

IFRS 9
CHAPTER 6
HEDGE ACCOUNTING

INTRODUCTION

**INTERNATIONAL FINANCIAL REPORTING
STANDARD 9 FINANCIAL INSTRUMENTS**

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International Financial Reporting Standard 9 *Financial Instruments* (IFRS 9) is set out in paragraphs 1.1–7.3.2 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. IFRS 9 should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the IFRS

- IN1 IAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The International Accounting Standards Board inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.
- IN2 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 financial reporting of financial instruments that was 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.
- IN3 In 2005 the Board and the US Financial Accounting Standards Board (FASB) began working towards a long-term objective to improve and simplify the reporting for financial instruments. This work resulted in the publication of a discussion paper, *Reducing Complexity in Reporting Financial Instruments*, in March 2008. Focusing on the measurement of financial instruments and hedge accounting, the paper identified several possible approaches for improving and simplifying the accounting for financial instruments. The responses to the paper indicated support for a significant change in the requirements for reporting financial instruments. In November 2008 the Board added this project to its active agenda, and in December 2008 the FASB also added the project to its agenda.
- IN4 In April 2009, in response to the input received on its work 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. As a result, in July 2009 the Board published an exposure draft *Financial Instruments: Classification and Measurement*, followed by the first chapter of IFRS 9 *Financial Instruments* in November 2009.

The Board's approach to replacing IAS 39

- IN5 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 will delete the relevant portions of IAS 39 and create chapters in IFRS 9 that replace the requirements in IAS 39.
- IN6 The three main phases of the Board's project to replace IAS 39 are:
- (a) **Phase 1: Classification and measurement of financial assets and financial liabilities.** In November 2009 the Board issued the chapters of IFRS 9 relating to the classification and measurement of financial assets. In October 2010 the Board added to IFRS 9 the requirements related to the classification and measurement of financial liabilities. Those additional requirements are described further in paragraph IN7. In November 2011 the Board decided to consider limited modifications to the classification and measurement requirements.

- (b) **Phase 2: Impairment methodology.** 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 and the supplement to the exposure draft, *Financial Instruments: Impairment*, published in January 2011. The Board is redeliberating the proposals in the exposure draft and the supplement to that exposure draft to address the comments received from respondents, and suggestions from an expert advisory panel and other outreach activities.
- (c) **Phase 3: Hedge accounting.** In [date] 2012 the Board added to IFRS 9 the requirements related to general hedge accounting. Those additional requirements are described further in paragraph IN8.

IN7 In October 2010 the Board added to IFRS 9 the requirements for classification and measurement of financial liabilities. Most of the requirements in IAS 39 for the classification and measurement of financial liabilities were carried forward unchanged to IFRS 9. However, the requirements related to the fair value option for financial liabilities were changed to address own credit risk. Those improvements respond to consistent feedback from users of financial statements and others that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. The improvements followed from the proposals published in May 2010 in the exposure draft *Fair Value Option for Financial Liabilities*.

IN8 In [date] 2012 the Board added to IFRS 9 the requirements related to hedge accounting:

- (a) The Board comprehensively reviewed the hedge accounting requirements in IAS 39 and replaced them with the requirements in IFRS 9.
- (b) The hedge accounting requirements in IFRS 9 align hedge accounting more closely with risk management, resulting in more useful information to users of financial statements. The requirements also establish a more principle-based approach to hedge accounting and address inconsistencies and weaknesses in the hedge accounting model in IAS 39.
- (c) The Board did not address specific accounting for open portfolios or macro hedging as part of the general hedge accounting requirements in IFRS 9. The Board is discussing proposals for accounting for open portfolios and macro hedging as part of its active agenda with the objective of issuing a discussion paper. Consequently, the Board has not reconsidered the exception in IAS 39 for a fair value hedge of an interest rate exposure of a portfolio of financial assets or financial liabilities. That exception continues to apply (see paragraphs 81A, 89A and AG114-AG132 of IAS 39).

IN9 In addition to the three phases described above, the Board published in March 2009 an exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7 *Financial Instruments: Disclosures*). However, in June 2010 the Board revised its strategy and work plan and decided to retain the existing requirements in IAS 39 for the derecognition of financial assets and financial liabilities but to finalise improved disclosure requirements. The new requirements were issued in October 2010 as an amendment to IFRS 7 and have an effective date of 1 July 2011. Later in October 2010 the requirements in IAS 39 related to the derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9.

IN10 As a result of the added requirements described in paragraphs IN7 and IN9, IFRS 9 (as issued in 2009) and its Basis for Conclusions (as issued in 2009) were restructured. Many paragraphs were renumbered and some were re-sequenced. New paragraphs were added to accommodate the guidance that was carried forward unchanged from IAS 39. Also, new sections were added to IFRS 9 as placeholders for the guidance that will result from subsequent phases of this project. Otherwise, the restructuring did not change the requirements in IFRS 9 issued in 2009. The Basis for Conclusions on IFRS 9 has been expanded to include material from the Basis for Conclusions on IAS 39 that discusses guidance that was carried forward without being reconsidered. Minor necessary edits have been made to that material.

Option to designate a financial asset at fair value through profit or loss

- 4.1.5** Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32).
- 4.1.6** IFRS 7 *Financial Instruments: Disclosures* requires the entity to provide disclosures about financial assets it has designated as at fair value through profit or loss.

Option to designate a financial liability at fair value through profit or loss

- 4.2.2** An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:
- (a)** it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
 - (b)** a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IAS 24 *Related Party Disclosures*), for example the entity’s board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).
- 4.2.3** IFRS 7 requires the entity to provide disclosures about financial liabilities it has designated as at fair value through profit or loss.
- 4.4.3** The following changes in circumstances are not reclassifications for the purposes of paragraphs 4.4.1 and 4.4.2:
- (a)** An item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such.
 - (b)** An item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.
 - (c)** Changes in measurement in accordance with section 6.7.

5.2 Subsequent measurement of financial assets

- 5.2.1** After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1–4.1.5 at fair value or amortised cost (see paragraphs 9 and AG5–AG8 of IAS 39).

- 5.2.2** An entity shall apply the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39 to financial assets measured at amortised cost.
- 5.2.3** An entity shall apply the hedge accounting requirements in paragraphs 6.5.8–6.5.14 (and, if applicable, paragraphs 89–94 of IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial asset that is designated as a hedged item.

5.3 Subsequent measurement of financial liabilities

- 5.3.1** After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1–4.2.2 (see paragraphs 9 and AG5–AG8 of IAS 39).
- 5.3.2** An entity shall apply the hedge accounting requirements in paragraphs 6.5.8–6.5.14 (and, if applicable, paragraphs 89–94 of IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial liability that is designated as a hedged item.

5.7 Gains and losses

- 5.7.1** A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:
- (a) it is part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, for fair value hedge accounting for a portfolio hedge of interest rate risk paragraphs 89–94 of IAS 39);
 - (b) it is an investment in an *equity instrument* and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5; or
 - (c) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's *credit risk* in other comprehensive income in accordance with paragraph 5.7.7.
- 5.7.2** A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, for fair value hedge accounting for a portfolio hedge of interest rate risk, paragraphs 89–94 of IAS 39) shall be recognised in profit or loss when the financial asset is derecognised, impaired or reclassified in accordance with paragraph 5.6.2, and through the amortisation process. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, for fair value hedge accounting for a portfolio hedge of interest rate risk, paragraphs 89–94 of IAS 39) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process.
- 5.7.3** A gain or loss on financial assets or financial liabilities that are hedged items in a hedging relationship shall be recognised in accordance with paragraphs 6.5.8–6.5.14 and, if applicable, for fair value hedge accounting for a portfolio hedge of interest rate risk in accordance with paragraphs 89–94 of IAS 39.
- 5.7.4** If an entity recognises financial assets using settlement date accounting (see paragraphs 3.1.2, B3.1.3 and B3.1.6), any change in the fair value of the asset to be received during the period between the trade date and the settlement

date is not recognised for assets measured at amortised cost (other than impairment losses). For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 5.7.1.

Chapter 6 Hedge accounting

6.1 Objective and scope of hedge accounting

- 6.1.1 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 (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.
- 6.1.2 An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 6.2.1–6.3.7 and B6.2.1–B6.3.25. For hedging relationships that meet the qualifying criteria, an entity shall account for the gain or loss on the hedging instrument and the hedged item in accordance with paragraphs 6.5.1–6.5.14 and B6.5.1–B6.5.28. When the hedged item is a group of items, an entity shall comply with the additional requirements in paragraphs 6.6.1–6.6.6 and B6.6.1–B6.6.16.
- 6.1.3 For a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements in IAS 39 instead of those in this IFRS. In that case, the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount (see paragraphs 81A, 89A and AG114–AG132 of IAS 39).

6.2 Hedging instruments

Qualifying instruments

- 6.2.1 **A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options (see paragraph B6.2.4).**
- 6.2.2 **A non-derivative financial asset or non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income in accordance with paragraph 5.7.7.**
- 6.2.3 **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

- 6.2.4 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 6.5.15 and B6.5.29–B6.5.33);

- (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the spot element of a forward contract and not the forward element (see paragraph 6.5.16 and B6.5.34–B6.5.35);
- (c) for a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5; and
- (d) a proportion 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 instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

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

- (a) derivatives or a proportion of them; and
- (b) non-derivatives or a proportion of them.

6.2.6 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 at the date of designation (unless it qualifies in accordance with paragraph B6.2.4). Similarly, two or more instruments (or proportions of them) may be jointly designated as the hedging instrument only if, in combination, they are not, in effect, a net written option at the date of designation (unless it qualifies in accordance with paragraph B6.2.4).

6.3 Hedged items

Qualifying items

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

- (a) a single item, or**
- (b) a group of items (subject to paragraphs 6.6.1–6.6.6 and B6.6.1–B6.6.16).**

A hedged item can also be a component of such an item or group of items (see paragraph 6.3.7 and B6.3.7–B6.3.25).

6.3.2 The hedged item must be reliably measurable.

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

6.3.4 An aggregated exposure that is a combination of an exposure that could qualify as a hedged item under paragraph 6.3.1 and a derivative may be designated as a hedged item (see paragraphs B6.3.3 and B6.3.4). This

includes a forecast transaction of an aggregated exposure (ie uncommitted but anticipated future transactions that would give rise to an exposure and a derivative) if that aggregated exposure is highly probable and, once it has occurred and therefore is no longer forecast, is eligible as a hedged item.

- 6.3.5 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting 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.**
- 6.3.6 However, as an exception to paragraph 6.3.5, 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 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

- 6.3.7 An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only 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, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable (see paragraphs B6.3.8–B6.3.15); 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 other variable (a one-sided risk).
 - (b) one or more selected contractual cash flows; and
 - (c) components of a nominal amount, ie a specified part of the amount of an item (see paragraphs B6.3.16–B6.3.20).

6.4 Qualifying criteria for hedge accounting

- 6.4.1 A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:**
- (a) The hedging relationship consists only of eligible hedging instruments and eligible hedged items.**

- (b) At the inception of the hedging relationship 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 shall include 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).
- (c) The hedging relationship meets all of the following hedge effectiveness requirements:
- (i) there is an economic relationship between the hedged item and the hedging instrument (see paragraphs B6.4.3–B6.4.5);
 - (ii) the effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs B6.4.6 and B6.4.7); and
 - (iii) the *hedge ratio* of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. (See paragraphs B6.4.8–B6.4.10).

6.5 Accounting for qualifying hedging relationships

- 6.5.1 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 6.4.1 (which include the entity's decision to designate the hedging relationship).
- 6.5.2 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 all, or a component of, 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.
- 6.5.3 If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5, the hedged exposure referred to in paragraph 6.5.2(a) must be one that could affect other comprehensive income. In that case, and only in that case, the recognised hedge ineffectiveness is presented in other comprehensive income.

- 6.5.4 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.
- 6.5.5 If a hedging relationship ceases to meet the hedge effectiveness requirement regarding the hedge ratio (see paragraph 6.4.1(c)(iii)) but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (“rebalancing”—see paragraphs B6.5.7–B6.5.21).**
- 6.5.6 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, and consistent with, the entity’s documented risk management objective). Discontinuing hedge accounting can affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).**
- 6.5.7 An entity shall apply:
- (a) paragraph 6.5.10 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 6.5.12 when it discontinues hedge accounting for cash flow hedges.

Fair value hedges

- 6.5.8 As long as a fair value hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:**
- (a) The gain or loss on the hedging instrument shall be recognised in profit or loss (or other comprehensive income, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5).**
 - (b) The hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss. However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5, those amounts shall remain in other comprehensive income. 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 profit or loss.**
- 6.5.9 When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or 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.
- 6.5.10 Any adjustment arising from paragraph 6.5.8(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 hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated effective interest rate at the date amortisation begins.

Cash flow hedges

6.5.11 As long as a cash flow hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship 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 cumulative 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 portion that is offset by 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 on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)), is hedge ineffectiveness that shall be 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:
 - (i) If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged 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 immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (see IAS 1).

6.5.12 When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 6.5.6 and 6.5.7(b)) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 6.5.11(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 or paragraph 6.5.11(d)(iii) applies. When the future cash flows occur, paragraph 6.5.11(d) applies.
- (b) If the hedged future cash flows are no longer expected to occur, that amount shall be immediately 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 to occur may still be expected to occur.

Hedges of a net investment in a foreign operation

6.5.13 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 to be an effective hedge shall be recognised in other comprehensive income (see paragraph 6.5.11).**
- (b) **The ineffective portion shall be recognised in profit or loss.**

6.5.14 The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation 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

6.5.15 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 6.2.4(a)), it shall account for the time value of the option as follows (see paragraphs B6.5.29–B6.5.33):

- (a) An entity shall distinguish the time value of options by the type of hedged item that the option hedges (see paragraphs B6.5.29 and B6.5.30):
 - (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 and shall be accumulated in a separate component of equity. 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. 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 immediately 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 it relates to the hedged item and shall be accumulated in a separate component of equity. The time value at the date of designation of the option as a hedging instrument, to the extent that it relates to the hedged item, shall be amortised on a systematic and rational basis over the period during which the hedge adjustment for the option’s intrinsic value could affect profit or loss (or other comprehensive income, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5). Hence, in each reporting 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).

Accounting for the forward element of forward contracts

6.5.16 When an entity separates the forward element and the spot element of a forward contract and designates as the hedging instrument only the change in the value of the spot element of the forward contract (see paragraph 6.2.4(b)), it may recognise the change in fair value of the forward element in other comprehensive income to the extent that it relates to the hedged item and accumulate that change in a separate component of equity (see paragraphs B6.5.34 and B6.5.35). The forward element that exists at the inception of the hedging relationship, to the extent that it relates to the hedged item, is amortised on a systematic and rational basis over the period to which the forward element relates. Hence, in each reporting 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 the spot element 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).

6.6 Hedges of a group of items

Eligibility of a group of items as the hedged item

- 6.6.1 A group of items (including a group of items that constitute a net position, see paragraphs B6.6.1–B6.6.8) 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) in the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that an offsetting risk position arises:**
 - (i) it is a hedge of foreign currency risk; and**
 - (ii) the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume (see paragraphs B6.6.7–B6.6.8).**

Designation of a component of a nominal amount

- 6.6.2 A component that is a proportion of an eligible group of items is an eligible hedged item provided that designation is consistent with the entity's risk management objective.**
- 6.6.3 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 significantly affected by which particular 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 hedging relationships); and**
 - (e) any items in the group that contain prepayment options meet the requirements for components of a nominal amount (see paragraph B6.3.20).**

Presentation

- 6.6.4 For a hedge of a group of items with offsetting risk positions (ie in a hedge of a net position), whose hedged risk affects different line items in the statement of profit or loss and other comprehensive income any hedging gains or losses in that statement shall be presented in a separate line from those affected by the hedged items. Hence, in that statement the amount in the line item that relates to the hedged item itself (eg revenue or cost of sales) remains unaffected.**

- 6.6.5 For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss in the statement of financial position on the individual assets and liabilities shall be recognised as an adjustment of the carrying amount of the respective individual items comprising the group in accordance with paragraph 6.5.8(b).

Nil net positions

- 6.6.6 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 hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (eg when transactions move into the time horizon for which the entity hedges);
 - (b) the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments 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, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

6.7 Option to designate a credit exposure as measured at fair value through profit or loss

Eligibility of credit exposures for designation at fair value through profit or loss

- 6.7.1 If an entity uses a credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it may designate that financial instrument to the extent that it is so managed (ie all or a proportion of it) as measured at fair value through profit or loss if:
- (a) the name of the credit exposure (eg the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and
 - (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this IFRS (eg an entity may designate loan commitments that are outside the scope of this IFRS). The entity may designate that financial instrument at initial recognition or subsequently, or while it is unrecognised. The entity shall document the designation concurrently.

Accounting for credit exposures designated at fair value through profit or loss

- 6.7.2 If a financial instrument is designated as measured at fair value through profit or loss after its initial recognition, or was previously not recognised, the difference at the time of designation between the carrying amount, if any, and the fair value shall immediately be recognised in profit or loss.
- 6.7.3 An entity shall discontinue measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss if:
- (a) the qualifying criteria in paragraph 6.7.1 are no longer met, for example:
 - (i) the credit derivative or the related financial instrument that gives rise to the credit risk expires or is sold, terminated or settled; or
 - (ii) the credit risk of the financial instrument is no longer managed using credit derivatives. For example, this could occur because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and
 - (b) the financial instrument that gives rise to the credit risk is not otherwise required to be measured at fair value through profit or loss (ie the entity's business model has not changed in the meantime so that a reclassification in accordance with paragraph 4.4.1 was required).
- 6.7.4 When an entity discontinues measuring the financial instrument that gives rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss, that financial instrument's fair value at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through profit or loss shall be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised cost would revert to that measurement and its effective interest rate would be recalculated based on its new carrying amount on the date of discontinuing measurement at fair value through profit or loss. Similarly, a loan commitment or a financial guarantee contract would be measured at the higher of:
- (a) the amount determined in accordance with IAS 37; and
 - (b) the new carrying amount at the date of discontinuation less cumulative amortisation. The amortisation period is the remaining life of the instrument.

Chapter 7 Effective date and transition

7.1 Effective date

- 7.1.1 An entity shall apply this IFRS for annual periods beginning on or after 1 January 2015. Earlier application is permitted. However, if an entity elects to apply this IFRS it must apply all of the requirements in this IFRS at the same time (see also paragraph 7.3.2). If an entity applies this IFRS in its financial statements for a period beginning before 1 January 2015, it shall disclose that fact and at the same time apply the amendments in Appendix C.
- 7.1.2 IFRS 10 and IFRS 11 *Joint Arrangements*, issued in May 2011, amended paragraphs 3.2.1, B3.2.1–B3.2.3, B4.3.12(c), B5.7.15, C11 and C30 and deleted paragraphs C23–C28 and the related headings. An entity shall apply those amendments when it applies IFRS 10 and IFRS 11.

7.2 Transition

- 7.2.1 An entity shall apply this IFRS retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4–7.2.15 and 7.2.17–7.2.21. This IFRS shall not be applied to items that have already been derecognised at the date of initial application.
- 7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1, 7.2.3–7.2.16 and 7.2.18, the date of initial application is the date when an entity first applies the requirements of this IFRS. The date of initial application may be:
- any date between the issue of this IFRS and 31 December 2010, for entities initially applying this IFRS before 1 January 2011; or
 - the beginning of the first reporting period in which the entity adopts this IFRS, for entities initially applying this IFRS on or after 1 January 2011.
- 7.2.3 If the date of initial application is not at the beginning of a reporting period, the entity shall disclose that fact and the reasons for using that date of initial application.
- 7.2.4 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraph 4.1.2(a) on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.
- 7.2.5 If an entity measures a hybrid contract at fair value in accordance with paragraph 4.1.4 or paragraph 4.1.5 but the fair value of the hybrid contract had not been determined in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (ie the non-derivative host and the embedded derivative) at the end of each comparative reporting period.
- 7.2.6 At the date of initial application, an entity shall recognise any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract at the date of initial application:
- in the opening retained earnings of the reporting period of initial application if the entity initially applies this IFRS at the beginning of a reporting period, or
 - in profit or loss if the entity initially applies this IFRS during a reporting period.
- 7.2.7 At the date of initial application, an entity may designate:

- (a) a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5, or
- (b) an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5.

Such designation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

7.2.8 At the date of initial application, an entity:

- (a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset does not meet the condition in paragraph 4.1.5.
- (b) may revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset meets the condition in paragraph 4.1.5.

Such revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

7.2.9 At the date of initial application, an entity:

- (a) may designate a financial liability as measured at fair value through profit or loss in accordance with paragraph 4.2.2(a).
- (b) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation does not satisfy that condition at the date of initial application.
- (c) may revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation satisfies that condition at the date of initial application.

Such designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

7.2.10 If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39, the entity shall treat the fair value of the financial asset or financial liability at the end of each comparative period as its amortised cost if the entity restates prior periods. If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39, the fair value of the financial asset or financial liability at the date of initial application shall be treated as the new amortised cost of that financial asset or financial liability at the date of initial application of this IFRS.

7.2.11 If an entity previously accounted for an investment in an unquoted equity instrument (or a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument) at cost in accordance with IAS 39, it shall measure that instrument at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.

- 7.2.12 If an entity previously accounted for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument at cost in accordance with IAS 39, it shall measure that derivative liability at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.
- 7.2.13 At the date of initial application, an entity shall determine whether the treatment in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of initial application. This IFRS shall be applied retrospectively on the basis of that determination.
- 7.2.14 Despite the requirement in paragraph 7.2.1, an entity that adopts the classification and measurement requirements of this IFRS for reporting periods:
- beginning before 1 January 2012 need not restate prior periods and is not required to provide the disclosures set out in paragraphs 44S–44W of IFRS 7;
 - beginning on or after 1 January 2012 and before 1 January 2013 shall elect either to provide the disclosures set out in paragraphs 44S–44W of IFRS 7 or to restate prior periods; and
 - beginning on or after 1 January 2013 shall provide the disclosures set out in paragraphs 44S–44W of IFRS 7. The entity need not restate prior periods.

If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in this IFRS.

- 7.2.15 If an entity prepares interim financial reports in accordance with IAS 34 *Interim Financial Reporting* the entity need not apply the requirements in this IFRS to interim periods prior to the date of initial application if it is impracticable (as defined in IAS 8).

Entities that have applied early IFRS 9 issued in 2009 or 2010

- 7.2.16 An entity shall apply the transition requirements in paragraphs 7.2.1–7.2.15 at the relevant date of initial application. In other words, an entity shall apply paragraphs 7.2.4–7.2.11 if it applies IFRS 9 (issued in 2009) or, not having done so, when it applies IFRS 9 (issued in 2010) in its entirety or, not having done so, IFRS 9 (issued in 2012) in its entirety. An entity is not permitted to apply those paragraphs more than once.

Transition for hedge accounting

- 7.2.17 Except as provided in paragraph 7.2.21, an entity shall apply the hedge accounting requirements of this IFRS prospectively.
- 7.2.18 To apply hedge accounting from the date of initial application of the hedge accounting requirements of this IFRS, all qualifying criteria must be met as at that date.
- 7.2.19 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 IFRS (see paragraph 6.4.1), after taking into account any rebalancing of the hedging

relationship on transition (see paragraph 7.2.20(b)), shall be regarded as continuing hedging relationships.

7.2.20 On initial application of the hedge accounting requirements of this IFRS, an entity:

- (a) may start to apply these requirements from the same point in time as it ceases to apply the hedge accounting requirements of IAS 39.
- (b) shall consider the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from such a rebalancing shall be recognised in profit or loss.

7.2.21 As an exception to prospective application of the hedge accounting requirements of this IFRS, an entity:

- (a) shall apply the accounting for the time value of options in accordance with paragraph 6.5.15 retrospectively if, in accordance with IAS 39, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.
- (b) may apply the accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 retrospectively if, in accordance with IAS 39, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (ie on transition this election is not available on a hedging relationship-by-hedging relationship basis).

