carrying amount of the hedging instrument	
		Assets	Liabilities
Cash flow hedges			
Commodity price risk - Forward sales contracts	xx	xx	xx
Fair value hedges			
Interest rate risk - Interest rate swaps	xx	xx	xx
Foreign exchange risk - Foreign currency loan	xx	xx	xx

IE2 Paragraph 51 of the exposure draft proposes that specific amounts related to items designated as hedged items should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

	Gain or loss on the hedged item presented in a separate line item in the statement of financial position		Cash flow hedge reserve
	Assets	Liabilities	
Cash flow hedges			
Commodity price risk - Forecast sales -Discontinued hedges (forecast sales)	n/a n/a	n/a n/a	xx xx
			continued...

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...continued			
Fair value hedges			
Interest rate risk - Hedge adjustment for loan payable	-	xx	n/a
- Discontinued hedges (hedge adjustment—loan payable)	-	xx	n/a
Foreign exchange risk - Firm commitment	xx	xx	n/a

IE3 Paragraph 52 of the exposure draft proposes that specific amounts that have affected the statement of comprehensive income as a result of applying hedge accounting should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

Cash flow hedges[(a)]	Separate line item recognised in profit or loss as a result of a hedge of a net position	Change in the value of the hedging instrument in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)	Amount reclassified from the cash flow hedge reserve to profit or loss	Line item affected in profit or loss because of the reclassification
Commodity price risk	xx	xx	xx	Line item X	xx	Line item Y
Discontinued hedge	n/a	n/a	n/a	n/a	xx	Line item Z

(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as the proposed disclosure requirements.

Fair value hedges	Change in the value of the hedged item recognised in other comprehensive income	Change in the value of the hedging instrument recognised in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)
Interest rate risk	xx	xx	xx	Line item X
Foreign exchange risk	xx	xx	xx	Line item Y