7.3 Withdrawal of IFRIC 9, IFRS 9 (2009) and IFRS 9 (2010)

7.3.1 This IFRS supersedes IFRIC 9 *Reassessment of Embedded Derivatives*. The requirements added to IFRS 9 in October 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of IFRIC 9. As a consequential amendment, IFRS 1 *First-time Adoption of International Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of IFRIC 9.

7.3.2 This IFRS supersedes IFRS 9 issued in 2009 and IFRS 9 issued in 2010. However, for annual periods beginning before 1 January 2015, an entity may elect to apply IFRS 9 issued in 2009 or 2010 instead of applying this IFRS.

Appendix A

Defined terms

This appendix is an integral part of the IFRS.

derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
derivative	<p>A financial instrument or other contract within the scope of this IFRS (see paragraph 2.1) with all three of the following characteristics.</p> <p>(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').</p> <p>(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.</p> <p>(c) It is settled at a future date.</p>
fair value	<i>Fair value</i> is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13.)
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
financial liability at fair value through profit or loss	<p>A financial liability that meets either of the following conditions.</p> <p>(a) It meets the definition of held for trading.</p> <p>(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.</p> <p>(c) It is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1.</p>

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 but anticipated future transaction.
hedge ratio	The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.
held for trading	A financial asset or financial liability that: <ul style="list-style-type: none"> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

The following terms are defined in paragraph 11 of IAS 32, paragraph 9 of IAS 39 or Appendix A of IFRS 7 and are used in this IFRS with the meanings specified in IAS 32, IAS 39 or IFRS 7:

- (a) amortised cost of a financial asset or financial liability;
- (b) credit risk;
- (c) effective interest method;
- (d) equity instrument;
- (e) financial asset;
- (f) financial instrument;
- (g) financial liability;
- (h) transaction costs.

Appendix B

Application guidance

This appendix is an integral part of the IFRS.

B3.1.2 The following are examples of applying the principle in paragraph 3.1.1:

- (a) Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this IFRS in accordance with paragraphs 5–7 of IAS 39, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 6.5.8(b) and 6.5.9).

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a).

- (a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by IFRS 4, paragraph 24), and financial assets it considers related that would otherwise be measured at amortised cost.
- (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (eg are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 6.4.1 are not met.
- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not use hedge accounting, eg because the liability position is actively traded and would hence require resetting of hedging relationships with a level of frequency that the entity considers burdensome. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or

loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

- B4.3.8 (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
- B5.7.2 An entity applies IAS 21 to financial assets and financial liabilities that are monetary items in accordance with IAS 21 and denominated in a foreign currency. IAS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge (see paragraph 6.5.11), a hedge of a net investment (see paragraph 6.5.13) or a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5 (see paragraph 6.5.8).

Hedge accounting (chapter 6)

Hedging instruments (section 6.2)

Qualifying instruments

- B6.2.1 Derivatives that are embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments.
- B6.2.2 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.
- B6.2.3 For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IAS 21.

Written options

- B6.2.4 This IFRS does not restrict the circumstances in which a derivative measured at fair value through profit or loss 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

- B6.2.5 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 may only designate the non-derivative financial instrument in its entirety or a proportion of it.
- B6.2.6 A single hedging instrument may be designated as a hedging instrument of more than one type of risk, provided that there is specific designation of the hedging

instrument and of the different risk positions as hedged items. Those hedged items can be in different hedging relationships.

Hedged items (section 6.3)

Qualifying items

- B6.3.1 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.
- B6.3.2 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 investee'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.
- B6.3.3 Paragraph 6.3.4 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 highly probable coffee purchases in 15 months' time against price risk (based on US dollars) using a 15-month futures contract for coffee. The highly probable coffee purchases and the futures contract for coffee in combination can be viewed as a 15-month fixed amount US dollar foreign currency risk exposure for risk management purposes (ie like any fixed amount US dollar cash outflow in 15 months' 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 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 functional currency exposure. This is overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable rate debt into fixed rate debt. In effect, the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable rate debt functional currency exposure for risk management purposes.
- B6.3.4 When designating the hedged item on the basis of the aggregated exposure, an entity considers the combined effect of the items that constitute the aggregated

exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness. However, the items that constitute the aggregated exposure remain accounted for separately. This means that, for example:

- (a) Derivatives that are part of an aggregated exposure are recognised as separate assets or liabilities measured at fair value.
- (b) If a hedging relationship is designated between the items that constitute the aggregated exposure, the way in which a derivative is included as part of an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure. For example, if an entity excludes the forward element of a derivative from its designation as the hedging instrument for the hedging relationship between the items that constitute the aggregated exposure, it must also exclude the forward element when including that derivative as a hedged item as part of the aggregated exposure. Otherwise, the aggregated exposure shall include a derivative in its entirety or a proportion of it.

B6.3.5 Paragraph 6.3.6 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 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. For this purpose an entity can be a parent, subsidiary, associate, joint arrangement 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.

B6.3.6 If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss is recognised in, and taken out of, other comprehensive income in accordance with paragraph 6.5.11. The relevant period or periods during which the foreign currency risk of the hedged transaction affects profit or loss is when it affects consolidated profit or loss.

Designation of hedged items

B6.3.7 A component is a hedged item that is less than the entire item. Consequently, 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 proportion of an item).

Risk components

- B6.3.8 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.
- B6.3.9 When identifying what risk components are eligible for designation as a hedged item, an entity assesses such risk components within 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.
- B6.3.10 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 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. Consequently, the gas oil price exposure in the supply contract is a risk component that is eligible for designation as a hedged item.
 - (b) Entity B hedges its future coffee purchases based on its production forecast. Hedging starts up to 15 months before delivery for part of the forecast purchase volume. Entity B increases the hedged volume over time (as the delivery date approaches). Entity B uses two different types of contracts to manage its coffee price risk:
 - (i) exchange traded coffee futures contracts; and
 - (ii) coffee supply contracts for Arabica coffee from Colombia delivered to a specific manufacturing site. These contracts price a tonne of coffee based on the exchange traded coffee futures contract price plus a fixed price differential plus a variable logistics services charge using a pricing formula. The coffee supply contract is an executory contract in accordance with which Entity B takes actual delivery of coffee.

For deliveries that relate to the current harvest, entering into the coffee supply contracts allows Entity B to fix the price differential between the actual coffee quality purchased (Arabica coffee from Colombia) and the benchmark quality that is the underlying of the exchange traded futures contract. However, for deliveries that relate to the next harvest, the coffee supply contracts are not yet available, so the price differential cannot be fixed. Entity B uses exchange traded coffee futures contracts to hedge the benchmark quality component of

its coffee price risk for deliveries that relate to the current harvest as well as the next harvest. Entity B determines that it is exposed to three different risks: coffee price risk reflecting the benchmark quality, coffee price risk reflecting the difference (spread) between the price for the benchmark quality coffee and the particular Arabica coffee from Colombia that it actually receives, and the variable logistics costs. For deliveries related to the current harvest, after Entity B enters into a coffee supply contract, the coffee price risk reflecting the benchmark quality is a contractually specified risk component because the pricing formula includes an indexation to the exchange traded coffee futures contract price. Entity B concludes that this risk component is separately identifiable and reliably measurable. For deliveries related to the next harvest, Entity B has not yet entered into any coffee supply contracts (ie those deliveries are forecast transactions). Hence, the coffee price risk reflecting the benchmark quality is a non-contractually specified risk component. Entity B's analysis of the market structure takes into account how eventual deliveries of the particular coffee that it receives are priced. Hence, on the basis of this analysis of the market structure, Entity B concludes that the forecast transactions also involve the coffee price risk reflecting the benchmark quality as a risk component that is separately identifiable and reliably measurable even though it is not contractually specified. Consequently, Entity B may designate hedging relationships for forecast coffee purchases on a risk components basis for the coffee price risk, reflecting the benchmark quality for the price risk resulting from coffee supply contracts as well as forecast transactions.

- (c) Entity C hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the volume that it hedges over time. Entity C 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 C uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity C uses gas oil derivatives because they are sufficiently liquid. For time horizons up to 6 months Entity C uses jet fuel contracts. Entity C's analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances is as follows:
- (i) Entity C operates in a geographical area in which Brent is the crude oil benchmark. Crude oil is a raw material benchmark that affects the price of various refined oil products as their most basic input. Gas oil is a benchmark for refined oil products, which is used as a pricing reference for oil distillates more generally. This is also reflected in the types of derivative financial instruments for the crude oil and refined oil products markets of the environment in which Entity C operates, such as:
- the benchmark crude oil futures contract, which is for Brent crude oil;
 - the benchmark gas oil futures contract, which is used as the pricing reference for distillates—eg jet fuel spread derivatives cover the price differential between jet fuel and that benchmark gas oil; and
 - the benchmark gas oil crack spread derivative (ie the derivative regarding the price differential between crude oil and gas oil—a refining margin), which is indexed to Brent crude oil.

- (ii) The pricing of refined oil products does not depend on which particular crude oil is processed by a particular refinery because those refined oil products (such as gas oil or jet fuel) are standardised products.

Hence, Entity C concludes that the price risk of its jet fuel purchases includes a crude oil price risk component based on Brent crude oil and a gas oil price risk component, even though crude oil and gas oil are not specified in any contractual arrangement. Entity C concludes that these two risk components are separately identifiable and reliably measurable even though they are not contractually specified. Consequently, Entity C may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil). This analysis also means that if, for example, Entity C used crude oil derivatives based on West Texas Intermediate (WTI) crude oil, changes in the price differential between Brent crude oil and WTI crude oil would cause hedge ineffectiveness.

- (d) Entity D holds a fixed rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (eg LIBOR) and variable rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate hedging relationships for the fixed rate debt instrument on a risk component basis for the benchmark interest rate risk.

B6.3.11 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 qualifying criteria apply, including that the hedging relationship must meet the hedge effectiveness requirements, and any hedge ineffectiveness must be measured and recognised.

B6.3.12 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.

B6.3.13 There is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.

B6.3.14 For example, an entity issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means

that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (ie in a manner similar to how a risk-free (nominal) interest rate component can be determined). Conversely, in many cases an inflation risk component is not separately identifiable and reliably measurable. For example, an entity issues only nominal interest rate debt in an environment with a market for inflation-linked bonds that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed. In this case the analysis of the market structure and the facts and circumstances does not support the entity concluding that inflation is a relevant factor that is separately considered by the debt markets. Hence, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable. Consequently, an inflation risk component would not be eligible for designation as the hedged item. This applies irrespective of any inflation hedging instrument that the entity has actually entered into. In particular, the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt.

B6.3.15A contractually specified inflation risk 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 risk component.

Components of a nominal amount

B6.3.16 There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.

B6.3.17 An example of a component that is a proportion is 50 per cent of the contractual cash flows of a loan.

B6.3.18 A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include:

- (a) part of a monetary transaction volume, eg the next FC10* cash flows from sales denominated in a foreign currency after the first FC20 in March 201X;
- (b) a part of a physical volume, eg the 5 million cubic metres bottom layer 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 from the nominal amount of the hedged item, eg the last CU80* million of a CU100 million firm commitment, the bottom layer of CU20 million of a CU100 million fixed rate bond or the top layer of CU30 million from a total amount of CU100 million of fixed rate debt that can be prepaid at fair value (the defined nominal amount is CU100 million).

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

- B6.3.19 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 fair value hedge adjustment must be recognised in profit or loss no later than when the item is derecognised. Consequently, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal amount from which it is defined. For example, in paragraph B6.3.18(d), the total defined nominal amount of CU100 million must be tracked in order to track the bottom layer of CU20 million or the top layer of CU30 million.
- B6.3.20 A layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in fair value of the hedged item.

Relationship between components and the total cash flows of an item

- B6.3.21 If a component of the cash flows of a financial or non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item. However, all of the cash flows of the entire item may be designated as the hedged item and hedged for only one particular risk (eg only for those changes that are attributable to changes in LIBOR or a benchmark commodity price).
- B6.3.22 For example, in the case of a financial liability whose effective interest rate is below LIBOR, an entity cannot designate:
- (a) a component of the liability equal to interest at LIBOR (plus the principal amount in case of a fair value hedge); and
 - (b) a negative residual component.
- B6.3.23 However, in the case of a fixed rate financial liability whose effective interest rate is (for example) 100 basis points below LIBOR, an entity can designate as the hedged item the change in the value of that entire liability (ie principal plus interest at LIBOR minus 100 basis points) that is attributable to changes in LIBOR. 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 risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day 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).

- B6.3.24** If a variable rate financial liability bears interest of (for example) three-month LIBOR minus 20 basis points (with a floor at zero basis points), an entity can designate as the hedged item the change in the cash flows of that entire liability (ie three-month LIBOR minus 20 basis points—including the floor) that is attributable to changes in LIBOR. Hence, as long as the three-month LIBOR forward curve for the remaining life of that liability does not fall below 20 basis points, the hedged item has the same cash flow variability as a liability that bears interest at three-month LIBOR with a zero or positive spread. However, if the three-month LIBOR forward curve for the remaining life of that liability (or a part of it) falls below 20 basis points, the hedged item has a lower cash flow variability than a liability that bears interest at three-month LIBOR with a zero or positive spread.
- B6.3.25** A similar example of a non-financial item is a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15 the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price. Hence, as long as the forward price (for each delivery) does not fall below CU25, the hedged item has the same cash flow variability as a crude oil sale at the benchmark crude oil price (or with a positive spread). However, if the forward price for any delivery falls below CU25, the hedged item has a lower cash flow variability than a crude oil sale at the benchmark crude oil price (or with a positive spread).

Qualifying criteria for hedge accounting (section 6.4)

Hedge effectiveness

- B6.4.1** Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item (eg when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item.
- B6.4.2** 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 B6.5.21 arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

Economic relationship between the hedged item and the hedging instrument

- B6.4.3** The requirement that an economic relationship exists means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk. Hence, there must be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged (eg Brent and WTI crude oil).

- B6.4.4 If the underlyings are not the same but are economically related, there can be situations when the values of the hedging instrument and the hedged item move in the same direction, eg because the price differential between the two related underlyings changes while the underlyings themselves do not move significantly. That is still consistent with an economic relationship between the hedging instrument and the hedged item if the values of the hedging instrument and the hedged item are still expected to typically move in the opposite direction when the underlyings move.
- B6.4.5 The assessment of whether an economic relationship exists 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. The mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists.

The effect of credit risk

- B6.4.6 Because the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item, hedge effectiveness is not solely determined by the economic relationship between those items (ie the changes in their underlyings) but also by the effect of credit risk on the value of both the hedging instrument and the hedged item. The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is of such a magnitude that the credit risk dominates the value changes that result from the economic relationship (ie the effect of the changes in the underlyings). A magnitude that gives rise to dominance is one that would result in the loss (or gain) from credit risk frustrating the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant. Conversely, if during a particular period there is little change in the underlyings, the fact that even small credit risk-related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlyings does not create dominance.
- B6.4.7 An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

Hedge ratio

- B6.4.8 In accordance with the hedge effectiveness requirements the hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. Hence, if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 per cent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 per cent. Similarly, if, for example, an entity hedges an exposure using a nominal amount of

40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (ie the entity must not use a hedge ratio based on a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units.

- B6.4.9 However, the designation of the hedging relationship using the same hedge ratio as that resulting from the quantities of the hedged item and the hedging instrument that the entity actually uses shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, for the purpose of designating a hedging relationship, an entity must adjust the hedge ratio that results from the quantities of the hedged item and the hedging instrument that the entity actually uses if that is needed to avoid such an imbalance.
- B6.4.10 Examples of relevant considerations in assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting are:
- (a) whether the intended hedge ratio is established to avoid recognising hedge ineffectiveness for cash flow hedges, or to achieve fair value hedge adjustments for more hedged items with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and
 - (b) whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though that creates hedge ineffectiveness. For example, an entity enters into and designates a quantity of the hedging instrument that is not the quantity that it determined as the best hedge of the hedged item because the standard volume of the hedging instruments does not allow it to enter into that exact quantity of hedging instrument (a 'lot size issue'). An example is an entity hedging 100 tonnes of coffee purchases with standard coffee futures contracts that have a contract size of 37,500 lbs (pounds). The entity could only use either 5 or 6 contracts (equivalent to 85.0 and 102.1 tonnes respectively) to hedge the purchase volume of 100 tonnes. In that case, the entity designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

Frequency of assessing whether the hedge effectiveness requirements are met

- B6.4.11 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 effectiveness and therefore is only forward-looking.

Methods for assessing whether the hedge effectiveness requirements are met

- B6.4.12 This IFRS does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. 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.
- B6.4.13 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 instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.3–B6.4.5).
- B6.4.14 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.
- B6.4.15 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 an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.3–B6.4.5). In some situations a quantitative assessment might also be needed to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements (see paragraphs B6.4.8–B6.4.10). An entity can use the same or different methods for these two different purposes.
- B6.4.16 If there are changes in circumstances that affect hedge effectiveness, an entity may 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.
- B6.4.17 An entity's risk management is the main source of information to perform the assessment of 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 for assessing whether a hedging relationship meets the hedge effectiveness requirements.
- B6.4.18 An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements, including the method or methods used. The documentation of the hedging relationship shall be updated for any changes to the methods (see paragraph B6.4.16).

Accounting for qualifying hedging relationships (section 6.5)

- B6.5.1 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.

- B6.5.2 The purpose of a cash flow hedge is to defer the gain or loss on the hedging instrument to a period or periods in which the hedged expected future cash flows affect profit or loss. An example of a cash flow hedge is the use of a swap to change floating rate debt (whether measured at amortised cost or fair value) to fixed rate debt (ie a hedge of a future transaction in which the future cash flows being hedged are the future interest payments). Conversely, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value through profit or loss, is an example of an item that cannot be the hedged item in a cash flow hedge, because any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to profit or loss during a period in which it would achieve offset. For the same reason, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value with changes in fair value presented in other comprehensive income can also not be the hedged item in a cash flow hedge.
- B6.5.3 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 6.5.4, 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

- B6.5.4 When measuring hedge ineffectiveness, an entity shall consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.
- B6.5.5 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be at the money at the time of designation of the hedging relationship. 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. Hence, using a 'hypothetical derivative' is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedged item. Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed rate or variable rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (eg cross-currency interest rate swaps).
- B6.5.6 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.

Rebalancing the hedging relationship and changes to the hedge ratio

- B6.5.7 Rebalancing refers to adjustments to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedged item or of a hedging instrument for a different purpose do not constitute rebalancing for the purpose of this standard.
- B6.5.8 Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B6.5.9–B6.5.21. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised immediately before adjusting the hedging relationship.
- B6.5.9 Adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item that arise 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 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.
- B6.5.10 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 would continue to meet the hedge effectiveness requirement regarding the hedge ratio 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 would continue to meet that hedge effectiveness requirement. 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.
- B6.5.11 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, which 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 hedge effectiveness requirement regarding the hedge ratio, ie to ensure that the hedging relationship does not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be

inconsistent with the purpose of hedge accounting. Hence, this evaluation requires judgement.

B6.5.12 Fluctuation around a constant hedge ratio (and hence the related hedge ineffectiveness) cannot be reduced 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 does not require rebalancing.

B6.5.13 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 reduced by adjusting the hedge ratio, whereas retaining the hedge ratio would increasingly produce hedge ineffectiveness. Hence, in such circumstances, an entity must evaluate whether the hedging relationship reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. If the hedge ratio is adjusted, it also affects measuring and recognising hedge ineffectiveness because, on rebalancing, the hedge ineffectiveness of the hedging relationship must be determined and recognised immediately before adjusting the hedging relationship in accordance with paragraph B6.5.8.

B6.5.14 Rebalancing means that for hedge accounting purposes after the start of a hedging relationship, an entity adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship. Typically, that adjustment should reflect adjustments in the quantities of the hedging instrument and the hedged item that it actually uses. However, an entity must adjust the hedge ratio that results from the quantities of the hedged item or the hedging instrument that it actually uses if:

- (a) the hedge ratio that results from changes to the quantities of the hedging instrument or the hedged item that the entity actually uses would reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting; or
- (b) an entity would retain quantities of the hedging instrument and the hedged item that it actually uses resulting in a hedge ratio that, in new circumstances, would reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (ie an entity must not create an imbalance by omitting to adjust the hedge ratio).

B6.5.15 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 B6.5.28).

B6.5.16 If a hedging relationship is rebalanced, the adjustment to 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 with the entity retaining the volume that is no longer needed. 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).

B6.5.17 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 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 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.

B6.5.18 Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair 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 nominal amount of 90 tonnes of the hedging instrument volume would remain (see paragraph B6.5.16 regarding the consequences for the derivative volume (ie the 10 tonnes) that is no longer a part of the hedging relationship).

B6.5.19 Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair value of the hedging instrument regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the fair 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).

B6.5.20 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 of 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 6.5.6 and 6.5.7 and B6.5.22–B6.5.28).

B6.5.21 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 B6.4.2). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of hedge accounting

B6.5.22 Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.

B6.5.23 An entity shall not de-designate and thereby discontinue a hedging relationship that:

- (a) still meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity still pursues that risk management objective); and
- (b) continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

B6.5.24 For the purposes of this IFRS, an entity's risk management strategy is distinguished from its risk management objectives. The risk management strategy is established at the highest level at which an entity determines how it manages its risk. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk management strategy is typically in place for a longer period and may include some flexibility to react to changes in circumstances that occur while that strategy is in place (eg different interest rate or commodity price levels that result in a different extent of hedging). This is normally a general document that is cascaded down through an entity through policies containing more specific guidelines. In contrast, the risk management objective for a hedging relationship applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used

to hedge the particular exposure that has been designated as the hedged item. Hence, a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy. For example:

- (a) An entity has a strategy of managing its interest rate exposure on debt funding that sets ranges for the overall entity for the mix between variable-rate and fixed-rate funding. The strategy is to maintain between 20 and 40 per cent of the debt at fixed rates. The entity decides from time to time how to execute this strategy (ie where it positions itself within the 20 to 40 per cent range for fixed rate interest exposure) depending on the level of interest rates. If interest rates are low the entity fixes the interest for more debt than when interest rates are high. The entity's debt is CU100 of variable-rate debt of which CU30 is swapped into fixed-rate. The entity takes advantage of low interest rates to issue an additional CU50 of debt to finance a major investment, which the entity does by issuing a fixed-rate bond. In the light of the low interest rates, the entity decides to set its fixed interest rate exposure to 40 per cent of total debt by reducing by CU20 the extent to which it previously hedged its variable rate exposure, resulting in CU60 of fixed rate exposure. In this situation the risk management *strategy* remains unchanged. However, the entity's execution of that strategy has changed and this means that, for CU20 of variable-rate exposure that was previously hedged, the risk management *objective* has changed (ie at the hedging relationship level). Consequently, in this situation hedge accounting must be discontinued for CU20 of previously hedged variable-rate exposure. This could involve reducing the swap position by a CU20 nominal amount but, depending on the circumstances, an entity might retain that swap volume and, for example, use it for hedging a different exposure or it might become part of a trading book. Conversely, if instead an entity swapped a part of its new fixed-rate debt into variable-rate, hedge accounting would have to be continued for its previously hedged variable-rate exposure.
- (b) Some exposures result from positions that frequently change, for example interest rate risk of an open portfolio of debt instruments. The addition of new debt instruments and the derecognition of debt instruments continuously change that exposure (ie it is different from simply running off a position that matures). This is a dynamic process in which both the exposure and the hedging instruments used to manage it do not remain the same for long. Consequently, an entity with such an exposure frequently adjusts the hedging instruments used to manage the interest rate risk as the exposure changes. For example, debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets. After a short period of time, the entity discontinues previously designated hedging relationships for time buckets and designates new hedging relationships for time buckets on the basis of their size and the hedging instruments that exist at that time. Hedge accounting must be discontinued, because those hedging relationships are established in such a way that the entity looks at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist.

- (c) An entity has a risk management strategy whereby it manages the foreign currency risk of forecast sales and the resulting receivables. Within that strategy the entity manages the foreign currency risk as a particular hedging relationship only up to the point of the recognition of the receivable. Thereafter, the entity no longer manages the foreign currency risk on the basis of that particular hedging relationship. Instead, it manages together the foreign currency risk from receivables, payables and derivatives (that do not relate to still-pending forecast transactions) denominated in the same foreign currency. For accounting purposes, this works as a 'natural' hedge because the gains and losses from the foreign currency risk on all of these items are immediately recognised in profit or loss. Consequently, for accounting purposes, if the hedging relationship is designated for the period up to the payment date, it must be discontinued when the receivable is recognised, because the risk management objective of the original hedging relationship no longer applies. The foreign currency risk is now managed within the same strategy but on a different basis. Conversely, if an entity had a different risk management objective and managed the foreign currency risk as one continuous hedging relationship specifically for that forecast sales amount and the resulting receivable until the settlement date, hedge accounting would continue until that date.

B6.5.25 The discontinuation of hedge accounting can affect:

- (a) a hedging relationship in its entirety; or
- (b) a part of a hedging relationship (which means that hedge accounting continues for the remainder of the hedging relationship).

B6.5.26 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 on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective).
- (b) The hedging instrument or instruments have been sold or terminated (in relation to the entire volume that was part of the hedging relationship).
- (c) There is no longer an economic relationship between the hedged item and the hedging instrument or the effect of credit risk starts dominating the value changes that result from that economic relationship.

B6.5.27 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 in such a way that some of the volume of the hedged item is no longer part of the hedging relationship (see paragraph B6.5.20); 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 of whether similar forecast transactions are highly probable (see paragraph 6.3.3) and hence whether they are eligible as hedged items.

B6.5.28 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 that 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 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

B6.5.29 The time value of an option can be considered as being related to a time period because an option provides protection for the option holder over a period of time. However, the relevant aspect for the purpose of assessing whether an option hedges a transaction or time–period related hedged item are the characteristics of that hedged item, including how and when it affects profit or loss. Hence, an entity shall assess the type of hedged item (see paragraph 6.5.15(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 a transaction for which the time value has the character of costs of that transaction. 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 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). As a consequence of including the time value of the option in the initial measurement of the particular hedged item, the time value affects profit or loss at the same time as that hedged item. 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 such that the time value has the character of 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 systematic and rational basis) over that six-month period. Another example is a hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange option, which would result in allocating the time value of the option over that 18-month period.

B6.5.30 The characteristics of the hedged item, including how and when it affects profit or loss, also affect the period over which the time value of an option that hedges a time-period related hedged item is amortised, which is consistent with the period over which the option's intrinsic value can affect profit or loss in accordance with hedge accounting. For example, if an interest rate option (a cap) is used to provide protection against increases in the interest expense on a floating rate bond, the time value of that cap is amortised to profit or loss over the same period over which any intrinsic value of the cap would affect profit or loss:

- (a) if the cap hedges increases in interest rates for the first three years out of a total life of the floating rate bond of five years, the time value of that cap is amortised over the first three years; or
- (b) if the cap is a forward start option that hedges increases in interest rates for years 2 and 3 out of a total life of the floating rate bond of five years, the time value of that cap is amortised during years 2 and 3.

B6.5.31 The accounting for the time value of options in accordance with paragraph 6.5.15 also applies to a combination of a purchased and a written option (one being a put option and one being a call option) that at the date of designation as a hedging instrument has a net nil time value (commonly referred to as a 'zero-cost collar'). In that case, an entity shall recognise any changes in time value in other comprehensive income, even though the cumulative change in time value over the total period of the hedging relationship is zero. Hence, if the time value of the option relates to:

- (a) a transaction related hedged item, the amount of time value that adjusts the hedged item or is reclassified to profit or loss (see paragraph 6.5.15(b)) at the end of the hedging relationship would be nil.
- (b) a time-period related hedged item, the amortisation expense regarding the time value is nil.

B6.5.32 The accounting for the time value of options in accordance with paragraph 6.5.15 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 (actual time value) relates to the hedged item (and therefore should be treated in accordance with paragraph 6.5.15). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

B6.5.33 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 6.5.15 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.
- (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.

Accounting for the forward element of forward contracts

B6.5.34 The accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 applies only to the extent that the forward element relates to the hedged item (aligned forward element). The forward element of a forward contract relates to the hedged item if the critical terms of the forward contract (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the forward contract and the hedged item are not fully aligned, an entity shall determine the aligned forward element, ie how much of the forward element included in the forward contract (actual forward element) relates to the hedged item (and therefore should be treated in accordance with paragraph 6.5.16). An entity determines the aligned forward element using the valuation of the forward contract that would have critical terms that perfectly match the hedged item.

B6.5.35 If the actual forward element and the aligned forward element differ, an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 6.5.16 as follows:

- (a) If, at inception of the hedging relationship, the absolute amount of the actual forward element is higher than that of the aligned forward element the entity shall:
 - (i) determine the amount that is accumulated in a separate component of equity on the basis of the aligned forward element; and
 - (ii) account for the differences in the fair value changes between the two forward elements in profit or loss.
- (b) If, at inception of the hedging relationship, the absolute amount of the actual forward element is lower than that of the aligned forward element, 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 absolute amount of the actual forward element; and
 - (ii) the absolute amount of the aligned forward element.

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

Hedge of a group of items (section 6.6)

Hedge of a net position

Eligibility for hedge accounting and designation of a net position

- B6.6.1 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 merely 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*.
- B6.6.2 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.
- B6.6.3 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 6.6.6 are met.
- B6.6.4 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 hedging relationships.

Application of the hedge effectiveness requirements to a hedge of a net position

- B6.6.5 In determining whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met when an entity hedges a net position, it shall consider the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. 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. It

hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. In determining whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met, the entity considers the relationship between:

- (a) the fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the firm sale commitments; and
- (b) the foreign currency risk related changes in the value of the firm purchase commitments.

B6.6.6 Similarly, if in the example the entity had a nil net position it would consider the relationship between the foreign currency risk related changes in the value of the firm sale commitments and the foreign currency risk related changes in the value of the firm purchase commitments in determining whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met.

Cash flow hedges that constitute a net position

B6.6.7 When an entity hedges a group of items with offsetting risk positions (ie a net position), 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 can only be eligible as a hedged item if it is a hedge of foreign currency risk and the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss and also specifies their nature and volume.

B6.6.8 For example, an entity has a net position that consists of a bottom layer of FC100 of sales and a bottom layer of FC150 of purchases. Both sales and purchases are denominated in the same foreign currency. For a sufficient specificity of the designation of the hedged net position, the entity specifies in the original documentation of the hedging relationship that sales can be of Product A or B and purchases can be of Machinery type A, Machinery type B and Raw Material A. The entity also specifies the volumes of the transactions by each nature. The entity documents that the bottom layer of sales (FC100) is made up of a forecast sales volume of the first FC70 of Product A and the first FC30 of Product B. If those sales volumes are expected to affect profit or loss in different reporting periods, the entity would include that in the documentation, for example the first FC70 from sales of Product A that are expected to affect profit or loss in reporting period 1 and the first FC30 from sales of Product B that are expected to affect profit or loss in reporting period 2. The entity also documents that the bottom layer of the purchases (FC150) is made up of purchases of the first FC60 of Machinery type A, the first FC40 of Machinery type B and the first FC50 of Raw Material A. If those purchase volumes are expected to affect profit or loss in different reporting periods, the entity would include in the documentation a disaggregation of the purchase volumes by the reporting periods in which they are expected to affect profit or loss (similarly to the documentation of the sales volumes). For example, the forecast transaction would be specified as the first FC60 of purchases of Machinery type A that are expected to affect profit or loss from reporting period 3 over ten reporting periods, the first FC40 of purchases of Machinery type B that are expected to affect profit or loss from reporting period 4 over 20 reporting periods and the first FC50 of purchases of Raw Material A that are expected to be received in reporting period 3 and sold, ie affect profit or loss, in that and the next reporting period. Specifying the nature of the forecast transaction volumes would include aspects such as the

depreciation pattern for items of property, plant and equipment of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items. For example, if the entity uses items of Machinery type A in two different production processes that result in straight-line depreciation over ten reporting periods and the units of production method, respectively, its documentation of the forecast purchase volume for Machinery type A would disaggregate that volume by which of those depreciation patterns will apply.

- B6.6.9 For a cash flow hedge of a net position, the amounts determined in accordance with paragraph 6.5.11 shall include the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. For example, an entity has a group of highly probable forecast sales in nine months' time for FC100 and a group of highly probable forecast purchases in 18 months' time for FC120. It hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. In determining the amount that is recognised in other comprehensive income in accordance with paragraph 6.5.116.5.11(a)–6.5.11(b), the entity compares:
- (a) the fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the highly probable forecast sales; with
 - (b) the foreign currency risk related changes in the value of the highly probable forecast purchases.
- B6.6.10 Similarly, if in the example the entity had a nil net position it would compare the foreign currency risk related changes in the value of the highly probable forecast sales with the foreign currency risk related changes in the value of the highly probable forecast purchases.

Layers of groups of items designated as the hedged item

- B6.6.11 For the same reasons noted in paragraph B6.3.19, 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.
- B6.6.12 A hedging relationship can include layers from several different groups of items. For example, in a hedge of a net position 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

- B6.6.13 If items are hedged together as a group in a cash flow hedge, the items might affect different line items in the statement of profit or loss and other comprehensive income. The presentation of hedging gains or losses in that statement depends on the group of items.
- B6.6.14 If the group of items does not have any offsetting risk positions (eg a group of foreign currency expenses that affect different line items in the statement of profit or loss and other comprehensive income that are 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 shall be done on a

systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument.

- B6.6.15 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 hedging gains or losses in a separate line item in the statement of profit or loss and other comprehensive income. For example, consider a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency expenses of FC80 using a forward exchange contract for FC20. The gain or loss on the forward exchange contract that is reclassified from the cash flow hedge reserve to profit or loss (when the net position affects profit or loss) shall be presented in a separate line item from the hedged sales and expenses. Moreover, if the sales occur in an earlier period than the expenses, the sales revenue is still measured at the spot exchange rate in accordance with IAS 21. The related hedging gain or loss is presented in a separate line item, so that profit or loss reflects the effect of hedging the net position, with a corresponding adjustment to the cash flow hedge reserve. When the hedged expenses affect profit or loss in a later period, the hedging gain or loss previously recognised in the cash flow hedge reserve on the sales is reclassified to profit or loss and presented as a separate line item from those that include the hedged expenses, which are measured at the spot exchange rate in accordance with IAS 21.
- B6.6.16 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 instead 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 the case of a hedge of a net position (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 statement of profit or loss and other comprehensive income. 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).

Appendix C

[Draft] Amendments to other IFRSs

Except where otherwise stated, an entity shall apply the amendments in this appendix when it applies IFRS 9 issued in [insert date 2012]. These amendments incorporate with additions the amendments issued in Appendix C of IFRS 9 in 2009 and 2010.

IFRS 1 First-time Adoption of International Financial Reporting Standards

C1 Paragraph 29 is amended to read as follows, paragraph 39B is deleted and paragraphs 29A and 39M are added:

29 An entity is permitted to designate a previously recognised financial asset as a financial asset measured at fair value through profit or loss in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated at the date of designation and their classification and carrying amount in the previous financial statements.

29A An entity is permitted to designate a previously recognised financial liability as a financial liability at fair value through profit or loss in accordance with paragraph D19. The entity shall disclose the fair value of financial liabilities so designated at the date of designation and their classification and carrying amount in the previous financial statements.

39B [Deleted]

39G [Deleted]

39M IFRS 9 *Financial Instruments*, issued in [insert date 2012], amended paragraphs 29, B1–B6, D1(j), D14, D15, D19 and D20, deleted paragraphs 39B and 39G and added paragraphs 29A, B8, B9, D19A–D19D, E1 and E2. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

C2 In Appendix B, paragraphs B1–B6 are amended to read as follows, and a heading and paragraph B8, and a heading and paragraph B9 are added:

B1 An entity shall apply the following exceptions:

- (a) derecognition of financial assets and financial liabilities (paragraphs B2 and B3);
- (b) hedge accounting (paragraphs B4–B6);
- (c) non-controlling interests (paragraph B7);
- (d) classification and measurement of financial assets (paragraph B8); and
- (e) embedded derivatives (paragraph B9).

Derecognition of financial assets and financial liabilities

B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in IFRS 9 prospectively for transactions occurring on or after the date of transition to IFRSs. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to IFRSs, it shall not recognise

those assets and liabilities in accordance with IFRSs (unless they qualify for recognition as a result of a later transaction or event).

- B3 Despite paragraph B2, an entity may apply the derecognition requirements in IFRS 9 retrospectively from a date of the entity's choosing, provided that the information needed to apply IFRS 9 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge accounting

- B4 As required by IFRS 9, at the date of transition to IFRSs an entity shall:
- (a) measure all derivatives at fair value; and
 - (b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.
- B5 An entity shall not reflect in its opening IFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IFRS 9 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate as a hedged item in accordance with IFRSs an individual item within that net position, or a net position if that meets the requirements in paragraph 6.6.1 of IFRS 9, provided that it does so no later than the date of transition to IFRSs.
- B6 If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IFRS 9, the entity shall apply paragraphs 6.5.6 and 6.5.7 of IFRS 9 to discontinue hedge accounting. Transactions entered into before the date of transition to IFRSs shall not be retrospectively designated as hedges.

Classification and measurement of financial assets

- B8 An entity shall assess whether a financial asset meets the conditions in paragraph 4.1.2 of IFRS 9 on the basis of the facts and circumstances that exist at the date of transition to IFRSs.

Embedded derivatives

- B9 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B4.3.11 of IFRS 9.
- C3 In Appendix D, paragraphs D1(j), D14, D15, D19 and D20 are amended to read as follows and paragraphs D19A–D19D are added:
- D1 An entity may elect to use one or more of the following exemptions:
- (a) ...
 - (j) designation of previously recognised financial instruments (paragraphs D19–D19D);

- (k) ...
- D14 When an entity prepares separate financial statements, IAS 27 requires it to account for its investments in subsidiaries, joint ventures and associates either:
- (a) at cost; or
 - (b) in accordance with IFRS 9.
- D15 If a first-time adopter measures such an investment at cost in accordance with IAS 27, it shall measure that investment at one of the following amounts in its separate opening IFRS statement of financial position:
- (a) cost determined in accordance with IAS 27; or
 - (b) deemed cost. The deemed cost of such an investment shall be its:
 - (i) fair value (determined in accordance with IFRS 9) at the entity's date of transition to IFRSs in its separate financial statements; or
 - (ii) previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, joint venture or associate that it elects to measure using a deemed cost.
- D19 IFRS 9 permits a financial liability (provided it meets certain criteria) to be designated as a financial liability at fair value through profit or loss. Despite this requirement an entity is permitted to designate, at the date of transition to IFRSs, any financial liability as at fair value through profit or loss provided the liability meets the criteria in paragraph 4.2.2 of IFRS 9 at that date.
- D19A An entity may designate a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5 of IFRS 9 on the basis of the facts and circumstances that exist at the date of transition to IFRSs.
- D19B An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 on the basis of the facts and circumstances that exist at the date of transition to IFRSs.
- D19C If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39, the fair value of the financial asset at the date of transition to IFRSs shall be the new amortised cost of that financial asset at the date of transition to IFRSs.
- D19D An entity shall determine whether the treatment in paragraph 5.7.7 of IFRS 9 would create an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of transition to IFRSs.

Fair value measurement of financial assets or financial liabilities at initial recognition

- D20 Despite the requirements of paragraphs 7 and 9, an entity may apply the requirements in the last sentence of paragraph B5.4.8 and in paragraph B5.4.9 of IFRS 9 prospectively to transactions entered into on or after the date of transition to IFRSs.

C4 In Appendix E, a heading and paragraphs E1 and E2 are added:

Exemption from the requirement to restate comparative information for IFRS 9

- E1 In its first IFRS financial statements, an entity that (a) adopts IFRSs for annual periods beginning before 1 January 2012 and (b) applies IFRS 9 shall present at least one year of comparative information. However, this comparative information need not comply with IFRS 7 *Financial Instruments: Disclosures* or IFRS 9, to the extent that the disclosures required by IFRS 7 relate to items within the scope of IFRS 9. For such entities, references to the 'date of transition to IFRSs' shall mean, in the case of IFRS 7 and IFRS 9 only, the beginning of the first IFRS reporting period.
- E2 An entity that chooses to present comparative information that does not comply with IFRS 7 and IFRS 9 in its first year of transition shall:
- (a) apply the recognition and measurement requirements of its previous GAAP in place of the requirements of IFRS 9 to comparative information about items within the scope of IFRS 9.
 - (b) disclose this fact together with the basis used to prepare this information.
 - (c) treat any adjustment between the statement of financial position at the comparative period's reporting date (ie the statement of financial position that includes comparative information under previous GAAP) and the statement of financial position at the start of the *first IFRS reporting period* (ie the first period that includes information that complies with IFRS 7 and IFRS 9) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)–(e) and (f)(i) of IAS 8. Paragraph 28(f)(i) applies only to amounts presented in the statement of financial position at the comparative period's reporting date.
 - (d) apply paragraph 17(c) of IAS 1 to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

IFRS 3 Business Combinations

C5 Paragraphs 16, 42, 53, 56 and 58(b) are amended to read as follows, paragraphs 64A and 64D are deleted and paragraph 64G is added:

- 16 In some situations, IFRSs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
- (a) classification of particular financial assets and liabilities as measured at fair value or at amortised cost, in accordance with IFRS 9 *Financial Instruments*;
 - (b) designation of a derivative instrument as a hedging instrument in accordance with IFRS 9; and

- (c) assessment of whether an embedded derivative should be separated from a host contract in accordance with IFRS 9 (which is a matter of 'classification' as this IFRS uses that term).
- 42 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.
- 53 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with IAS 32 and IFRS 9.
- 56 After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:
- (a) the amount that would be recognised in accordance with IAS 37; and
 - (b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.
- This requirement does not apply to contracts accounted for in accordance with IFRS 9.
- 58 Some changes ...
- (b) Contingent consideration classified as an asset or a liability that:
 - (i) is a financial instrument and is within the scope of IFRS 9 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with IFRS 9.
 - (ii) is not within the scope of IFRS 9 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.
- 64A [Deleted]
- 64D [Deleted]
- 64G IFRS 9, issued in [insert date 2012], amended paragraphs 16, 42, 53, 56 and 58(b) and deleted paragraphs 64A and 64D. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IFRS 4 Insurance Contracts

C6 Paragraph IN3 is amended to read as follows:

- IN3 The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IFRS 9 *Financial Instruments*. Furthermore, it does not address accounting by policyholders.
- C7 Paragraphs 3, 4(d), 7, 8, 12, 34(d), 35 and 45 are amended to read as follows, paragraph 41C and 41D are deleted and paragraph 41F is added:
- 3 This IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 7 and IFRS 9 *Financial Instruments*), except in the transitional provisions in paragraph 45.
- 4 An entity shall not apply this IFRS to:
- (a) ...
 - (d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either IAS 32, IFRS 7 and IFRS 9 or this IFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.
 - (e) ...
- 7 IFRS 9 requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in profit or loss. IFRS 9 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.
- 8 As an exception to the requirements in IFRS 9, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirements in IFRS 9 do apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, those requirements also apply if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).
- 12 To unbundle a contract, an insurer shall:
- (a) apply this IFRS to the insurance component.
 - (b) apply IFRS 9 to the deposit component.
- 34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:
- (a) ...

- (d) shall, if the contract contains an embedded derivative within the scope of IFRS 9, apply IFRS 9 to that embedded derivative.
- (e) ...

Discretionary participation features in financial instruments

35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:

- (a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15–19 to the whole contract (ie both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying IFRS 9 to the guaranteed element.
- (b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying IFRS 9 to the guaranteed element. That amount shall include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying IFRS 9 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher.

(c) ...

41C [Deleted]

41D [Deleted]

41F IFRS 9, issued in [insert date 2012], amended paragraphs 3, 4(d), 7, 8, 12, 34(d), 35, 45 and B18–B20 and Appendix A and deleted paragraphs 41C and 41D. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

45 Despite paragraph 4.4.1 of IFRS 9, when an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets so that they are measured at fair value. This reclassification is permitted if an insurer changes accounting policies when it first applies this IFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and IAS 8 applies.

C8 In Appendix A the defined term ‘deposit component’ is amended to read as follows:

deposit component	A contractual component that is not accounted for as a derivative under IFRS 9 and would be within the scope of IFRS 9 if it were a separate instrument.
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C9 In Appendix B, paragraphs B18–B20 are amended to read as follows:

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

- (a) ...
- (g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in IFRS 9 and are within the scope of IAS 32 [footnote omitted] and IFRS 9, not this IFRS (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 32 [footnote omitted] and IFRS 9 or this IFRS to such financial guarantee contracts.
- (h) ...

B19 The following are examples of items that are not insurance contracts:

- (a) ...
- (e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (see IFRS 9).
- (f) a credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see IFRS 9).
- (g) ...

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9. Among other things, this means ...

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

C10 Paragraph 5 is amended to read as follows, paragraph 44F is deleted and paragraph 44J is added:

- 5 The measurement provisions of this IFRS [footnote omitted] do not apply to the following assets, which are covered by the IFRSs listed, either as individual assets or as part of a disposal group:
 - (a) ...
 - (c) financial assets within the scope of IFRS 9 *Financial Instruments*.
 - (d) ...

44F [Deleted]

44J IFRS 9, issued in [insert date 2012], amended paragraph 5 and deleted paragraph 44F. An entity shall apply that amendment when it applies IFRS 9 as issued in [insert date 2012].

IFRS 7 *Financial Instruments: Disclosures*

C11 In the rubric, the reference to ‘Appendices A–D’ is amended to ‘Appendices A–C’. Paragraphs 2–5, 8–10, 11, 14, 20, 28 and 30 are amended to read as follows, paragraphs 12, 12A, 22–24, 29(b), 44E, 44F, 44H and 44N are deleted and several headings and paragraphs 10A, 11A, 11B, 12B–12D, 20A, 21A–21D, 22A–22C, 23A–23F, 24A–24G, 44I, 44J and 44R are added:

2 The principles in this IFRS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*.

Scope

3 This IFRS shall be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures*. However, in some cases, IAS 27 or IAS 28 permits an entity to account for an interest in a subsidiary, associate or joint venture using IFRS 9; in those cases, entities shall apply the requirements of this IFRS. Entities shall also apply this IFRS to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in IAS 32.

(b) ...

(d) insurance contracts as defined in IFRS 4 *Insurance Contracts*. However, this IFRS applies to derivatives that are embedded in insurance contracts if IFRS 9 requires the entity to account for them separately. Moreover, an issuer shall apply this IFRS to *financial guarantee contracts* if the issuer applies IFRS 9 in recognising and measuring the contracts, but shall apply IFRS 4 if the issuer elects, in accordance with paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring them.

(e) ...

4 This IFRS applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of IFRS 9. Unrecognised financial instruments include some financial instruments that, although outside the scope of IFRS 9, are within the scope of this IFRS (such as some loan commitments).

5 This IFRS applies to contracts to buy or sell a non-financial item that are within the scope of IFRS 9.

8 The carrying amounts of each of the following categories, as specified in IFRS 9, shall be disclosed either in the statement of financial position or in the notes:

- (a) financial assets measured at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of IFRS 9 and (ii) those mandatorily measured at fair value in accordance with IFRS 9.
- (b)–(d)[deleted]
- (e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of IFRS 9 and (ii) those that meet the definition of held for trading in IFRS 9.
- (f) financial assets measured at amortised cost.
- (g) financial liabilities measured at amortised cost.
- (h) financial assets measured at fair value through other comprehensive income.

Financial assets or financial liabilities at fair value through profit or loss

- 9 If the entity has designated as measured at fair value a financial asset (or group of financial assets) that would otherwise be measured at amortised cost, it shall disclose:
 - (a) the maximum exposure to *credit risk* (see paragraph 36(a)) of the financial asset (or group of financial assets) at the end of the reporting period.
 - (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
 - (c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) ...
 - (d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.
- 10 If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 4.2.2 of IFRS 9 and is required to present the effects of changes in that liability's credit risk in other comprehensive income (see paragraph 5.7.7 of IFRS 9), it shall disclose:
 - (a) the amount of change, cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs B5.7.13–B5.7.20 of IFRS 9 for guidance on determining the effects of changes in a liability's credit risk).
 - (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
 - (c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

- (d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.
- 10A If an entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 4.2.2 of IFRS 9 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss (see paragraphs 5.7.7 and 5.7.8 of IFRS 9), it shall disclose:
- (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs B5.7.13–B5.7.20 of IFRS 9 for guidance on determining the effects of changes in a liability’s credit risk); and
 - (b) the difference between the financial liability’s carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- 11 The entity shall also disclose:
- (a) a detailed description of the methods used to comply with the requirements in paragraphs 9(c), 10(a) and 10A(a) and paragraph 5.7.7(a) of IFRS 9, including an explanation of why the method is appropriate.
 - (b) if the entity believes that the disclosure it has given, either in the statement of financial position or in the notes, to comply with the requirements in paragraph 9(c), 10(a) or 10A(a) or paragraph 5.7.7(a) of IFRS 9 does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.
 - (c) a detailed description of the methodology or methodologies used to determine whether presenting the effects of changes in a liability’s credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss (see paragraphs 5.7.7 and 5.7.8 of IFRS 9). If an entity is required to present the effects of changes in a liability’s credit risk in profit or loss (see paragraph 5.7.8 of IFRS 9), the disclosure must include a detailed description of the economic relationship described in paragraph B5.7.6 of IFRS 9.

Financial assets measured at fair value through other comprehensive income

- 11A If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 5.7.5 of IFRS 9, it shall disclose:
- (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.
 - (b) the reasons for using this presentation alternative.
 - (c) the fair value of each such investment at the end of the reporting period.

- (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.
 - (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
- 11B If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:
- (a) the reasons for disposing of the investments.
 - (b) the fair value of the investments at the date of derecognition.
 - (c) the cumulative gain or loss on disposal.
- 12B An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 4.4.1 of IFRS 9. For each such event, an entity shall disclose:
- (a) the date of reclassification.
 - (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.
 - (c) the amount reclassified into and out of each category.
- 12C For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified so that they are measured at amortised cost in accordance with paragraph 4.4.1 of IFRS 9:
- (a) the effective interest rate determined on the date of reclassification; and
 - (b) the interest income or expense recognised.
- 12D If an entity has reclassified financial assets so that they are measured at amortised cost since its last annual reporting date, it shall disclose:
- (a) the fair value of the financial assets at the end of the reporting period; and
 - (b) the fair value gain or loss that would have been recognised in profit or loss during the reporting period if the financial assets had not been reclassified.
- 14 An entity shall disclose:
- (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 3.2.23(a) of IFRS 9; and
 - (b) the terms and conditions relating to its pledge.
- 20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:
- (a) net gains or net losses on:
 - (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of IFRS 9, and those on financial assets or financial liabilities that are mandatorily measured at fair value in accordance with IFRS 9 (eg financial

liabilities that meet the definition of held for trading in IFRS 9). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

(ii)–(iv) [deleted]

(v) financial liabilities measured at amortised cost.

(vi) financial assets measured at amortised cost.

(vii) financial assets measured at fair value through other comprehensive income.

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or financial liabilities not at fair value through profit or loss.

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets measured at amortised cost or financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

(d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39.

(e) ...

20A An entity shall disclose an analysis of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure shall include the reasons for derecognising those financial assets.

Hedge accounting

21A An entity shall apply the disclosure requirements in paragraph 21B–24F for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. 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.

21B 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.

- 21C When paragraphs 22A–24F require the entity to separate by risk category the information disclosed, the entity shall determine each risk category 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.
- 21D To meet the objectives in paragraph 21A, 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 additional explanations to evaluate the quantitative information disclosed. However, an entity shall use the same level of aggregation or disaggregation it uses for disclosure requirements of related information in this IFRS and IFRS 13 *Fair Value Measurement*.

The risk management strategy

- 22 [Deleted]
- 22A An entity shall explain its risk management strategy for each risk category of risk exposures 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 and why.
 - (c) The extent of risk exposures that the entity manages.
- 22B To meet the requirements in paragraph 22A, the information should include (but is not limited to) a description of:
- (a) the hedging instruments that are used (and how they are used) to hedge risk exposures;
 - (b) how the entity determines the economic relationship between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness; and
 - (c) how the entity establishes the hedge ratio and what the sources of hedge ineffectiveness are.
- 22C When an entity designates a specific risk component as a hedged item (see paragraph 6.3.7 of IFRS 9) it shall provide, in addition to the disclosures required by paragraphs 22A and 22B, qualitative or quantitative information about:
- (a) how the entity determined the risk component that is designated as the hedged item (including a description of the nature of the relationship between the risk component and the item as a whole); and

- (b) how the risk component relates to the item in its entirety (for example, the designated risk component historically covered on average 80 per cent of the changes in fair value of the item as a whole).

The amount, timing and uncertainty of future cash flows

- 23 [Deleted]
- 23A Unless exempted by paragraph 23C, an entity shall disclose by risk category quantitative information to allow users of its financial statements to evaluate the terms and conditions of hedging instruments and how they affect the amount, timing and uncertainty of future cash flows of the entity.
- 23B To meet the requirement in paragraph 23A, an entity shall provide a breakdown that discloses:
- (a) a profile of the timing of the nominal amount of the hedging instrument; and
 - (b) if applicable, the average price or rate (for example strike or forward prices etc) of the hedging instrument.
- 23C In situations in which an entity frequently resets (ie discontinues and restarts) hedging relationships because both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the exposure and the hedging instruments used to manage that exposure do not remain the same for long—such as in the example in paragraph B6.5.24(b) of IFRS 9) the entity:
- (a) is exempt from providing the disclosures required by paragraphs 23A and 23B.
 - (b) shall disclose:
 - (i) information about what the ultimate risk management strategy is in relation to those hedging relationships;
 - (ii) a description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
 - (iii) an indication of how frequently the hedging relationships are discontinued and restarted as part of the entity's process in relation to those hedging relationships.
- 23D An entity shall disclose by risk category a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.
- 23E If other sources of hedge ineffectiveness emerge in a hedging relationship, an entity shall disclose those sources by risk category and explain the resulting hedge ineffectiveness.
- 23F For cash flow hedges, an entity shall disclose a description of any forecast transaction for which hedge accounting had been used in the previous period, but which is no longer expected to occur.

The effects of hedge accounting on financial position and performance

- 24 [Deleted]

- 24A An entity shall disclose, in a tabular format, the following amounts related to items designated as hedging instruments separately by risk category 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);
 - (b) the location of the hedging instrument in the statement of financial position;
 - (c) the change in fair value of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period; and
 - (d) the nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.
- 24B An entity shall disclose, in a tabular format, the following amounts related to hedged items separately by risk category for the types of hedges as follows:
- (a) for fair value hedges:
 - (i) the carrying amount of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);
 - (ii) the accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);
 - (iii) the location of the hedged item in the statement of financial position;
 - (iv) the change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period; and
 - (v) the balance of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses in accordance with paragraph 6.5.10 of IFRS 9.
 - (b) for cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) the change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period (ie for cash flow hedges the change in value used to determine the recognised hedge ineffectiveness in accordance with paragraph 6.5.11(c) of IFRS 9);
 - (ii) the balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges that are accounted for in accordance with paragraphs 6.5.11 and 6.5.13(a) of IFRS 9; and
 - (iii) the balances remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting is no longer applied.

- 24C An entity shall disclose, in a tabular format, the following amounts separately by risk category for the types of hedges as follows:
- (a) for fair value hedges:
 - (i) hedge ineffectiveness—ie the difference between the hedging gains or losses of the hedging instrument and the hedged item—recognised in profit or loss (or other comprehensive income for hedges of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5); and
 - (ii) the location of the recognised hedge ineffectiveness in the statement of comprehensive income.
 - (b) for cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) hedging gains or losses of the reporting period that were recognised in other comprehensive income;
 - (ii) hedge ineffectiveness recognised in profit or loss;
 - (iii) the location of the recognised hedge ineffectiveness in the statement of comprehensive income;
 - (iv) the amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (see IAS 1) (differentiating between amounts for which hedge accounting 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);
 - (v) the location of the reclassification adjustment (see IAS 1) in the statement of comprehensive income; and
 - (vi) for hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive income (see paragraph 6.6.4 of IFRS 9).
- 24D When the volume of hedging relationships to which the exemption in paragraph 23C applies is unrepresentative of normal volumes during the period (ie the volume at the reporting date does not reflect the volumes during the period) an entity shall disclose that fact and the reason it believes the volumes are unrepresentative.
- 24E 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) differentiates, at a minimum, between the amounts that relate to the disclosures in paragraph 24C(b)(i) and (b)(iv) as well as amounts accounted for in accordance with paragraph 6.5.11(d)(i) and (d)(iii) of IFRS 9;
 - (b) differentiates between the 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 6.5.15 of IFRS 9, and amounts associated with the forward element of a forward contract accounted for in accordance with paragraph 6.5.16 of IFRS 9.

- 24F An entity shall disclose the information required in paragraph 24E(a) and (b) separately by risk category.

Option to designate a credit exposure as measured at fair value through profit or loss

- 24G If an entity designated a financial instrument, or a proportion of it, as measured at fair value through profit or loss because it uses a credit derivative to manage the credit risk of that financial instrument it shall disclose:

- (a) for credit derivatives that have been used to manage the credit risk of financial instruments designated as measured at fair value through profit or loss in accordance with paragraph 6.7.1 of IFRS 9, a reconciliation of each of the nominal amount and the fair value at the beginning and at the end of the period;
- (b) the gain or loss recognised in profit or loss on designation of a financial instrument, or a proportion of it, as measured at fair value through profit or loss in accordance with paragraph 6.7.1 of IFRS 9; and
- (c) on discontinuation of measuring a financial instrument, or a proportion of it, at fair value through profit or loss, that financial instrument's fair value that has become the new carrying amount in accordance with paragraph (b) of IFRS 9 and the related nominal or principal amount (except for providing comparative information in accordance with IAS 1, an entity does not need to continue this disclosure in subsequent periods).

- 28 In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets (see paragraph B5.1.2A of IFRS 9). In such cases, the entity shall disclose by class of financial asset or financial liability:

- (a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability (see paragraph B5.1.2A(b) of IFRS 9).
- (b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.
- (c) why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

- 29 Disclosures of fair value are not required:

- (a) ...
- (b) [deleted]

(c) ...

30 In the case described in paragraph 29(c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:

(a) ...

44H [Deleted]

44I When an entity first applies IFRS 9, it shall disclose for each class of financial assets at the date of initial application:

- (a) the original measurement category and carrying amount determined in accordance with IAS 39;
- (b) the new measurement category and carrying amount determined in accordance with IFRS 9;
- (c) the amount of any financial assets in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated, distinguishing between those that IFRS 9 requires an entity to reclassify and those that an entity elects to reclassify.

An entity shall present these quantitative disclosures in tabular format unless another format is more appropriate.

44J When an entity first applies IFRS 9, it shall disclose qualitative information to enable users to understand:

- (a) how it applied the classification requirements in IFRS 9 to those financial assets whose classification has changed as a result of applying IFRS 9.
- (b) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

44N [Deleted]

44R IFRS 9, issued in [insert date 2012], amended paragraphs 2–5, 8–10, 11, 14, 20, 28, 30, Appendix A, B1, B5, B10(a), B22 and B27, deleted paragraphs 12, 12A, 22–24, 29(b), 44H and 44N, B4 and Appendix D and added paragraphs 10A, 11A, 11B, 12B–12D, 20A, 21A–21D, 22A–22C, 23A–23F, 24A–24G, 44I and 44J. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012]. Those amendments need not be applied to comparative information provided for periods before the date of initial application of IFRS 9 as issued in [insert date 2012].

C12 In Appendix A, the last paragraph is amended to read as follows:

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

- amortised cost of a financial asset or financial liability
- derecognition
- derivative
- effective interest method

- equity instrument
- fair value
- financial asset
- financial guarantee contract
- financial instrument
- financial liability
- financial liability at fair value through profit or loss
- forecast transaction
- hedging instrument
- held for trading
- reclassification date
- regular way purchase or sale.

C13 In Appendix B, the heading above paragraph B4 and paragraph B4 are deleted and paragraphs B1, B5, B10(a), B22 and B27 are amended to read as follows:

B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IFRS 9 (which determine how financial instruments are measured and where changes in fair value are recognised).

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

- (a) for financial liabilities designated as at fair value through profit or loss:
 - (i) the nature of the financial liabilities the entity has designated as at fair value through profit or loss;
 - (ii) the criteria for so designating such financial liabilities on initial recognition; and
 - (iii) how the entity has satisfied the conditions in paragraph 4.2.2 of IFRS 9 for such designation.
- (aa) for financial assets designated as measured at fair value through profit or loss:
 - (i) the nature of the financial assets the entity has designated as measured at fair value through profit or loss; and
 - (ii) how the entity has satisfied the criteria in paragraph 4.1.5 of IFRS 9 for such designation.
- (b) [deleted]

(c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 3.1.2 of IFRS 9).

(d) ...

B10 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

(a) granting loans to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.

(b) ...

B22 *Interest rate risk* arises on interest-bearing financial instruments recognised in the statement of financial position (eg debt instruments acquired or issued) and on some financial instruments not recognised in the statement of financial position (eg some loan commitments).

B27 In accordance with paragraph 40(a), the sensitivity of profit or loss (that arises, for example, from instruments measured at fair value through profit or loss) is disclosed separately from the sensitivity of other comprehensive income (that arises, for example, from investments in equity instruments whose changes in fair value are presented in other comprehensive income).

C14 Appendix D is deleted.

IAS 1 Presentation of Financial Statements

C15 In paragraph 7, the definition of 'other comprehensive income' and paragraphs 68, 71, 82, 93, 95, 96, 106 and 123 are amended to read as follows, paragraphs 139E and 139G are deleted and paragraph 139M is added:

7 The following terms are used in this Standard with the meanings specified:

***Other comprehensive income* comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.**

The components of other comprehensive income include:

(a) ...

(d) gains and losses from investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 *Financial Instruments*;

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gain or loss on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 (see Chapter 6 of IFRS 9);

(f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of IFRS 9);

(g) changes in fair value of the time value of options when separating the intrinsic value and time value of an option contract and designating as

the hedging instrument only the changes in the intrinsic value (see Chapter 6 of IFRS 9);

- (h) changes in fair value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element (see Chapter 6 of IFRS 9);

...

- 68 The operating cycle of an entity ... Current assets also include assets held primarily for the purpose of trading (examples include some financial assets that meet the definition of held for trading in IFRS 9) and the current portion of non-current financial assets.
- 71 Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading. Examples are some financial liabilities that meet the definition of held for trading in IFRS 9, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities, subject to paragraphs 74 and 75.
- 82 In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:**
- (a) revenue;**
 - (aa) gains and losses arising from the derecognition of financial assets measured at amortised cost;**
 - (b) finance costs;**
 - (c) share of the profit or loss of associates and joint ventures accounted for using the equity method;**
 - (ca) if a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date (as defined in IFRS 9);**
 - (d) ...**
- 93 Other IFRSs specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments. A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. These amounts may have been recognised in other comprehensive income ...
- 95 Reclassification adjustments arise, for example, on disposal of a foreign operation (see IAS 21) and when a hedged forecast transaction affects profit or loss (see paragraph 6.5.11(d) of IFRS 9 in relation to cash flow hedges).

- 96 Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with IAS 16 or IAS 38 or on remeasurements of defined benefit plans recognised in accordance with IAS 19. These components are recognised in other comprehensive income and are not reclassified to profit or loss in subsequent periods. Changes in revaluation surplus may be transferred to retained earnings in subsequent periods as the asset is used or when it is derecognised (see IAS 16 and IAS 38). In accordance with IFRS 9, reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option result in amounts that are removed from the cash flow hedge reserve or a separate component of equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability. These amounts are directly transferred to assets or liabilities.
- 106 An entity shall present a statement of changes in equity as required by paragraph 10. The statement of changes in equity includes the following information:
- (a) ...
 - (b) ...
 - (c) [deleted]
 - (d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:
 - (i) profit or loss;
 - (ii) other comprehensive income; and
 - (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.
- 123 In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements. For example, management makes judgements in determining:
- (a) [deleted]
 - (b) ...
- 139E [Deleted]
- 139G [Deleted]
- 139M IFRS 9, issued in [insert date 2012], amended paragraphs 7, 68, 71, 82, 93, 95 and 123 and deleted paragraphs 139E and 139G. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 2 Inventories

- C16 Paragraph 2(b) is amended to read as follows, paragraphs 40A and 40B are deleted and paragraph 40D is added:

2 This Standard applies to all inventories, except:

- (a) ...
- (b) **financial instruments (see IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*); and**
- (c) ...

40A [Deleted]

40B [Deleted]

40D IFRS 9, issued in [insert date 2012], amended paragraph 2(b) and deleted paragraphs 40A and 40B. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

C17 Paragraph 53 is amended to read as follows, paragraphs 54A and 54B are deleted and paragraph 54D is added:

53 Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with IAS 19 *Employee Benefits*, it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

54A [Deleted]

54B [Deleted]

54D IFRS 9 *Financial Instruments*, issued in [insert date 2012], amended paragraph 53 and deleted paragraphs 54A and 54B. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 12 Income Taxes

C18 In the rubric 'paragraphs 1–95' is amended to 'paragraphs 1–97A'. Paragraph 20 is amended to read as follows, paragraphs 96 and 97 are deleted and paragraph 97C is added:

20 IFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets*, IAS 40 *Investment Property* and IFRS 9 *Financial Instruments*). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, ...

96 [Deleted]

97 [Deleted]

97C IFRS 9, issued in [insert date 2012], amended paragraph 20 and deleted paragraphs 96 and 97. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 18 Revenue

C19 Paragraphs 6(d) and 11 are amended to read as follows, paragraphs 39 and 40 are deleted and paragraph 43 is added:

6 This Standard does not deal with revenue arising from:

- (a) ...
- (d) changes in the fair value of financial assets and financial liabilities or their disposal (see IFRS 9 *Financial Instruments*);
- (e) ...

11 In most cases ... The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IFRS 9.

39 [Deleted]

40 [Deleted]

43 IFRS 9, issued in [insert date 2012], amended paragraphs 6(d) and 11 and deleted paragraph 39 and 40. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

C20 In the rubric 'paragraphs 1–43' is amended to 'paragraphs 1–45'. Paragraph 10A is amended to read as follows, paragraph 44 is deleted and paragraph 47 is added:

10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IFRS 9 *Financial Instruments*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

44 [Deleted]

47 IFRS 9, issued in [insert date 2012], amended paragraph 10A and deleted paragraph 44. An entity shall apply that amendment when it applies IFRS 9 as issued in [insert date 2012].

IAS 21 The Effects of Changes in Foreign Exchange Rates

C21 Paragraph IN5 is amended to read as follows:

IN5 The Standard excludes from its scope foreign currency derivatives that are within the scope of IFRS 9 *Financial Instruments*. Similarly, the material on hedge accounting has been moved to IAS 39.

The reference to IAS 39 in paragraph IN5 is footnoted as follows:

- * In [insert date 2012] the Board replaced the hedge accounting requirements in IAS 39 and relocated them to IFRS 9.

C22 Paragraphs 3(a), 4, 5, 27 and 52(a) are amended to read as follows, paragraphs 60C and 60E are deleted and paragraph 60I is added:

3 This Standard shall be applied: [footnote omitted]

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of IFRS 9 *Financial Instruments*;

(b) ...

4 IFRS 9 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of IFRS 9 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.

5 This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. IFRS 9 applies to hedge accounting.

27 As noted in paragraphs 3(a) and 5, IFRS 9 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an entity to account for some exchange differences differently from the treatment of exchange differences required by this Standard. For example, IFRS 9 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are recognised initially in other comprehensive income to the extent that the hedge is effective.

52 An entity shall disclose:

(a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IFRS 9; and

(b) ...

60C [Deleted]

60E [Deleted]

60I IFRS 9, issued in [insert date 2012], amended paragraphs 3(a), 4, 5, 27 and 52(a) and deleted paragraph 60C and 60E. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012],

IAS 32 *Financial Instruments: Presentation*

C29 Paragraph IN13 is amended to read as follows:

IN13 The revisions eliminate the option previously in IAS 32 to measure the liability component of a compound financial instrument on initial recognition either as a residual amount after separating the equity component, or by using a relative-fair-value method. Thus, any asset and liability components are separated first and the residual is the amount of any equity component. These requirements for separating the liability and equity components of a

compound financial instrument are conformed to both the definition of an equity instrument as a residual and the measurement requirements in IFRS 9.

C30 Paragraphs 3, 4, 8, 12, 23, 31, 42 and 96C are amended to read as follows, paragraphs 97F and 97H are deleted and paragraph 97L is added:

- 3 The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in IFRS 9 *Financial Instruments*, and for disclosing information about them in IFRS 7 *Financial Instruments: Disclosures*.

Scope

- 4 **This Standard shall be applied by all entities to all types of financial instruments except:**
- (a) **those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures*. However, in some cases, IAS 27 or IAS 28 permits an entity to account for an interest in a subsidiary, associate or joint venture using IFRS 9; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.**
 - (b) ...
 - (d) **insurance contracts as defined in IFRS 4 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if IFRS 9 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies IFRS 9 in recognising and measuring the contracts, but shall apply IFRS 4 if the issuer elects, in accordance with paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring them.**
 - (e) **financial instruments that are within the scope of IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IFRS 9).**
- 8 **This standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts 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. However, this standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 5A of IAS 39 *Financial Instruments: Recognition and Measurement*.**

- 12 The following terms are defined in Appendix A of IFRS 9 or paragraph 9 of IAS 39 and are used in this Standard with the meaning specified in IAS 39 and IFRS 9.
- amortised cost of a financial asset or financial liability
 - derecognition
 - derivative
 - effective interest method
 - financial guarantee contract
 - financial liability at fair value through profit or loss
 - firm commitment
 - forecast transaction
 - hedge effectiveness
 - hedged item
 - hedging instrument
 - held for trading
 - regular way purchase or sale
 - transaction costs.
- 23 With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under IFRS 9, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with IFRS 9. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).
- 31 IFRS 9 deals with the measurement of financial assets and financial liabilities. Equity instruments ...
- 42 ...
- In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see IFRS 9, paragraph 3.2.22).**
- 96C The classification of instruments under this exception shall be restricted to the accounting for such an instrument under IAS 1, IAS 32, IAS 39, IFRS 7 and

IFRS 9. The instrument shall not be considered an equity instrument under other guidance, for example IFRS 2.

97F [Deleted]

97H [Deleted]

97L IFRS 9, issued in [insert date 2012], added paragraph 8A, amended paragraphs 3, 4, 8, 12, 23, 31, 42, 96C, AG2 and AG30 and deleted paragraphs 97F and 97H. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

C31 In the Appendix, paragraphs AG2 and AG30 are amended to read as follows:

AG2 The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in IFRS 9.

AG30 Paragraph 28 applies only to issuers of non-derivative compound financial instruments. Paragraph 28 does not deal with compound financial instruments from the perspective of holders. IFRS 9 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective.

IAS 36 *Impairment of Assets*

C32 Paragraphs 2(e) and 5 are amended to read as follows, paragraphs 140F and 140G are deleted and paragraph 140J is added:

2 ...

**(e) financial assets that are within the scope of IFRS 9
Financial Instruments;**

(f) ...

5 This Standard does not apply to financial assets within the scope of IFRS 9, investment property measured at fair value in accordance with IAS 40, or biological assets related to agricultural activity measured at fair value less costs to sell in accordance with IAS 41. However, ...

140F [Deleted]

140G [Deleted]

140J IFRS 9, issued in [insert date 2012], amended paragraphs 2(e) and 5 and deleted paragraphs 140F and 140G. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

C33 In the rubric 'paragraphs 1–95' is amended to 'paragraphs 1–98'. Paragraph 2 is amended to read as follows, paragraph 97 is deleted and paragraph 98 is added:

2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of IFRS 9 *Financial Instruments*.

97 [Deleted]

- 98 IFRS 9, issued in [insert date 2012], amended paragraph 2 and deleted paragraph 97. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IAS 39 *Financial Instruments: Recognition and Measurement*

- C34 Paragraphs IN1–IN26 are deleted. A new Introduction is added as follows:
- The International Accounting Standards Board has decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* over a period of time. The first instalment, dealing with classification and measurement of financial assets, was issued as IFRS 9 *Financial Instruments* in November 2009. The requirements for classification and measurement of financial liabilities and derecognition of financial assets and liabilities were added to IFRS 9 in October 2010. Requirements for hedge accounting were added to IFRS 9 in [insert month] 2012. As a consequence, parts of IAS 39 are being superseded and will become obsolete for annual periods beginning on or after 1 January 2015. The Board is re-deliberating proposals to replace the requirements on impairment. The Board is also deliberating proposals on accounting for macro hedging, which are expected to be published as a discussion paper. The remaining requirements of IAS 39 continue in effect until superseded by future instalments of IFRS 9. The Board expects to replace IAS 39 in its entirety.
- C35 Paragraph 1 is deleted.
- C36 Paragraph 5A is added and paragraphs 2, 4 and 5 are amended to read as follows:
- 2 This Standard shall be applied by all entities to all types of financial instruments except:**
- (a) ...
- (b) **rights and obligations under leases to which IAS 17 *Leases* applies. However:**
- (i) **lease receivables recognised by a lessor are subject to the derecognition provisions of IFRS 9 *Financial Instruments* and impairment provisions of this Standard;**
- (ii) **finance lease payables recognised by a lessee are subject to the derecognition provisions of IFRS 9; and**
- (iii) **derivatives that are embedded in leases are subject to the embedded derivatives provisions of IFRS 9.**
- (c) ...
- (e) **rights and obligations arising under (i) an insurance contract as defined in IFRS 4 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in Appendix A of IFRS 9, or (ii) a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of IFRS 4 if the derivative is not itself a contract within the scope of IFRS 4. Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance**

contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or IFRS 4 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.

- (f) ...
- (h) loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard.
- (i) financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies.
- (j) ...

4 The following loan commitments are within the scope of this Standard:

- (a) loan commitments that the entity designates as financial liabilities at fair value through profit or loss (see paragraph 4.2.2 of IFRS 9). An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
- (b) ...
- (c) commitments to provide a loan at a below market interest rate (see paragraph 4.2.1 of IFRS 9).

5 This standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts 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. However, this standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 5A.

5A An entity may, at initial recognition, irrevocably designate as measured at fair value through profit or loss a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, that was entered into 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 may make this designation only if doing so eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this standard (see paragraph 5).

C37 Paragraphs 8 and 9 are amended to read as follows:

8 The terms defined in IFRS 9 and IAS 32 are used in this Standard with the meanings specified in Appendix A of IFRS 9 and paragraph 11 of IAS 32. IFRS 9 and IAS 32 define the following terms:

- derecognition
- derivative
- equity instrument
- fair value
- financial asset
- financial guarantee contract
- financial instrument
- financial liability

and provide guidance on applying those definitions.

In paragraph 9, the 'Definition of a derivative', 'Definitions of four categories of financial instruments' and 'Definition of a financial guarantee contract' are deleted. In 'Definitions relating to recognition and measurement', the definitions 'derecognition', 'fair value' and 'regular way purchase or sale' are deleted.

C38 Paragraphs 10–57 are deleted.

C39 The heading 'Impairment and uncollectibility of financial assets' above paragraph 58 and paragraphs 58 and 63 are amended to read as follows and paragraphs 61 and 66–70 and the headings above paragraphs 63, 66 and 67 are deleted:

Impairment and uncollectibility of financial assets measured at amortised cost

58 An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.

63 If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as ...

C40 Paragraph 79 is deleted and paragraphs 71, 88(d), 89(b), 90 and 96(c) are amended to read as follows:

71 If an entity applies IFRS 9 (as issued in [Date] 2012) it shall apply the hedge accounting requirements in chapter 6 of IFRS 9. However, for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, an entity may, in accordance with paragraph 6.1.3 of IFRS 9, apply the hedge accounting requirements in this standard instead of those in IFRS 9. In that case the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114-AG132).

88 A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of the following conditions are met.

(a) ...

- (d) **The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.**
- (e) ...

Fair value hedges

89 If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

- (a) ...
- (b) **the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost.**

90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 5.7.1 of IFRS 9.

96 More specifically, a cash flow hedge is accounted for as follows:

- (a) ...
- (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 5.7.1 of IFRS 9.

C41 Paragraphs 103B, 103C, 103K, 104 and 108C are amended to read as follows, paragraphs 103H–103J, 103L, 103M, 103O and 105–107A are deleted and paragraph 103R is added:

103B *Financial Guarantee Contracts* (Amendments to IAS 39 and IFRS 4), issued in August 2005, amended paragraphs 2(e) and (h), 4 and AG4, added paragraph AG4A, added a new definition of financial guarantee contracts and deleted paragraph 3. An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to IAS 32 [footnote omitted] and IFRS 4 at the same time.

103C IAS 1 (as revised in 2007) amended the terminology used throughout IFRSs. In addition it amended paragraphs 95(a), 97, 98, 100, 102, 108 and AG99B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies IAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

103K *Improvements to IFRSs*, issued in April 2009, amended paragraphs 2(g), 97 and 100. An entity shall apply the amendments to those paragraphs prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

103L [Deleted]

103M [Deleted]

103O [Deleted]

103R IFRS 9, issued in [Date] 2012, added paragraph 5A, amended paragraphs 2, 4, 5, 8, 9, 58, 63, 71, 88(d), 89(b), 90, 96(c), 103B, 103C, 103K, 104, 108C, AG3–AG4, AG8, AG84, AG95, AG114(a) and AG118(b) and deleted paragraphs 1, 10–57, 61, 66–70, 79, 103H–103J, 103L, 103M, 103O, 105–107A, AG4B–AG4K, AG9–AG12A, AG14–AG15, AG27–AG83 and AG96. An entity shall apply those amendments when it applies IFRS 9 as issued in [Date] 2012.

104 This Standard shall be applied retrospectively except as specified in paragraph 108. The opening balance of retained earnings for the earliest prior period presented and all other comparative amounts shall be adjusted as if this Standard had always been in use unless restating the information would be impracticable. If restatement is impracticable, the entity shall disclose that fact and indicate the extent to which the information was restated.

108C Paragraphs 73 and AG8 were amended by *Improvements to IFRSs*, issued in May 2008. Paragraph 80 was amended by *Improvements to IFRSs*, issued in April 2009. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application of all the amendments is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

C42 In Appendix A, paragraphs AG3–AG4 are amended to read as follows:

AG3 ... If the equity method is not appropriate, the entity applies this Standard and IFRS 9 to that strategic investment.

AG3A This Standard and IFRS 9 apply to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of IFRS 4.

AG4 Financial guarantee contracts may have various legal forms, such as...

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 4 if the risk transferred is significant, the issuer applies this Standard and IFRS 9. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard and IFRS 9 or IFRS 4 to such financial guarantee contracts. If this Standard and IFRS 9 apply, paragraph 5.1.1 of IFRS 9 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 of IFRS 9 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with IAS 37; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 (see paragraph 4.2.1(c) of IFRS 9).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in IFRS 9, and are not insurance contracts as defined in IFRS 4. Such guarantees are derivatives and the issuer applies this Standard and IFRS 9 to them.

(c) ...

C43 In Appendix A, paragraphs AG4B–AG4K, AG9–AG12A and AG14–AG15 are deleted and paragraph AG8 is amended to read as follows:

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense.

C44 In Appendix A, paragraphs AG27–AG83 are deleted.

C45 In Appendix A, the heading 'Impairment and uncollectibility of financial assets (paragraphs 58–70)' above paragraph AG84 and paragraph AG84 are amended to read as follows:

Impairment and uncollectibility of financial assets measured at amortised cost (paragraphs 58–65)

AG84 Impairment of a financial asset measured at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a financial asset measured at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a financial asset measured at amortised cost has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset measured at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

C46 In Appendix A, paragraph AG96 and the first footnote to paragraph AG118(b) are deleted and paragraphs AG95, AG114(a) and AG118(b) are amended to read as follows:

AG95 A financial asset measured at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 [Deleted]

AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG115–AG132 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios, in which case it applies the guidance below to each portfolio separately.

(b) ...

AG118 As an example of the designation set out...

(a) ...

(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because IFRS 9 specifies that the fair value of a financial liability with a demand feature (such as...

C47 The heading 'Transition (paragraphs 103–108N)' above paragraph AG133 is amended to read as follows:

Transition (paragraphs 103–108C)

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

C48 In the rubric 'paragraphs 1–14A' is amended to 'paragraphs 1–16'. Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. Paragraph 15 is deleted and paragraph 17 is added:

15 [Deleted]

17 IFRS 9, issued in [insert date 2012], amended paragraphs A8 and A10 and deleted paragraph 15. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

C49 In the Appendix, paragraphs A8 and A10 are amended to read as follows:

A8 Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 5.4.3 of IFRS 9, which states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand ...' Accordingly, the co-operative entity

classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

- A10 Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on 1 January 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 5.4.3 of IFRS 9. It therefore transfers on 1 January 20X3 from equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity. In this example the entity does not recognise a gain or loss on the transfer.

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

- C50 Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. Paragraph 5 is amended to read as follows and paragraph 14A is deleted and paragraph 14C is added:

5 A residual interest in a fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of IFRS 9 and is not within the scope of this Interpretation.

14A [Deleted]

14C IFRS 9, issued in [insert date 2012], amended paragraph 5 and deleted paragraph 14A. An entity shall apply that amendment when it applies IFRS 9 as issued in [insert date 2012].

IFRIC 10 Interim Financial Reporting and Impairment

- C51 In the rubric 'paragraphs 1–10' is amended to 'paragraphs 1–13'. Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. Paragraphs 5, 6, 11 and 12 are deleted, paragraphs 1, 2, 7 and 8 are amended to read as follows and paragraph 13 is added:

1 An entity is required to assess goodwill for impairment at the end of each reporting period, and, if required, to recognise an impairment loss at that date in accordance with IAS 36. However, ...

2 The Interpretation addresses the interaction between the requirements of IAS 34 and the recognition of impairment losses on goodwill in IAS 36, and the effect of that interaction on subsequent interim and annual financial statements.

5 [Deleted]

6 [Deleted]

7 The Interpretation addresses the following issue:

Should an entity reverse impairment losses recognised in an interim period on goodwill if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period?

Consensus

- 8 An entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill.
- 11 [Deleted]
- 12 [Deleted]
- 13 IFRS 9, issued in [insert date 2012], amended paragraphs 1, 2, 7 and 8 and deleted paragraphs 5, 6, 11 and 12. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

IFRIC 12 *Service Concession Arrangements*

- C52 Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. Paragraphs 23–25 are amended to read as follows, paragraphs 28A and 28B are deleted and paragraph 28C is added:
- 23 IAS 32 and IFRSs 7 and 9 apply to the financial asset recognised under paragraphs 16 and 18.
- 24 The amount due from or at the direction of the grantor is accounted for in accordance with IFRS 9 as:
- (a) at amortised cost; or
- (b) measured at fair value through profit or loss.
- 25 If the amount due from the grantor is accounted for at amortised cost, IFRS 9 requires interest calculated using the effective interest method to be recognised in profit or loss.
- 28A [Deleted]
- 28B [Deleted]
- 28C IFRS 9, issued in [insert date 2012], amended paragraphs 23–25 and deleted paragraphs 28A and 28B. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

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

- C53 A reference to IFRS 9 *Financial Instruments* is added under the heading 'References'.
- C54 Paragraphs 3, 5, 6, 7, 14 and 16 are amended to read as follows and paragraph 18A is added:
- 3 IFRS 9 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship...
- 5 IFRS 9 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk...
- 6 IAS 21 and IFRS 9 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective

hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation...

- 7 This Interpretation applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IFRS 9...
- 14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group, as long as the designation, documentation and effectiveness requirements of IFRS 9 paragraph 6.4.1 that relate to a net investment hedge are satisfied...
- 16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount that IFRS 9 paragraph 6.5.14 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.
- 18A IFRS 9, issued in [insert date 2012], amended paragraphs 3, 5-7, 14, 16, AG1 and AG8(a). An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

C55 In the Appendix, paragraphs AG1 and AG8(a) are amended to read as follows:

AG1 This appendix illustrates the application of the Interpretation using the corporate structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with IFRS 9...

AG8 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

- (a) in respect of the US\$300 million external borrowing of Subsidiary A, the amount that IFRS 9 requires to be identified, ie the total change in value in respect of foreign exchange risk that was recognised in other comprehensive income as the effective portion of the hedge; and

...

IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments

C56 In the rubric 'paragraphs 1–13' is amended to 'paragraphs 1–15'. Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. Paragraphs 4(a), 5, 7, 9 and 10 are amended to read as follows, paragraph 14 is deleted and paragraph 16 is added:

4 This Interpretation addresses the following issues:

- (a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 3.3.3 of IFRS 9?

(b) ...

Consensus

- 5 The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 3.3.3 of IFRS 9. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph 3.3.1 of IFRS 9.
- 7 If the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished. In measuring the fair value of a financial liability extinguished that includes a demand feature (eg a demand deposit), paragraph 5.4.3 of IFRS 9 is not applied.
- 9 The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in profit or loss, in accordance with paragraph 3.3.3 of IFRS 9. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.
- 10 When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph 8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph 3.3.2 of IFRS 9.
- 14 [Deleted]
- 16 IFRS 9, issued in [insert date 2012], amended paragraphs 4(a), 5, 7, 9 and 10 and deleted paragraph 14. An entity shall apply those amendments when it applies IFRS 9 as issued in [insert date 2012].

SIC Interpretation 7 *Introduction of the Euro*

C57 The footnote to the third sentence in paragraph 6 is amended to read as follows:

- * As SIC-7 was issued before IAS 39, the previous version of this Interpretation could refer only to the entity's own accounting policies on the matter. The accounting for hedges was subsequently covered under IAS 39 *Financial Instruments: Recognition and Measurement*. In [insert date 2012] the Board replaced the hedge accounting requirements in IAS 39 and relocated them to IFRS 9 *Financial Instruments*.

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

C58 Below the heading 'References', the reference to IAS 39 is deleted and a reference to IFRS 9 *Financial Instruments* is added. In the Consensus, paragraph 7 and the section below 'Effective date' is amended to read as follows:

- 7 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under IAS 37, IFRS 4 or IFRS 9, depending on the terms.

Effective date

This Interpretation becomes effective on 31 December 2001. Changes in accounting policies shall be accounted for in accordance with IAS 8.

IFRS 9, issued in [insert date 2012], amended paragraph 7. An entity shall apply that amendment when it applies IFRS 9 as issued in [insert date 2012].

IFRS 9
CHAPTER 6
HEDGE ACCOUNTING
Basis for Conclusions

**BASIS FOR CONCLUSIONS ON
IFRS 9 FINANCIAL INSTRUMENTS**

	<i>from paragraph</i>
INTRODUCTION	BCIN.1
SCOPE	BC2.1
RECOGNITION AND DERECOGNITION	BCZ3.1
Derecognition of a financial asset	BCZ3.1
Arrangements under which an entity retains the contractual rights to receive the contractual cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients	BCZ3.14
Transfers that do not qualify for derecognition	BCZ3.25
Continuing involvement in a transferred asset	BCZ3.27
Improved disclosure requirements issued in October 2010	BC3.30
CLASSIFICATION	BC4.1
Classification of financial assets	BC4.1
Classification of financial liabilities	BC4.46
Option to designate a financial asset or financial liability at fair value through profit or loss	BCZ4.54
Embedded derivatives	BC4.83
Reclassification	BC4.111
MEASUREMENT	BCZ5.1
Fair value measurement considerations	BCZ5.1
Gains and losses	BC5.21
HEDGE ACCOUNTING	BC6.1
The objective of hedge accounting	BC6.1
Hedging instruments	BC6.27
Hedged items	BC6.64
Qualifying criteria for hedge accounting	BC6.136
Accounting for qualifying hedges	BC6.178
Hedges of a group of items	BC6.304
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EFFECTIVE DATE AND TRANSITION	BC7.1
Effective date	BC7.1
Mandatory Effective Date of IFRS 9—November 2011	BC7.9A
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Transition related to IFRS 9 as issued in November 2009	BC7.10
Transitional disclosures	BC7.24
Transition related to the requirements added to IFRS 9 in October 2010	BC7.26
Transitional insurance issues	BC7.30

Disclosures on Transition from IAS 39 to IFRS 9—November 2011	BC7.34A
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Summary of main changes from the exposure draft issued in 2009	BCG.1
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APPENDIX	
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Basis for Conclusions on IFRS 9 *Financial Instruments*

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

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

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

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

Introduction

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

Classification and measurement

- BCIN.3 IFRS 9 is a new standard dealing with the accounting for financial instruments. In developing IFRS 9, the Board considered the responses to its exposure draft *Financial Instruments: Classification and Measurement*, published in July 2009.
- BCIN.4 That exposure draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the Board should finalise its proposals on classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the Board had more fully considered and debated the issues relating to financial liabilities. Those respondents pointed out that the Board accelerated its project on financial instruments

because of the global financial crisis, which placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the Board should consider issues related to financial liabilities more fully before finalising the requirements for classification and measurement of financial liabilities.

- BCIN.5 The Board noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with the classification and measurement of financial assets. In the Board's view, requirements on classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and the requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the Board noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement of financial assets in accordance with IAS 39.
- BCIN.6 Thus, financial liabilities, including derivative liabilities, remained within the scope of IAS 39. Taking that course enabled the Board to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.
- BCIN.7 Immediately after issuing IFRS 9, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The Board obtained information and views from its Financial Instruments Working Group (FIWG) and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the Board received were that the requirements in IAS 39 for classifying and measuring financial liabilities are generally working well but that the effects of the changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46–BC4.53).
- BCIN.8 By taking that course, the issue of credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010, the Board published an exposure draft *Fair Value Option for Financial Liabilities*, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised requirements that were added to IFRS 9 in October 2010.
- BCIN.9 The Board is committed to completing its project on financial instruments expeditiously. The Board is also committed to increasing comparability between IFRSs and US generally accepted accounting principles (GAAP) requirements for financial instruments.

Hedge accounting

- BCIN.10 In December 2010 the Board published the exposure draft Hedge Accounting. That exposure draft contained an objective for hedge accounting that aimed to align accounting more closely with risk management and to provide useful information about the purpose and effect of hedging instruments. It also proposed requirements for:

- (a) what financial instruments qualify for designation as hedging instruments;
- (b) what items (existing or expected) qualify for designation as hedged items;
- (c) an objective-based hedge effectiveness assessment;
- (d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*); and
- (e) hedge accounting presentation and disclosures.

- BCIN.11 After the publication of the exposure draft, the Board began an extensive outreach programme to gather feedback on the hedge accounting proposals. The Board obtained information and views from users, preparers, treasurers, risk management experts, auditors, standard-setters and regulators from a range of industries across different geographical regions.
- BCIN.12 The views from participants in the Board's outreach activities were largely consistent with the views in the comment letters to the exposure draft. The Board received strong support for the objective of aligning accounting more closely with risk management. However, many asked the Board for added clarification on some of the fundamental changes proposed in the exposure draft.
- BCIN.13 The Board considered the responses in the comment letters to that exposure draft and the information received during its outreach activities in finalising the requirements for hedge accounting that were added to IFRS 9 in [Date] 2012.

Hedge accounting (chapter 6)

The objective of hedge accounting

- BC6.1 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRSs. For example, the hedge accounting guidance in IAS 39 permitted:
- (a) recognition of items that would otherwise not be recognised (for example, a firm commitment);
 - (b) measurement of an item on a basis that is different from the measurement basis that is normally required (for example, adjusting the measurement of a hedged item in a fair value hedge); and
 - (c) deferral of the changes in the 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 (for example, the hedging of a highly probable forecast transaction).
- BC6.2 The Board noted that, although hedge accounting was an exception from normal accounting requirements, in many situations the information that resulted from applying those normal requirements without using hedge accounting did not provide useful information or omitted important information. Hence, the Board concluded that hedge accounting should be retained.
- BC6.3 In the Board's view, a consistent hedge accounting model requires an objective that describes *when* and *how* an entity should:
- (a) override the general recognition and measurement requirements in IFRSs (ie when and how an entity should apply hedge accounting); and

- (b) recognise effectiveness and/or ineffectiveness of a hedging relationship (ie when and how gains and losses should be recognised).

BC6.4 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 accounting for hedged items and manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

BC6.5 However, the Board rejected both objectives for hedge accounting. 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.

BC6.6 Consequently, the Board decided to propose in the exposure draft an objective that combined elements of the two objectives. The Board considered that the proposed objective of hedge accounting reflected a broad articulation of a principle-based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provided for a focus on the statement of financial position and the statement of comprehensive income thus reflecting the effects of the individual assets and liabilities associated with the risk management activities on those statements. This reflected the Board's intention that entities should provide useful information about the purpose and effect of hedging instruments for which hedge accounting is applied.

BC6.7 The Board also noted that, notwithstanding that an entity's risk management activities were central to the objective of hedge accounting, an entity would only achieve hedge accounting if it met all the qualifying criteria.

BC6.8 Almost all respondents to the exposure draft as well as participants in the Board's outreach activities supported the objective of hedge accounting proposed in the exposure draft.

Open portfolios

BC6.9 In practice, risk management often assesses risk exposures on a continuous basis and at a portfolio level. Risk management strategies tend to have a time horizon (for example, two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to such hedged portfolios and other exposures are removed from them.

BC6.10 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 discontinuation of the hedging relationship for the previous closed portfolio of items and designation of a new hedging relationship for the 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 (for example, daily).

- BC6.11 Closed hedged portfolios are hedged portfolios in which items cannot be added, removed or replaced without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies at inception the hedged items that form that particular hedging relationship.
- BC6.12 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 for which the items that make up that position are included in a specified overall group of items. See paragraphs BC6.305–BC6.345.
- BC6.13 Consequently, for fair value hedge accounting for a portfolio hedge of interest rate risk the exposure draft did not propose replacing the requirements in IAS 39.
- BC6.14 The Board received feedback from financial institutions as well as from entities outside the financial sector that addressing situations in which entities use a dynamic risk management strategy was important. Financial institutions also noted that this was important because some of their risk exposures might only qualify for hedge accounting in an open portfolio context (for example, non-interest bearing demand deposits).
- BC6.15 The Board noted that this is a complex topic that warrants thorough research and input from constituents. Accordingly, the Board decided to separately deliberate accounting for macro hedging as part of its active agenda with the objective of issuing a discussion paper. The Board noted that this would enable IFRS 9 to be completed more quickly and would enable the new 'general' hedge accounting requirements to be available as part of IFRS 9. The Board also noted that during the project on accounting for macro hedging the status quo of 'macro' hedge accounting under previous IFRSs would broadly be maintained so that entities would not be worse off in the meantime.

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

- BC6.16 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 defined a hedging relationship as a relationship in which the exposure to be hedged could affect profit or loss. Consequently, an entity could not apply hedge accounting if the hedged exposure affected other comprehensive income without reclassification out of other comprehensive income to profit or loss because only such a reclassification would mean that the hedged exposure could ultimately affect profit or loss.
- BC6.17 For its exposure draft, 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, instead of only profit or loss. However, the Board had concerns about the mechanics of matching the changes

in the fair value of the hedging instrument with the changes in the value of the hedged item attributable to the hedged risk. Furthermore, the Board was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the Board considered alternative approaches.

- BC6.18 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 on the classification and measurement (the first phase of the IFRS 9 project) 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.
- BC6.19 Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:
- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but
 - (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income.
- BC6.20 Consequently, in its exposure draft the Board proposed prohibiting hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it could not be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the 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).
- BC6.21 However, the Board noted that dividends from such investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from such investments could be an eligible hedged item (if all qualifying criteria for hedge accounting are met).
- BC6.22 Almost all respondents to the exposure draft disagreed with the Board's proposal to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. Those respondents argued that hedge accounting should be available for equity investments at fair value through other comprehensive income so that hedge accounting can be more closely aligned with risk management activities. In particular, respondents commented that it was a common risk management strategy for an entity to hedge the foreign exchange risk exposure of equity investments (irrespective of the accounting designation at fair value through profit or loss or other comprehensive income). In addition, an entity might also hedge the equity price risk even though it does not intend to sell the equity investment because it might still want to protect itself against equity volatility.

- BC6.23 In the light of those concerns, the Board reconsidered whether it should allow investments in equity instruments designated as at fair value through other comprehensive income to be designated as a hedged item in a fair value hedge. Some respondents argued that the inconsistencies that the Board had discussed in its original deliberations (see paragraphs BC6.18 and BC6.19) could be overcome by using a differentiating approach, whereby if fair value changes of the hedging instrument exceeded those of the hedged item hedge ineffectiveness would be presented in profit or loss and otherwise in other comprehensive income. However, the Board noted that the cumulative ineffectiveness presented in profit or loss or other comprehensive income over the total period of the hedging relationship might still contradict the principle of not recycling to profit or loss changes in the fair value of equity investments at fair value through other comprehensive income. Hence, the Board rejected that approach.
- BC6.24 The Board noted that recognising hedge ineffectiveness always in profit or loss would be inconsistent with the irrevocable election of presenting in other comprehensive income fair value changes of investments in equity instruments (see paragraph BC6.19). The Board considered that that outcome would defeat its aim to reduce complexity in accounting for financial instruments.
- BC6.25 The Board considered that an approach that would recognise hedge ineffectiveness always in other comprehensive income (without recycling) could facilitate hedge accounting in situations in which an entity's risk management involves hedging risks of equity investments designated as at fair value through other comprehensive income without contradicting the classification and measurement requirements of IFRS 9. The Board noted that, as a consequence, hedge ineffectiveness would not always be presented in profit or loss but would always follow the presentation of the value changes of the hedged item.
- BC6.26 The Board considered that, on balance, the advantages of the approach that always recognises hedge ineffectiveness in other comprehensive income (without recycling) for these investments in equity instruments would outweigh any disadvantages and, overall, that this alternative was superior to the other alternatives that the Board had contemplated. Hence, the Board decided to include this approach in the final requirements.
- BC6.27 The Board also considered whether hedge accounting should be more generally available for exposures that only affect other comprehensive income (but not profit or loss). However, the Board was concerned that such a broad scope might result in items qualifying for hedge accounting that might not be suitable hedged items and hence have unintended consequences. Consequently, the Board decided against making hedge accounting more generally available to such exposures.

Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

- BC6.28 IAS 39 required the separation of derivatives embedded in hybrid financial assets and liabilities that are not closely related to the host contract (bifurcation). In accordance with IAS 39, the separated derivative was eligible for designation as

a hedging instrument. In accordance with IFRS 9, hybrid financial assets are measured in their entirety (ie including any embedded derivative) at either amortised cost or fair value through profit or loss. No separation of any embedded derivative is permitted.

- BC6.29 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.
- BC6.30 The Board rejected both alternatives. Consequently, the Board proposed not to allow derivative features embedded in financial assets to be eligible hedging instruments (even though they can be an integral part of a hybrid financial asset that is measured at fair value through profit or loss and designated as the hedging instrument in its entirety—see paragraph BC6.40). The reasons for the Board’s decision are summarised below.
- BC6.31 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 was not to reflect risk management activities, but instead to prevent an entity from circumventing the requirements for the recognition and measurement of derivatives. The Board also noted that the designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 was not very common in practice. Hence, the Board considered that reintroducing the separation of embedded derivatives for hybrid financial assets does not target hedge accounting considerations, would therefore not be an appropriate means to address any hedge accounting concerns and in addition would reintroduce complexity for situations that were not common in practice.
- BC6.32 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 (for example, 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.
- BC6.33 The Board therefore retained its original decision during the redeliberations of its exposure draft.

Non-derivative financial instruments

- BC6.34 Hedge accounting shows how the changes in the fair value or cash flows of a hedging instrument offset the changes in the fair value or cash flows of a designated hedged item attributable to the hedged risk if it reflects an entity's risk management strategy.
- BC6.35 IAS 39 permitted non-derivative financial assets and non-derivative financial liabilities (for example, monetary items denominated in a foreign currency) to be designated as hedging instruments only for a hedge of foreign currency risk. Designating a non-derivative financial asset or liability denominated in a foreign currency as a hedge of foreign currency risk in accordance with IAS 39 was equivalent to designating a risk component of a hedging instrument in a hedging relationship. This foreign currency risk component is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because the foreign currency risk component is determined in accordance with foreign currency translation requirements in IAS 21, it is already available for incorporation by reference in the financial instruments standard. Consequently, permitting the use of a foreign currency risk component for hedge accounting purposes did not require separate, additional requirements for risk components within the hedge accounting model.
- BC6.36 Not allowing the disaggregation of a non-derivative financial instrument used as a hedge into risk components, other than foreign currency risk, has implications for the likelihood of achieving hedge accounting for those instruments. This is because the effects of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness assessment. Consequently, depending on the size of the components that are not related to the risk being hedged, in most scenarios it will be difficult to demonstrate that there is an economic relationship between the hedged item and the hedging instrument that gives rise to an expectation that their values will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged.
- BC6.37 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 BC6.32 the Board decided not to explore such an approach.
- BC6.38 The Board also considered two alternatives to the requirements of IAS 39 (which limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk). The Board considered whether for hedges of all types of risk (ie not limited to hedges of foreign currency risk) it should extend the eligibility as hedging instruments to non-derivative financial instruments:
- (a) that are classified as at fair value through profit or loss; or (alternatively to those)
 - (b) that are part of other categories of IFRS 9.
- BC6.39 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 because to apply hedge accounting would require changing the measurement of non-derivative financial instruments measured at amortised cost when designated as hedging instruments. The Board considered that the only way to mitigate this issue was to allow for the designation of components of the non-derivative financial instrument. This would limit the change in measurement to a component of the instrument attributable to the hedged risk. However, the Board had already rejected that idea in its deliberations (see paragraph BC6.37).

- BC6.40 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 or the recognition of gains and losses 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 proposed in its exposure draft that non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments if they are designated in their entirety (in addition to hedges of foreign currency risk for which the hedging instrument can be designated on a risk component basis—see paragraph BC6.35).
- BC6.41 Generally, respondents to the exposure draft agreed that distinguishing between derivative and non-derivative financial instruments was not appropriate for the purpose of determining their eligibility as hedging instruments. Many respondents believed that extending the eligibility criteria to non-derivative financial instruments at fair value through profit or loss would allow better representation of an entity's risk management activities in the financial statements. The feedback highlighted that this was particularly relevant in countries that have legal and regulatory restrictions on the use and availability of derivative financial instruments.
- BC6.42 Some respondents argued that there was no conceptual basis to restrict the eligibility of non-derivative financial instruments to those that are measured at fair value through profit or loss. In their view all non-derivative financial instruments should be eligible as hedging instruments.
- BC6.43 Other respondents thought that that the proposals were not restrictive enough, particularly in relation to non-derivative financial instruments that are measured at fair value through profit or loss as a result of applying the fair value option. Those respondents thought that the Board should specifically restrict the use of non-derivative financial instruments designated under the fair value option because these have usually been elected to be measured at fair value to eliminate an accounting mismatch and hence should not qualify for hedge accounting. Some respondents also questioned whether a financial liability that is measured at fair value, with changes in the fair value attributable to changes in the liability's credit risk presented in other comprehensive income, would be an eligible hedging instrument under the proposals in the exposure draft.
- BC6.44 The Board noted that in its deliberations leading to the exposure draft it had already considered whether non-derivative financial instruments measured at amortised cost should also be eligible for designation as hedging instruments. The Board remained concerned that designating as hedging instruments those non-derivative financial instruments that were not already accounted for at fair

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

- BC6.45 The Board was also concerned that allowing non-derivative financial instruments not already accounted for at fair value through profit or loss to be designated as hedging instruments would mean that the hedge accounting model would not only change the measurement basis of the hedged item, as the existing hedge accounting model already does, but also the measurement basis of hedging instruments. Hence, it could for example result in situations where a natural hedge (ie an accounting match) is already achieved on an amortised cost basis between two non-derivative financial instruments, but hedge accounting could still be used to change the measurement basis of both those instruments to fair value (one as a hedged item and the other as the hedging instrument).
- BC6.46 Consequently, the Board decided that non-derivative financial instruments should be eligible hedging instruments only if they are already accounted for at fair value through profit or loss.
- BC6.47 The Board also discussed whether or not those non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of applying the fair value option should be eligible for designation as a hedging instrument. The Board considered that any designation as a hedging instrument should not contradict the entity's election of the fair value option (ie recreate the accounting mismatch that the election of the fair value option addressed). For example, if a non-derivative financial instrument that has previously been designated under the fair value option is included in a cash flow hedge relationship, the accounting for the non-derivative financial instrument under the fair value option would have to be overridden. This is because all (or part) of the changes in the fair value of that hedging instrument are recognised in other comprehensive income. However, recognising the changes in fair value in other comprehensive income re-introduces the mismatch that the application of the fair value option eliminated in the first instance. The Board noted that similar considerations apply to fair value hedges and hedges of net investments in foreign operations.
- BC6.48 Consequently, the Board considered whether it should introduce a general prohibition against designating, as hedging instruments, non-derivative instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option. However, such a prohibition would not necessarily be appropriate. The Board noted that one of the items underlying the fair value option might be sold or terminated at a later stage (ie the circumstances that made the fair value option available might be subject to change or later disappear). However, because the fair value option is irrevocable it would mean a non-derivative financial instrument for which the fair value option was initially elected could never qualify as a hedging instrument

even if there was no longer a conflict between the purpose of the fair value option and the purpose of hedge accounting. A general prohibition would not allow the use of hedge accounting at a later stage even when hedge accounting might then mitigate an accounting mismatch (without recreating another one).

- BC6.49 The Board noted that when a non-derivative financial instrument is accounted for at fair value through profit or loss as a result of electing the fair value option, the appropriateness of its use as a hedging instrument depends on the relevant facts and circumstances underlying the fair value option designation. The Board considered that if an entity designates as a hedging instrument a financial instrument for which it originally elected the fair value option, and this results in the mitigation of an accounting mismatch (without recreating another one), using hedge accounting was appropriate. However, the Board emphasised that if applying hedge accounting recreates, in the financial statements, the mismatches that electing the fair value option sought to eliminate, then designating the financial instrument for which the fair value option was elected as a hedging instrument would contradict the basis (qualifying criterion) on which the fair value option was elected. Hence, in those situations there would be a conflict between the purpose of the fair value option and the purpose of hedge accounting as they could not be achieved at the same time but instead would overall result in another accounting mismatch. Consequently, the Board emphasised that designating the non-derivative financial instrument as a hedging instrument in those situations would call into question the legitimacy of electing the fair value option and would be inappropriate. The Board considered that, to this effect, the requirements of the fair value option were sufficient and hence no additional guidance was necessary.
- BC6.50 As a result, the Board decided to not introduce a general prohibition against the eligibility of designating as hedging instruments non-derivative financial instruments accounted for at fair value through profit or loss as a result of electing the fair value option.
- BC6.51 The Board also considered whether it needed to provide more guidance on when a non-derivative financial liability designated as at fair value through profit or loss under the fair value option would qualify as a hedging instrument. The Board noted that IFRS 9 refers to liabilities for which the fair value option is elected as “liabilities designated at fair value through profit or loss”, irrespective of whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or (if that presentation would enlarge an accounting mismatch) in profit or loss. However, for the eligibility as a hedging instrument, the Board considered that it would make a difference whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or profit or loss. The Board noted that if a financial liability whose credit risk related fair value changes are presented in other comprehensive income was an eligible hedging instrument there would be two alternatives for what could be designated as part of the hedging relationship:
- (a) only the part of the liability that is measured at fair value through profit or loss, in which case the hedging relationship would exclude credit risk and hence any related hedge ineffectiveness would not be recognised; or
 - (b) the entire fair value change of the liability, in which case the presentation in other comprehensive income of the changes in fair value related to changes in the credit risk of the liability would have to be overridden (ie

using reclassification to profit or loss) to comply with the hedge accounting requirements.

- BC6.52 Consequently, the Board decided to clarify its proposal by adding an explicit statement that a financial liability is not eligible for designation as a hedging instrument if under the fair value option the amount of change in the fair value attributable to changes in the liability's own credit risk is presented in other comprehensive income.

Internal derivatives as hedging instruments

- BC6.53 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.
- BC6.54 Internal derivatives are typically used to aggregate risk exposures of a group (often on a net basis) to allow the entity to manage the resulting consolidated exposure. However, IAS 39 was primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align accounting with risk management, the Board considered whether internal derivatives should be eligible for designation as hedging instruments. However, the Board noted that the ineligibility of internal derivatives as hedging instruments was not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge was how to make hedge accounting operational for groups of items and net positions.
- BC6.55 The Board noted that, for financial reporting purposes, the mitigation or transformation of risk is generally only relevant if it results in a transfer of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity does not change the risk exposure from the perspective of that reporting entity as a whole. This is consistent with the principles of consolidated financial statements.
- BC6.56 For example, a subsidiary might transfer cash flow interest rate risk from variable rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (instead of hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's consolidated perspective, the cash flow interest rate risk has not changed but merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).
- BC6.57 Consequently, in the deliberations leading to the exposure draft, the Board decided that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting entity (for example, intragroup derivatives in the consolidated financial statements) because they do not represent an instrument that the reporting entity uses to transfer the risk to an external party (ie outside the reporting entity). This meant that the related requirements in IAS 39 would be retained.
- BC6.58 The Board retained its original decision during the redeliberations of its exposure draft.

Intragroup monetary items as hedging instruments

- BC6.59 In accordance with IAS 39, the difference arising from the translation of intragroup monetary items in the consolidated financial statements in accordance with IAS 21 was eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.
- BC6.60 The Board noted that, when translating an intragroup monetary item, IAS 21 requires the recognition of a gain or loss in the consolidated statement of profit or loss and other comprehensive income. Consequently, in the 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, in the deliberations leading to the exposure draft, the Board decided not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).
- BC6.61 The Board retained its original decision during the redeliberations of its exposure draft.

Written options

- BC6.62 In its exposure draft, the Board retained the restriction in IAS 39 that a written option does not qualify as a hedging instrument except when it is used to hedge a purchased option or unless it is combined with a purchased option as one derivative instrument (for example, a collar) and that derivative instrument is not a net written option.
- BC6.63 However, respondents to the exposure draft commented that a stand-alone written option should not be excluded from being eligible for designation as a hedging instrument if it is jointly designated with other instruments such that in combination they do not result in a net written option. Those respondents highlighted that entities sometimes enter into two separate option contracts because of, for example, legal or regulatory considerations, and that these two separate option contracts achieve, in effect, the same economic outcome as one contract (for example, a collar contract).
- BC6.64 The Board considered that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance rather than its legal form. Consequently, the Board decided to amend the requirements such that a written and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument, provided that the combination is not a net written option. The Board also noted that by aligning the accounting for combinations of written and purchased options with that for derivative instruments that combine written and purchased options (for example, a collar contract), the assessment of what is, in effect, a net written option would be the same, ie it would follow the established practice under IAS 39. That practice considers the following cumulative factors to ascertain that an interest rate collar or other derivative instrument that includes a written option is not a net written option:

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

Hedged items

Qualifying items

Designation of derivatives

- BC6.65 The guidance on implementing IAS 39 stated that derivatives could be designated as hedging instruments only, not as hedged items (either individually or as part of a group of hedged items). As the sole exception, paragraph AG94 in the application guidance in IAS 39 allowed a purchased option to be designated as a hedged item. In practice, this has generally prevented derivatives from qualifying as hedged items. Similarly, positions that are a combination of an exposure and a derivative (aggregated exposures) failed to qualify as hedged items. The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives (or aggregated exposures that include a derivative) to be designated as hedged items. It stated that derivative instruments were always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.
- BC6.66 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*.
- BC6.67 The Board noted that an entity was sometimes economically required to enter into transactions that result in, for example, both interest rate risk and foreign currency risk. While 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 functional currency exposure. This is then overlaid with a two-year interest rate swap that—on the

basis of the functional currency—swaps variable rate debt into fixed rate debt. In effect, the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable rate debt functional currency exposure for risk management purposes.

- BC6.68 Consequently, for the purpose of its exposure draft, 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.
- BC6.69 Most respondents to the exposure draft supported the proposal to allow aggregated exposures to be designated as hedged items. Those respondents noted that the proposal better aligns hedge accounting with an entity's risk management by allowing hedge accounting to be used for common ways in which entities manage risks. In addition, those respondents noted that the proposal removes the arbitrary restrictions that were in IAS 39 and moves closer towards a principle-based requirement. The Board therefore decided to retain the notion of an aggregated exposure as proposed in the exposure draft.
- BC6.70 The main requests that respondents made to the Board were:
- (a) to provide examples that would illustrate the accounting mechanics for aggregated exposures;
 - (b) to clarify that accounting for aggregated exposures is not tantamount to 'synthetic accounting'; and
 - (c) to clarify whether an entity would, in a first step (and as a precondition), have to achieve hedge accounting for the combination of the exposure and the derivative that together constitute the aggregated exposure so that, in a second step, the aggregated exposure itself can then be eligible as the hedged item in the other hedging relationship.
- BC6.71 In response to the request for examples of the accounting mechanics for aggregated exposures, the Board decided to provide illustrative examples to accompany IFRS 9. The Board considered that numerical examples illustrating the mechanics of the accounting for aggregated exposures would, at the same time, address other questions raised in the feedback on the proposals, such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved. Moreover, the Board noted that those examples would also demonstrate that the proposed accounting for aggregated exposures is very different from 'synthetic accounting', which would reinforce the second clarification respondents had requested.
- BC6.72 The Board thought that the confusion about 'synthetic accounting' arose from accounting debates in the past about whether two items should be treated for accounting purposes as if they were one single item. This would have had the consequence that a derivative could have assumed the accounting treatment for a non-derivative item (for example, accounting at amortised cost). The Board noted that, in contrast, under the exposure draft's proposal for aggregated exposures the accounting for derivatives would always be at fair value and hedge accounting would be applied to them. Hence, the Board emphasised that accounting for aggregated exposures does not allow 'synthetic accounting'.
- BC6.73 The Board noted that most respondents had correctly understood the exposure draft (ie that it does not allow 'synthetic accounting') but the Board was still concerned because any misconception that aggregated exposures are

tantamount to 'synthetic accounting' would result in a fundamental accounting error. Hence, the Board decided to provide, in addition to illustrative examples, an explicit statement confirming that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value.

BC6.74 The Board also discussed the request to clarify whether an entity would have to first (as a precondition) achieve hedge accounting for the combination of the underlying exposure and the derivative that constitute the aggregated exposure (first level relationship) so that the aggregated exposure itself can be eligible as the hedged item in the other hedging relationship (second level relationship). The Board noted that the effect of not achieving hedge accounting for the first level relationship depended on the circumstances (in particular the types of hedge used). In many circumstances, it would make the accounting for the aggregated exposure more complicated and the outcome inferior compared to achieving hedge accounting for the first level relationship. However, the Board considered that achieving hedge accounting for the first level relationship was not required to comply with the general hedge accounting requirements for the second level relationship (ie the hedging relationship in which the aggregated exposure is the hedged item). Consequently, the Board decided not to make achieving hedge accounting for the first level relationship a prerequisite for qualifying for hedge accounting for the second level relationship.

BC6.75 The Board also clarified two other aspects that had been raised by some respondents:

- (a) that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure, once it has occurred, is eligible as a hedged item; and
- (b) how to apply the general requirements of designating a derivative as the hedging instrument in the context of aggregated exposures. The Board noted that the way in which a derivative is included in the hedged item that is an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure (ie at the level of the first level relationship—if applicable, ie if hedge accounting is applied at that level). If the derivative is not designated as the hedging instrument at the level of the aggregated exposure, it must be designated in its entirety or as a proportion of it. The Board noted that, consistent with the general requirements of the hedge accounting model, this also ensures that including a derivative in an aggregated exposure does not allow splitting a derivative by risk, by parts of its term or by cash flows.

Designation of hedged items

Designation of a risk component

BC6.76 IAS 39 distinguished the eligibility of risk components for designation as the hedged item by the type of item that includes the component:

- (a) for financial items, an entity could designate a risk component if that risk component was separately identifiable and reliably measurable; however,
- (b) for non-financial items, an entity could only designate foreign currency risk as a risk component.

- BC6.77 Risk components of non-financial items, even when they are contractually specified, were not eligible risk components in accordance with IAS 39. So other than for foreign currency risk, a non-financial item was required to be designated as the hedged item for all risks. The rationale for including this restriction in IAS 39 was that permitting risk components (portions) of non-financial assets and non-financial liabilities to be designated as the hedged item for a risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing because the portion could be designated so that no ineffectiveness would ever arise.
- BC6.78 The hedge accounting model in IAS 39 used the entire item as the default unit of account and then provided rules to govern what risk components of that entire item were available for separate designation in hedging relationships. This has resulted in the hedge accounting requirements being misaligned with many risk management strategies. The outcome was that the normal approach for risk management purposes was treated as the exception by the hedge accounting requirements.
- BC6.79 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.
- BC6.80 The Board noted that the conclusion in IAS 39, that permitting, as hedged items, risk components of non-financial assets and non-financial liabilities would compromise the principles of identification of the hedged item and effectiveness testing, was not appropriate in all circumstances. As part of its deliberations, the Board considered whether risk components should be eligible for designation as hedged items when they are:
- (a) contractually specified; and
 - (b) not contractually specified.
- BC6.81 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).
- BC6.82 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 reasons for using a component approach to hedging, including:
- (a) the entire item cannot be hedged because there is a lack of appropriate hedging instruments.

- (b) it is cheaper to hedge the single components individually than the entire item (for example, because an active market exists for the risk components, but not for the entire item).
- (c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (for example, because one of the risk components is particularly volatile and it therefore justifies the costs of hedging it).

- BC6.83 The Board learned from its outreach activities that there are circumstances in which entities are able to identify and measure many risk components (other than foreign currency risk) of non-financial items with sufficient reliability. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure 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.
- BC6.84 Consequently, in its exposure draft, the Board proposed 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.
- BC6.85 Most respondents to the exposure draft supported the Board's proposal and its rationale for allowing risk components (both contractually specified and those not contractually specified) to be eligible for designation as hedged items. Those respondents noted that the proposal on risk components was a key aspect of the new hedge accounting model because it would allow hedge accounting to reflect that, in commercial reality, hedging risk components was the norm and hedging items in their entirety was the exception.
- BC6.86 Many commentators noted that IAS 39 was biased against hedges of non-financial items such as commodity hedges. They considered the distinction between financial and non-financial items for determining which risk components would be eligible hedged items as arbitrary and without conceptual justification. The main request by respondents was for additional guidance or clarifications.
- BC6.87 Only a few respondents disagreed with the Board's proposal on risk components. Those respondents believed that, in situations in which non-contractually specified risk components of non-financial items would be designated as hedged items, no hedge ineffectiveness would be recognised.
- BC6.88 The Board noted that the debate about risk components suffered from some common misunderstandings. In the Board's opinion, the root cause of those misunderstandings is the large number of markets and circumstances in which hedging takes place. This results in an inevitable lack of familiarity with many markets. In the light of the arguments raised and to address some of the misunderstandings, the Board focused its discussions on non-contractually specified risk components of non-financial items and, in particular, on:
- (a) the effect of risk components; and
 - (b) hedge ineffectiveness when designating a risk component.
- BC6.89 The Board noted that some believe that designating a risk component as a hedged item should not be allowed if it could result in the value of that risk

component moving in an opposite direction to the value of the entire item (ie its overall price). For example, if the hedged risk component increases in value this would offset the loss on the hedging instrument, while decreases in the value of other unhedged risk components remain unrecognised.

- BC6.90 The Board noted that this was not specific to non-contractually specified risk components of non-financial items, but that it applied to risk components in general. For example, consider an entity that holds a fixed rate bond and the benchmark interest rate decreases but the bond's spread over the benchmark increases. If the entity hedges only the benchmark interest rate using a benchmark interest rate swap, the loss on the swap is offset by a fair value hedge adjustment for the benchmark interest rate component of the bond (even though the bond's fair value is lower than its carrying amount after the fair value hedge adjustment because of the increase in the spread).
- BC6.91 The Board also noted that designating a risk component was not tantamount to 'hiding losses' or avoiding their recognition by applying hedge accounting. Instead, it would help to mitigate accounting mismatches that would otherwise result from how an entity manages its risks. If hedge accounting is not applied, only the gain or loss from the change in fair value of the financial instrument that hedges the risk is recognised in profit or loss, whereas the gain or loss on the entire item that gives rise to the risk remains fully unrecognised (until it is realised in a later period) so that any offset is obscured. If designation on a risk component basis is not available, that initially creates an issue of whether the hedge qualifies at all for hedge accounting and is inconsistent with the economic decision of hedging done on a components basis. Consequently, the accounting assessment would be completely disconnected from the decision making of an entity, which is driven by risk management purposes. The Board also noted that this consequence would be amplified by the fact that the hedged component is not necessarily the main or largest component (for example, in the case of a power purchase agreement with a contractual pricing formula that includes indexations to fuel oil and inflation, only the inflation risk but not the fuel oil price risk is hedged).
- BC6.92 The Board noted that even if hedge accounting can be achieved between the hedging instrument and the item (which includes the hedged risk component) in its entirety, the accounting outcome would be more akin to a fair value option for the entire item than reflecting the effect of the economic hedge. However, because hedge accounting would be disconnected from what is economically hedged, there would also be ramifications for the hedge ratio that would have to be used for designating the hedging relationship. The hedge ratio that an entity actually uses (ie for decision making purposes driven by risk management) would be based on the economic relationship between the underlyings of the hedged risk component and the hedging instrument. This is the sensible basis for hedging decisions. However, for accounting purposes, an entity would be forced to compare changes in the value of the hedging instrument to those of the entire item. This means that, in order to improve the offset for the hedging relationship that is designated for accounting purposes, an entity would have to create a deliberate mismatch compared to the economic hedging relationship, which is tantamount to distorting the economic hedge ratio for accounting purposes. The Board noted that distorting the hedge ratio also meant that prohibiting the designation of hedged items on a risk components basis would, ultimately, not necessarily result in the financial statements reflecting the change in the value of the unhedged risk component as a gain or loss for which there is

no offset. Hence, prohibiting that kind of designation would not achieve transparency about the changes in the value of unhedged components by showing a gain or loss for which there is no offset.

- BC6.93 The Board also noted that designating risk components as hedged items would reflect the fact that risk management typically operates on a ‘by risk’ instead of a ‘by item’ basis (which is the unit of account for financial reporting purposes). Hence, the use of risk components as hedged items would reflect what in commercial reality is the norm instead of requiring that all hedged items are ‘deemed’ to be hedged in their entirety (ie for all risks).
- BC6.94 The Board also considered the effect that risk components have on the recognition of hedge ineffectiveness. A few respondents believed that if a risk component was designated as the hedged item, it would result in no hedge ineffectiveness being recognised.
- BC6.95 The Board noted that the effect of designating a risk component as the hedged item was that it became the point of reference for determining offset (ie the fair value change on the hedging instrument would be compared to the change in value of the designated risk component instead of the entire item). This would make the comparison more focused because it would exclude the effect of changes in the value of risks that are not hedged, which would also make hedge ineffectiveness a better indicator of the success of the hedge. The Board noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components. Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised. For example:
- (a) A floating rate debt instrument is hedged against the variability of cash flows using an interest rate swap. The two instruments are indexed to the same benchmark interest rate but have different reset dates for the variable payments. Even though the hedged item is designated as the benchmark interest rate related variability in cash flows (ie as a risk component), the difference in reset dates causes hedge ineffectiveness. There is no market structure that would support identifying a ‘reset date’ risk component in the variable payments on the floating rate debt that would mirror the reset dates of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto floating rate debt.
 - (b) A fixed rate debt instrument is hedged against fair value interest rate risk using an interest rate swap. The two instruments have different day count methods for the fixed rate payments. Even though the hedged item is designated as the benchmark interest rate related change in fair value (ie as a risk component), the difference in the day count methods causes hedge ineffectiveness. There is no market structure that would support identifying a ‘day count’ risk component in the payments on the debt that would mirror the day count method of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto the fixed rate debt.
 - (c) An entity purchases crude oil under a variable–price oil supply contract that is indexed to a light sweet crude oil benchmark. Because of the natural decline of the benchmark oil field the derivatives market for that benchmark

has suffered a significant decline in liquidity. In response, the entity decides to use derivatives for a different benchmark for light sweet crude oil in a different geographical area because the derivatives market is much more liquid. The changes in the crude oil price for the more liquid benchmark and the less liquid benchmark are closely correlated but vary slightly. The variation between the two oil benchmark prices causes hedge ineffectiveness. There is no market structure that would support identifying the more liquid benchmark as a component in the variable payments under the oil supply contract. In particular, the terms and conditions of the derivatives indexed to the more liquid benchmark cannot be simply imputed by projecting terms and conditions of those derivatives onto the oil supply contract.

- (d) An entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude oil benchmark for jet fuel purchases at its North American locations is WTI whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe. Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness regarding the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot be simply imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

BC6.96 Consequently, the Board noted that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.

BC6.97 The Board noted that the concerns about hedge ineffectiveness not being recognised related particularly to non-contractually specified risk components of non-financial items. However, the Board considered that this was not a financial versus non-financial item problem. Determining the hedge ineffectiveness, for example, for a fixed rate debt instrument when designating the benchmark interest rate component as the hedged item is no more or less troublesome than doing so for commodity price risk. In both cases the appropriate designation of a risk component depends on an appropriate analysis of the market structure. The Board noted that the derivative markets for commodity risk had evolved and had resulted in customs that helped improve the effectiveness of hedging. For example, very liquid commodity benchmarks have evolved, allowing for a market volume for derivatives that is far larger than the physical volume of the underlying commodity thus facilitating benchmarks that can be widely used.

BC6.98 In the light of those considerations and the responses received on the exposure draft, the Board decided to retain the notion of risk components as eligible hedged items. Because of the large variety of markets and circumstances in which hedging takes place, the Board considered that, in order to avoid arbitrary discrimination against some markets, risks or geographies, there was no alternative to using a criteria-based approach to identifying eligible risk

components. Consequently, the Board decided that for risk components (of both financial and non-financial items) to qualify as eligible hedged items, they must be separately identifiable and reliably measureable. In response to requests from commentators, the Board also decided to expand the examples of how to determine eligible risk components including the role of the market structure.

- BC6.99 The Board also discussed the proposal in the exposure draft to prohibit the designation of non-contractually specified inflation risk components. That prohibition was carried over from IAS 39. The Board noted that an outright ban meant that the general criteria for the eligibility of risk components could not be applied and, as a result, would leave no room for the possibility that in some situations there might be circumstances that could support identifying a risk component for inflation risk. On the other hand, the Board was concerned that the removal of the restriction would encourage the use of inflation risk components for hedge accounting when it was not necessarily appropriate to do so. This would be the case where a risk component, instead of being supported by the market structure and independently determined for the hedged item, would for example be determined by simply projecting the terms and conditions of the inflation derivative that was actually used as the hedge onto the hedged item. In the light of this trade-off, the Board also considered that financial markets continuously evolve and that the requirements should be capable of addressing changes in the market over time.
- BC6.100 On balance, the Board decided to remove the prohibition. However, the Board was concerned its decision could be misunderstood as simply ‘rubber stamping’ the use of inflation risk components for hedge accounting without proper application of the criteria for designating risk components. The Board therefore agreed to include a caution in the final requirements that in order to determine whether inflation risk is an eligible risk component, a careful analysis of the facts and circumstances is required so that the criteria for designating risk components are properly applied. Consequently, the Board decided to add a ‘rebuttable presumption’ regarding non-contractually specified inflation risk components of financial items.

Designation of ‘one-sided’ risk components

- BC6.101 IAS 39 permitted an entity to designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a ‘one-sided’ risk). So, an entity might hedge an exposure to a specific type of risk of a financial instrument (for example, interest rates) above a predetermined level (for example, above 5 per cent) using a purchased option (for example, an interest rate cap). In this situation an entity hedged some parts of a specific type of risk (ie interest exposure above 5 per cent).
- BC6.102 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 decided to permit the designation of one-sided risk components as hedged items, as was the case in IAS 39 for some risk components. However, the Board decided to change the accounting for the time value of options (see paragraphs BC6.264–BC6.291).
- BC6.103 The Board retained its original decisions about the eligibility of one-sided risk components as hedged items during the redeliberations of its exposure draft.

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

- BC6.104 The Board noted that components that are some quantifiable nominal part of the total cash flows of the instrument are typically separately identifiable. For example, a proportion, such as 50 per cent, of the contractual cash flows of a loan includes all the characteristics of that loan. In other words, changes in the value and cash flows for the 50 per cent component are half of those for the entire instrument.
- BC6.105 The Board noted that a proportion of an item forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The Board concluded that if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a proportion of an item as a hedged item (as previously permitted by IAS 39).
- BC6.106 The Board retained its original decisions during the redeliberations of its exposure draft.

Components of a nominal amount—designation of a layer component

- BC6.107 IAS 39 required 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 permitted forecast transactions to be identified as a 'layer' component of a nominal amount, for example, the first 100 barrels of the total oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item 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).
- BC6.108 The Board considered whether similar considerations should also apply to a hedge of an existing transaction or item in some situations. For example, a firm commitment or a loan might also involve some uncertainty because:
- (a) a contract might be cancelled for breach of contract (ie non-performance); or
 - (b) a contract with an early termination option (for repayment at fair value) might be terminated before maturity.
- BC6.109 Because there is uncertainty for both anticipated transactions and existing transactions and items, the Board decided not to distinguish between such transactions and items for the purposes of designating a layer component.
- BC6.110 The Board noted that designating as the hedged item a component that is a proportion of an item can give rise to a different accounting outcome when compared with designating a layer component. If the designation of those components is not aligned with the risk management strategy of the entity, it might result in profit or loss providing misleading or less useful information to users of financial statements.
- BC6.111 In the Board's view there might be circumstances when it is appropriate to designate a hedged item as a layer component. Consequently, in its exposure draft the Board proposed to permit designating a layer component as the hedged item (for anticipated and existing transactions). The Board also proposed that a

layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The Board noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how the hedge effectiveness would be measured).

- BC6.112 Most respondents to the exposure draft agreed with the proposed change for fair value hedges, which would allow designating a layer component from a defined nominal amount. They agreed that such layers would allow entities to better reflect what risk they actually hedge.
- BC6.113 However, many respondents disagreed with the Board's proposal to prohibit, in any circumstances, the designation of a layer component in a fair value hedge for all contracts that include any prepayment option whose fair value is affected by changes in the hedged risk. Those respondents' main objection was that the proposal was inconsistent with common risk management strategies and that the fair value changes of a prepayment option were irrelevant in the context of a bottom layer.
- BC6.114 In the light of the comments received, the Board discussed:
- (a) whether the prohibition to designate a layer component as the hedged item in a fair value hedge should relate to an (entire) item or contract containing a prepayment option or whether it should relate only to those situations in which the designated layer contains a prepayment option;
 - (b) whether a layer component can be designated as the hedged item in a fair value hedge if it includes the effect of a related prepayment option; and
 - (c) whether the requirement should differentiate between written and purchased prepayment options, thereby allowing a layer component to be designated for items with a purchased option, ie if the entity is the option holder (for example, a debtor's call option included in prepayable debt).
- BC6.115 The Board discussed situations in which a contract is prepayable for only a part of its entire amount, which means that the remainder is not prepayable and hence does not include a prepayment option. For example, a loan with a principal amount of CU100 and a maturity of five years that allows the debtor to repay (at par) up to CU10 at the end of each year would mean that only CU40 is prepayable (at different points in time) whereas CU60 is non-prepayable but has a five year fixed term. Because the CU60 is fixed term debt that is not affected by prepayments, its fair value does not include the effect of a prepayment option. Consequently, the changes in the fair value related to the CU60 are unrelated to the fair value changes of the prepayment option for other amounts. This means that if the CU60 were designated as a layer component, the hedge ineffectiveness would appropriately exclude the change in the fair value of the prepayment option. The Board considered that this would be consistent with its rationale for proposing prohibiting a layer component of an (entire) item or contract that contains a prepayment option (see paragraph BC6.111) to be designated. However, the Board noted that the changes in fair value of the amounts that are prepayable (ie the CU40 at inception, CU30 after one year, CU20 after two years and CU10 after three years) include a prepayment option and the designation of a layer for these amounts would therefore contradict the Board's rationale (see paragraph BC6.111). The Board noted that the layer of

CU60 in the example above should not be confused with a bottom layer of CU60 that is expected to remain at maturity from a total amount of CU100 that is prepayable in its entirety. The difference is that the expected remaining amount of a larger prepayable amount is the expected eventual outcome of a variable contractual maturity, whereas the CU60 in the example above is the definite outcome of a fixed contractual maturity.

BC6.116 Consequently, the Board decided to:

- (a) confirm the proposals in the exposure draft to allow a layer-based designation of a hedged item (when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk); and
- (b) to allow a layer-based designation for those amounts that are not prepayable at the time of designation of a partially prepayable item.

BC6.117 The Board also discussed whether a layer component should be available for designation as the hedged item in a fair value hedge if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.

BC6.118 Including the change in fair value of the prepayment option that affects a layer in determining hedge ineffectiveness has the following consequences:

- (a) The designated hedged item would include the entire effect of changes in the hedged risk on the fair value of the layer, ie including those resulting from the prepayment option.
- (b) If the layer was hedged with a hedging instrument (or a combination of instruments that are designated jointly) that does not have option features that mirror the layer's prepayment option, hedge ineffectiveness would arise.

BC6.119 The Board noted that a designation of a layer as the hedged item, if it included the effects of a related prepayment option when determining the change in fair value of the hedged item, would not conflict with its rationale for proposing the requirements related to the implication of prepayment options for layer designations (see paragraph BC6.111).

BC6.120 Consequently, the Board decided that designating a layer as the hedged item should be allowed if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.

BC6.121 The Board also considered whether it should differentiate between written and purchased prepayment options for the purpose of determining the eligibility of a layer-based designation of a hedged item in a fair value hedge. Some respondents had argued that if the entity was the option holder, the entity would control the exercise of the option and could therefore demonstrate that the option was not affected by the hedged risk.

BC6.122 However, the Board noted that the hedged risk affects the fair value of a prepayment option irrespective of whether the particular option holder actually exercises it at that time or intends to actually exercise it in the future. The fair value of the option captures the possible outcomes and hence the risk that an amount that would be 'in the money' might be repaid at a different amount than at fair value before taking the prepayment option into account (for example, at par). Consequently, the Board noted that whether a prepayment option is a purchased or a written option does not affect the change in the option's absolute

fair value but instead determines whether it is either a gain or a loss from the entity's perspective. In other words, the Board considered that the aspect of who controls the exercise of the option relates to whether any intrinsic value would be realised (but not whether it exists).

- BC6.123 Consequently, the Board decided not to differentiate between written and purchased prepayment options for the purpose of the eligibility of a layer-based designation of hedged items.

Relationship between components and the total cash flows of an item

- BC6.124 IAS 39 allowed an entity to designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).
- BC6.125 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing a variable interest coupon at LIBOR minus a spread or an equivalent fixed rate coupon), the negative spread represents a positive margin for the borrower. This is because banks on average pay LIBOR for their funding in the interbank market. Another example 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) a standardised hedging instrument for all transactions that are priced sub-LIBOR. Consequently, such an entity uses hedging instruments that have LIBOR as their underlying.
- BC6.126 In the deliberations leading to the exposure draft, the Board noted that it had received feedback on the sub-LIBOR issue from its outreach activities that accompanied those deliberations. That feedback showed that some participants believed that designating a risk component that assumes cash flows that would exceed the actual cash flows of the instrument reflected risk management in situations in which the hedged item has a negative spread to the benchmark rate. They believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argued that they were hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.
- BC6.127 In the deliberations leading to the exposure draft, 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 benchmark interest rate risk is managed and that the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes, provided that LIBOR is not below the absolute value of the negative spread. This risk management strategy provides offsetting changes 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 value of that negative spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The Board noted that these outcomes are inconsistent with the economic phenomenon to which they relate.

- BC6.128 To avoid these outcomes, the Board proposed retaining the restriction in IAS 39 for the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the 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 BC6.124).
- BC6.129 The Board received mixed views on its proposal to retain this restriction. Some agreed with the restriction and the Board's rationale for retaining it. Others were concerned that the restriction was inconsistent with common risk management practices. Those who disagreed believed that it should be possible to designate as the hedged item a benchmark risk component equivalent to the entire LIBOR and treat the spread between the entire LIBOR and the contractual rate as a negative residual component. Their view reflects the fact that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps (see paragraph BC6.133 for an example). In their view, the Board's proposal would not allow them to properly reflect the hedging relationship, and would force them to recognise hedge ineffectiveness that, in their view, would not reflect their risk management strategy.
- BC6.130 In response to the concerns raised, the Board considered whether it should allow designating risk components on a benchmark risk basis that assumes cash flows exceeding the total actual cash flows of the hedged item.
- BC6.131 As part of its redeliberations, the Board discussed how contractual terms and conditions that determine whether an instrument has a zero interest rate floor or 'negative' interest (ie no floor) might affect the designation of a full LIBOR component of a sub-LIBOR instrument.
- BC6.132 The Board discussed an example of an entity that has a liability that pays a fixed rate and grants a loan at a floating rate with both instruments being priced at sub-LIBOR interest rates. The entity enters into a LIBOR-based interest rate swap with the aim of locking in the margin that it will earn on the combined position. If the entity wants to designate the hedged item on the basis of the interest rate risk that results from its financial asset this would be an example of a cash flow hedge of variable rate interest cash flows from a sub-LIBOR asset.
- BC6.133 The Board noted that if the floating rate asset had a zero interest rate floor and LIBOR decreased below the absolute value of the negative spread on the asset, the return on the asset (after taking into account the effect of the swap) would increase as a result of the interest rate swap not having a floor. This means that if designated on a full LIBOR risk component basis, the hedging relationship would have outcomes that would be inconsistent with the notion of a locked margin. In this example, the margin could become variable instead of being locked. The Board was of the view that, in the context of hedge accounting, this would give rise to hedge ineffectiveness that must be recognised in profit or loss. The Board noted that this hedge ineffectiveness resulted from the absence of offsetting cash flows and hence represented a genuine economic mismatch between changes in cash flows on the floating rate asset and the swap. Hence, if a full LIBOR component was imputed for instruments that are priced sub-

LIBOR, it would inappropriately defer hedge ineffectiveness in other comprehensive income. In the Board's view this would be tantamount to accrual accounting for the interest rate swap.

- BC6.134 In contrast, the Board noted that if the floating rate asset had no floor, the sub-LIBOR instrument included in the hedging relationship would still have changes in their cash flows that would move with LIBOR even if LIBOR was below the absolute value of the spread. Consequently, the variability in cash flows of the hedging instrument that locks the margin would be offset by the variability of the cash flows of the sub-LIBOR instrument irrespective of the LIBOR level. In other words, the LIBOR-related cash flow variability when the asset had no floor would be equivalent to that of a full LIBOR component and therefore the proposed requirement would not prohibit designating the hedged item accordingly (ie as changes in cash flows of a full LIBOR risk component).
- BC6.135 As a result, the Board decided to confirm the proposal in the exposure draft that if a component of the cash flows of a financial or non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item.
- BC6.136 Furthermore, the Board noted that the examples carried over from IAS 39 to the exposure draft only included financial items because under IAS 39 the issue could only apply to that type of item. But, given that under the new hedge accounting model this issue also applies to non-financial items that are traded below their respective benchmark price, the Board decided to add an example of a hedge of commodity price risk in a situation in which the commodity is priced at a discount to the benchmark commodity price.

Qualifying criteria for hedge accounting

Effectiveness assessment

- BC6.137 To qualify for hedge accounting in accordance with IAS 39, a hedge had to be highly effective, both prospectively and retrospectively. Consequently, an entity had to perform two effectiveness assessments for each hedging relationship. The prospective assessment supported the expectation that the hedging relationship would be effective in the future. The retrospective assessment determined that the hedging relationship had been effective in the reporting period. All retrospective effectiveness assessments were required to be performed using quantitative methods. However, IAS 39 did not specify a particular method for testing hedge effectiveness.
- BC6.138 The term 'highly effective' referred to the degree to which the hedging relationship achieved offsetting between changes in the fair value or cash flows of the hedging instrument and changes in the fair value or cash flows of the hedged item attributable to the hedged risk during the hedge period. IAS 39 regarded a hedge as highly effective if the offset was within the range of 80-125 per cent (often colloquially referred to as a 'bright line' test).
- BC6.139 In the deliberations leading to the exposure draft, the Board noted that it had received feedback on the hedge effectiveness assessment under IAS 39 from its outreach activities that accompanied those deliberations. The feedback showed that:
- (a) many participants found that the hedge effectiveness assessment in IAS 39 was arbitrary, onerous and difficult to apply;

- (b) as a result, there was often little or no link between hedge accounting and the risk management strategy; and
- (c) because hedge accounting was not achieved if the hedge effectiveness was outside the 80-125 per cent range, it made hedge accounting difficult to understand in the context of the risk management strategy of the entity.

BC6.140 Consequently, in its exposure draft the Board proposed a more principle-based hedge effectiveness assessment. The Board proposed that a hedging relationship meets the hedge effectiveness requirements if it:

- (a) meets the objective of the hedge effectiveness assessment (ie that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and
- (b) is expected to achieve other than accidental offsetting.

BC6.141 Most respondents to the exposure draft supported the removal of the 80-125 per cent quantitative test. Those respondents also supported the Board in avoiding the use of bright lines in hedge accounting generally and the move towards a more principle-based effectiveness assessment.

BC6.142 Only a few respondents disagreed with the proposal, largely because they believed that the quantitative threshold in IAS 39 was appropriate. They also believed that an approach that was completely principle-based would generate operational difficulties and would have the potential to inappropriately extend the application of hedge accounting.

BC6.143 The sections below elaborate on the Board's considerations.

The objective of the hedge effectiveness assessment

BC6.144 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The Board noted that this resulted in hedge accounting that was arbitrary and onerous. Furthermore, the arbitrary 'bright line' of 80-125 per cent resulted in a disconnect between hedge accounting and risk management. Consequently, it made it difficult to explain the results of hedge accounting to users of financial statements. To address 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 test in IAS 39.

BC6.145 During its deliberations, the Board initially considered an objective-based assessment to determine which hedging relationships would 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. The Board held the view that the objective of the hedge effectiveness assessment should reflect that hedge accounting was based on the notion of offset.

BC6.146 In accordance with the Board's initially considered approach, the effectiveness assessment would have aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment would have been based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it could be expected to meet the risk management objective. The Board believed that the proposed approach would therefore have

strengthened the relationship between hedge accounting and risk management practice.

- BC6.147 However, the Board was concerned that this approach might not be rigorous enough. This was because, without clear guidance, an entity might designate hedging relationships that would not be appropriate because they would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation of the hedging relationship and hence be biased. The Board noted that the bright line of 80-125 per cent in IAS 39 created a trade-off when an entity chose a hedge ratio that would have a biased result, because that result came at the expense of higher ineffectiveness and hence increased the risk of falling outside that range. However, the Board noted that the 80-125 per cent range would be eliminated by its proposals. The Board therefore decided to extend its initial objective of the effectiveness assessment so that it also included the hedge ratio. Consequently, in its exposure draft, the Board proposed that the objective of assessing the effectiveness of a hedging relationship was that the entity designated the hedging relationship so that it gave an unbiased result and minimised expected ineffectiveness.
- BC6.148 The Board noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of differences in the underlyings or other differences between the hedging instrument and the hedged item that the entity accepts in order to achieve a cost-effective hedging relationship. The Board considered that when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, the Board proposed in its exposure draft that hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument.
- BC6.149 However, many respondents to the exposure draft asked the Board to provide further guidance on the objective-based effectiveness assessment, particularly on the notions of 'unbiased result' and 'minimise expected hedge ineffectiveness'. Those respondents were concerned that the requirements, as drafted in the exposure draft, could be interpreted to be more restrictive and onerous than the bright line effectiveness test in IAS 39 and would be inconsistent with risk management practice. More specifically, those respondents were concerned that the objective of the hedge effectiveness assessment as drafted in the exposure draft could be interpreted as requiring entities to set up a hedging relationship that was 'perfectly effective'. They were concerned that this would result in an effectiveness assessment that would be based on a bright line of 100 per cent effectiveness, and that such an approach:
- (a) would not take into account that in many situations entities do not use a hedging instrument that would make the hedging relationship 'perfectly effective'. They noted that entities use hedging instruments that do not achieve perfect hedge effectiveness because the 'perfect' hedging instrument is:
 - (i) not available; or
 - (ii) not cost-effective as a hedge (compared to a standardised instrument that is cheaper and/or more liquid, but does not provide the perfect fit).

- (b) could be interpreted as a mathematical optimisation exercise. In other words, they were concerned that it would require entities to search for the perfect hedging relationship at inception (and on a continuous basis), because if they did not, the results could be considered to be biased and hedge ineffectiveness would probably not be 'minimised'.

BC6.150 In the light of the concerns regarding the use of hedging instruments that are not 'perfectly effective', the Board noted that the appropriate hedge ratio was primarily a risk management decision rather than an accounting decision. When determining the appropriate hedge ratio, risk management would take into consideration, among other things, the following factors:

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

BC6.151 The Board's intention behind its proposal in the exposure draft was that entities would use the actual hedging instrument it had chosen based on commercial considerations as a starting point and, on that basis, determine the hedge ratio that would comply with the proposed requirements. In other words, the Board's intention was not that entities would have to consider the hedge effectiveness and related hedge ratio that could have been achieved with a different hedging instrument that might have been a better fit for the hedged risk but that the entity did not enter into.

BC6.152 The Board also reconsidered the proposed objective of the hedge effectiveness assessment in respect of the concerns that it might result in a mathematical optimisation exercise. In particular, the Board considered the effect of its proposal in situations in which a derivative is designated as a hedging instrument only after its inception so that it is already in or out of the money at the time of its designation (often colloquially referred to as a 'late hedge'). The Board considered whether the hedge ratio would have to be adjusted with regard to the (non-zero) fair value of the derivative at the time of its designation. This is because the fair value of the hedging instrument at the time of its designation is a present value. Over the remaining life of the hedging instrument this present value will accrete to the undiscounted amount (this is often referred to as the unwinding of the discount). The Board noted that there is no offsetting fair value change in the hedged item for this effect (unless the hedged item was also in or out of the money in an equal but opposite way). Consequently, in situations in which the derivative is designated as the hedging instrument after its inception, an entity would expect that the changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item (ie the hedge ratio would not be 'unbiased'). To meet the proposed objective of the hedge effectiveness assessment an entity would need to explore whether it could adjust the hedge ratio to avoid the systematic difference between the value changes of the hedging instrument and the hedged item over the hedging period. However, to determine the ratio that would avoid the systematic difference, an entity would need to know what the actual price or rate of the underlying will be at the end of the hedging relationship. Hence, the Board

noted that the proposed objective of the hedge effectiveness assessment could be interpreted to the effect that, in the (quite common) situations in which an entity has a 'late hedge', the proposed hedge effectiveness requirements would not be met. This is because the entity would not be able to identify a hedge ratio for the designation of the hedging relationship that would not involve an expectation that the changes in value of the hedging instrument will systematically either exceed or be less than the changes in value of the hedged item. The Board did not intend this outcome when it made its proposals in its exposure draft.

BC6.153 The Board noted that the feedback on the requirement that the hedging relationship should minimise hedge ineffectiveness suggested that identifying a 'minimum' would involve considerable effort in all situations in which the terms of the hedging instrument and the hedged item are not fully matched. Hence, the requirement to minimise hedge ineffectiveness would bring back many of the operational problems of the hedge effectiveness assessment in IAS 39. Furthermore, regardless of the effort involved, it would be difficult to demonstrate that the 'minimum' had been identified.

BC6.154 The Board noted that when it developed the exposure draft, it included the notions of 'unbiased' and 'minimise expected hedge ineffectiveness' to ensure that:

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

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

BC6.155 Taking into account the responses to the exposure draft, the Board decided to remove the terms 'unbiased' (ie no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result) and 'minimising expected hedge ineffectiveness'. Instead the Board decided to state, more directly, that the entity's designation of the hedging relationship shall use a hedge ratio based on:

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

BC6.156 The Board noted that this approach has the following advantages:

- (a) The use of the hedge ratio resulting from the requirement in this IFRS provides information about the hedge ineffectiveness in situations in which an entity uses a hedging instrument that does not provide the best fit (for example, because of cost-efficiency considerations). The Board noted that the hedge ratio determined for risk management purposes has the effect of showing the characteristics of the hedging relationship and the entity's

expectations about hedge ineffectiveness. This includes hedge ineffectiveness that results from using a hedging instrument that does not provide the best fit.

- (b) It also aligns hedge accounting with risk management and hence is consistent with the overall objective of the new hedge accounting model.
- (c) It addresses the requests from respondents to the exposure draft for clarification that the relevant hedging instrument to be considered in the hedge effectiveness assessment is the actual hedging instrument the entity decided to use.
- (d) It retains the notion proposed in the exposure draft that the hedge ratio is not a free choice for accounting purposes as it was in IAS 39 (subject to passing the 80-125 per cent bright line test).

BC6.157 The Board noted that the only situation open to abuse is if the entity purposefully (for risk management purposes) used a hedge ratio that would be considered 'inappropriately loose' from an accounting perspective. For example:

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

BC6.158 The Board noted that the potential for abuse, as illustrated above, was implicitly addressed in IAS 39 by the 80-125 per cent bright line of the retrospective hedge effectiveness assessment. Given its decision to remove that bright line (see paragraph BC6.144), the Board decided to explicitly address this potential for abuse. As a consequence, this IFRS requires that, for the purpose of hedge accounting, an entity shall not designate a hedging relationship in a manner that reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

Other than accidental offsetting

- BC6.159 IAS 39 was based on a purely accounting-driven percentage-based bright line test (the 80-125 per cent range). This disconnected accounting from risk management (see paragraph BC6.144). Consequently, the Board proposed replacing the bright line test with a notion that aims to reflect the way entities look at the design and monitoring of hedging relationships from a risk management perspective. Inherent in this was the notion of ‘other than accidental offsetting’. This linked the risk management perspective with the hedge accounting model’s general notion of offset between gains and losses on hedging instruments and hedged items. The Board also considered that this link reflected the intention that the effectiveness assessment should not be based on a particular level of effectiveness (hence avoiding a new bright line).
- BC6.160 Many respondents to the exposure draft asked the Board to provide further guidance on the notion of ‘other than accidental offsetting’. Many also suggested that the Board revise the proposed guidance by directly referring to the aspect of an economic relationship between the hedged item and the hedging instrument that was included in the application guidance proposed in the exposure draft.
- BC6.161 The Board noted that qualifying criteria that use terminology such as ‘other than accidental offsetting’ can be abstract. The feedback suggested that this makes the relevant aspects or elements of the hedge effectiveness assessment more difficult to understand. The Board considered that it could address the respondents’ request and reduce the abstractness of this proposal by avoiding the use of an ‘umbrella term’ and instead making explicit all aspects that the requirement comprises. This would provide greater clarity and facilitate a better understanding of what aspects are relevant when assessing hedge effectiveness.
- BC6.162 Consequently, the Board decided to replace the term ‘other than accidental offsetting’ with requirements that better conveyed its original notion:
- (a) an economic relationship between the hedged item and the hedging instrument, which gives rise to offset, must exist at inception and during the life of the hedging relationship; and
 - (b) the effect of credit risk does not dominate the value changes that result from that economic relationship.

A ‘reasonably effective’ threshold

- BC6.163 A few respondents suggested that the Board consider using a ‘qualitative threshold’ instead of a principle-based hedge effectiveness assessment. Those respondents believed that, in order to meet the hedge effectiveness criteria, a hedging relationship should be required to be ‘reasonably effective’ in achieving offsetting changes in the fair value of the hedged item and in the fair value of the hedging instrument.
- BC6.164 The Board noted that a ‘reasonably effective’ criterion would retain the threshold design of the effectiveness assessment that was used in IAS 39. The Board considered that moving, rather than removing, the threshold would not address the root cause of the problem (see paragraph BC6.144). The suggested approach would instead only change the level of the threshold. The Board considered that, even though the threshold would be of a qualitative nature, it would still create a danger of reverting back to a quantitative measure (such as

the percentage range of IAS 39) in order for it to be operational. The Board noted that similar concerns had been raised as part of the feedback.

- BC6.165 The Board also noted that one of the major concerns that respondents had raised about the reference in the exposure draft to ‘unbiased result’ was that it could be perceived as requiring entities to identify the ‘perfect’ hedging instrument or that the entity’s commercial decision of which hedging instrument to actually use could be restricted or second guessed (see paragraph BC6.149).
- BC6.166 The Board considered that using a reference to ‘reasonably effective’ would give rise to similar concerns because it would raise the question of how much ineffectiveness that results from the choice of the actual hedging instrument is ‘reasonable’ (similar to the notion of ‘unbiased’ proposed in the exposure draft). The Board was also concerned that this might have a particular impact on emerging economies because entities in those economies often have to transact hedging instruments in more liquid markets abroad, which means it is more difficult for them to find a hedging instrument that fits their actual exposure than it is for entities in economies with those liquid markets.
- BC6.167 Furthermore, the Board was concerned that using the single term ‘reasonably effective’ would mingle different aspects, which would be tantamount to aggregating the different aspects of the effectiveness assessment that the Board had considered (ie the economic relationship, the effect of credit risk and the hedge ratio). The Board noted that it was clear from feedback received on its proposed objective of the hedge effectiveness assessment that a single term was too abstract if the notion described by that term included a number of different aspects (also see paragraph BC6.161).
- BC6.168 Consequently, the Board decided not to use a qualitative ‘reasonably effective’ threshold for assessing hedge effectiveness.

Frequency of assessing whether the hedge effectiveness requirements are met

- BC6.169 In the deliberations leading to the exposure draft, as a consequence of its proposed hedge effectiveness requirements, the Board considered how frequently an entity should assess whether the hedge effectiveness requirements were met. The Board decided that an entity should perform this assessment at the inception of the hedging relationship.
- BC6.170 Furthermore, the Board considered that an entity should assess on an ongoing basis whether the hedge effectiveness requirements are (still) met, including any adjustment (rebalancing) that might be required in order to continue to meet those requirements (see paragraphs BC6.199–BC6.212). This was because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship. The Board also decided that the assessment of those requirements should be only forward-looking (ie prospective) because it related to expectations about hedge effectiveness.
- BC6.171 Hence, in the deliberations leading to the exposure draft, 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.
- BC6.172 Given that the changes made to the proposed hedge effectiveness requirements during the redeliberations of the exposure draft did not affect the Board’s rationale regarding the frequency of the assessment, the Board retained its original decision.

Method of assessing hedge effectiveness

- BC6.173 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.
- BC6.174 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.
- BC6.175 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 considered that, in the context of an effectiveness assessment that does not use a threshold, it can be appropriate to assess the effectiveness qualitatively for a hedging relationship for which the terms of the hedging instrument and the hedged item match or are closely aligned.
- BC6.176 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 considered that a quantitative assessment would be more suitable in such situations.
- BC6.177 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The Board noted that selecting the appropriate tool or technique depends on the complexity of the hedge, the availability of data and the level of uncertainty of offset in the hedging relationship. The type of assessment and the method used to assess hedge effectiveness therefore depends on the relevant characteristics of the hedging relationship. Consequently, in the deliberations leading to the exposure draft, the Board decided that an entity should assess the effectiveness of a hedging relationship either qualitatively or quantitatively depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. However, the Board decided not to prescribe any specific method of assessing hedge effectiveness.
- BC6.178 The Board retained its original decisions during the redeliberations of its exposure draft.

Accounting for qualifying hedging relationships

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

- BC6.179 Against the background of potential interaction with the classification of financial instruments in accordance with IFRS 9, the Board, in its deliberations leading to the exposure draft, considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows. The Board focused on fair value hedges of interest rate risk because other risks (for example, foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seemed clearly appropriate. More specifically, the Board was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the entity's business model is to hold the financial instrument to collect (or pay) contractual cash flows, rather than to sell (or settle/transfer) the instrument before contractual maturity in order to realise the fair value changes. Consequently, some argue that, on the basis of the assertion underlying the business model assessment, the entity should be interested only in the contractual cash flows arising from these investments and not in changes in fair value.
- BC6.180 The Board discussed several situations in which a fair value hedge of interest rate risk does not contradict that a financial instrument is held with the objective to collect or pay contractual cash flows. One example is an entity that seeks to invest in a variable rate asset of a particular credit quality, but could only obtain a fixed rate asset of the desired credit quality. That entity could create the cash flow profile of a variable rate asset indirectly by buying both the available fixed rate investment and entering into an interest rate swap that transforms the fixed interest cash flows from that asset into variable interest cash flows. The Board noted that this and other examples demonstrated that what is a fair value hedge for accounting purposes is, from a risk management perspective, often a choice between receiving (or paying) fixed versus variable interest cash flows, rather than a strategy to protect against fair value changes. Hence, the Board considered that a fair value hedge of interest rate risk in itself would not contradict the assertion that a financial instrument is held with the objective to collect or pay contractual cash flows.
- BC6.181 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 held with the objective to collect or pay contractual cash flows. Consequently, the Board decided that fair value hedge accounting should be available for financial instruments that are held with the objective to collect or pay contractual cash flows.
- BC6.182 The Board retained its original decisions during the redeliberations of its exposure draft.

Hedge of a foreign currency risk of a firm commitment

- BC6.183 IAS 39 allowed an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. In its deliberations leading to the exposure draft, the Board considered whether it should continue to allow this choice.

- BC6.184 The Board noted that requiring an entity to apply cash flow hedge accounting for all hedges of foreign currency risk of a firm commitment could result in what some regard as 'artificial' other comprehensive income and equity volatility (see paragraphs BC6.231 and BC6.232). 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).
- BC6.185 However, the Board also noted that requiring an entity to apply fair value hedge accounting for all hedges of foreign currency risk of a firm commitment would require a change in the type of hedging relationship to a fair value hedge when the foreign currency cash flow hedge of a forecast transaction becomes a hedge of a firm commitment. This results in operational complexity. For example, this would require changing the measurement of ineffectiveness from a 'lower of' test to a symmetrical test.
- BC6.186 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.
- BC6.187 Consequently, the Board proposed in its exposure draft to continue to permit an entity the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge.
- BC6.188 The Board retained its original decision during the redeliberations of its exposure draft.

Measuring the ineffectiveness of a hedging relationship

- BC6.189 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the Board in its deliberations leading to the exposure draft decided that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).
- BC6.190 The Board retained its original decision during the redeliberations of its exposure draft.

Time value of money

- BC6.191 The objective of measuring hedge ineffectiveness is to recognise, in profit or loss, the extent to which the hedging relationship did not achieve offset (subject to the restrictions that apply to the recognition of hedge ineffectiveness for cash flow hedges—often referred to as the 'lower of' test).
- BC6.192 The Board noted that hedging instruments are subject to measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts that are compared with the changes in the value of the hedging instrument must also be determined on a present value basis. The Board noted that hedge accounting does not change the measurement of the hedging instrument, but that it might change only the location of where the change in its carrying amount is presented. As a result, the same basis (ie present value) for the hedged item must be used in order to avoid a mismatch when determining the amount to be recognised as hedge ineffectiveness.

- BC6.193 Consequently, in the deliberations leading to the exposure draft, the Board decided that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.
- BC6.194 The Board retained its original decision during the redeliberations of its exposure draft.

Hypothetical derivatives

- BC6.195 In its deliberations leading to the exposure draft, 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. 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.
- BC6.196 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.
- BC6.197 Consequently, in the deliberations leading to the exposure draft, the Board decided that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The Board noted that this notion of a hypothetical derivative means that using a hypothetical derivative is only 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 (ie it is a mathematical expedient).
- BC6.198 The Board retained its original decision during the redeliberations of its exposure draft.

Rebalancing the hedging relationship

- BC6.199 IAS 39 did not allow adjustments that were not envisaged (documented) at the inception of the hedge to be treated as adjustments to a continuing hedging relationship. IAS 39 treated adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The 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.
- BC6.200 The Board noted that this is inconsistent with risk management practices. There are instances where, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. For example, such adjustments are often required to re-align the hedging relationship with risk management policies in view of changed circumstances. Hence, 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. The Board referred to such adjustments of hedging relationships as ‘rebalancing’.

- BC6.201 In its deliberations leading to the exposure draft, the Board also considered the ramifications of the proposed hedge effectiveness requirements, which, for some changes in circumstances, would create the need for an adjustment to the hedging relationship to ensure that those requirements would continue to be met. An example is a change in the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid a level of ineffectiveness that would fail the effectiveness requirements (which would not be met when using the original hedge ratio in the new circumstances).
- BC6.202 The Board concluded that, in such situations, if the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the Board proposed that an adjustment to a hedging relationship is treated as a rebalancing when that adjustment changes the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument but risk management otherwise continues the originally designated hedging relationship.
- BC6.203 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.
- BC6.204 Most respondents to the exposure draft agreed that the hedge accounting model should include a notion whereby a hedging relationship can be adjusted and accounted for as the continuation of an existing hedging relationship. Respondents thought that the inclusion of the concept of rebalancing would enhance the application of hedge accounting and would be a better representation of what entities do as part of their risk management activities. However, some respondents requested that the Board clarify the circumstances in which rebalancing is required or permitted. They were unsure as to whether rebalancing has been designed in the narrower sense to only deal with adjustments to the hedge ratio in the context of the hedge effectiveness requirements, or whether in a wider sense it also relates to the adjustment of hedged volumes when the hedge ratio is still appropriate (ie when the entity simply wants to hedge more or less than originally).
- BC6.205 Even though respondents generally supported the concept of rebalancing, some were concerned that, on the basis of how the hedge effectiveness requirement was proposed in the exposure draft, it would be unclear when to rebalance and that the Board should provide more guidance to ensure consistent application. Some respondents also thought that rebalancing should be permitted but not mandatory. They argued that risk management often chose not to adjust its (economic) hedging relationships based on a mathematical optimisation exercise that was implied in the exposure draft (see paragraph BC6.149). This was because of cost-effectiveness considerations or simply because the hedge was still within the tolerance limits an entity might use for adjusting the hedging

relationship. There was concern that the wording, as proposed in the exposure draft, implied a continuous optimisation exercise (ie to always have the 'perfect' hedge ratio) and would therefore require constant rebalancing. Consequently, almost all respondents (directly or indirectly) requested that the Board clarify that rebalancing should only be required when done for risk management purposes. They believed that hedge accounting should follow and represent rebalancing based on what an entity actually did for risk management purposes but that rebalancing should not be triggered merely by accounting requirements.

BC6.206 In the light of the feedback, the Board decided to retain the notion of rebalancing but to add some clarification on:

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

Mandatory or voluntary rebalancing

BC6.207 The Board noted that its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft had ramifications for rebalancing. This decision resulted in designating hedging relationships using a hedge ratio based on the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item. However, this is provided that the hedge ratio would not reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs BC6.155–BC6.158). The Board considered that this decision addressed the main concerns respondents had about rebalancing (ie how rebalancing for hedge accounting purposes related to rebalancing for risk management purposes).

BC6.208 The Board's proposal in the exposure draft included the notion of proactive rebalancing as a complement to the proposed hedge effectiveness assessment in order to allow an entity to adjust hedging relationships on a timely basis and at the same time strengthen the link between hedge accounting and risk management. However, the Board considered that its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft (see paragraph BC6.155) had an effect on rebalancing that would facilitate the adjustments to a hedging relationship that the exposure draft had addressed by the proposed notion of proactive rebalancing. In other words, if an entity adjusted the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument for risk management purposes (including adjustments that the exposure draft would have considered 'proactive'), the hedging relationship for hedge accounting purposes would usually be adjusted in the same way. Consequently, the Board considered that the notion of proactive rebalancing had become obsolete.

BC6.209 The Board also noted that its decisions on the hedge effectiveness assessment during the redeliberations of the exposure draft had an effect on rebalancing that addressed respondents' concerns related to the frequency of rebalancing because that also clarified that rebalancing was not a mathematical optimisation exercise (see paragraphs BC6.155 and BC6.156).

Clarification of the term ‘rebalancing’

- BC6.210 The Board noted that it had already clarified the notion of ‘rebalancing’ as a result of its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft (see paragraphs BC6.207–BC6.209). However, the Board considered whether it also needed to provide clarification on the scope of rebalancing—in other words, what adjustments to a hedging relationship constitute rebalancing.
- BC6.211 The Board noted that the notion of rebalancing, as proposed in its exposure draft, was used in the context of adjusting the designated quantities of the hedging instrument or hedged item in order to maintain a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedging instrument or of a hedged item for different purposes did not constitute the notion of ‘rebalancing’ that was proposed in the exposure draft.
- BC6.212 Consequently, the Board decided to clarify that rebalancing only covers adjustments to the designated quantities of the hedged item or of the hedging instrument for the purpose of maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment (ie not when the entity simply wants to hedge more or less than it did originally).

Discontinuation of hedge accounting

- BC6.213 In accordance with IAS 39, an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria (including when the hedging instrument no longer existed or was sold). However, in accordance with IAS 39, an entity also had a free choice to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).
- BC6.214 The Board noted that entities voluntarily discontinued hedge accounting often because of how the effectiveness assessment in IAS 39 worked. For example, entities revoked the designation of a hedging relationship and re-designated it as a new hedging relationship in order to apply a different method of assessing hedge ineffectiveness from the method originally documented (expecting that the new method would be a better fit). Another example was entities that revoked the designation of a hedging relationship because they wanted to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument (typically in response to a change in the relationship between different underlyings). The hedging relationship was then re-designated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The Board noted that in these situations the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the Board’s view, these outcomes created a disconnect between the hedge accounting model in IAS 39 and hedging from a risk management perspective and also undermined the usefulness of the information provided.
- BC6.215 In its deliberations leading to the exposure draft, 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 hedge ratio to be adjusted as part of a continuing hedging relationship.

- BC6.216 The Board also noted that sometimes a hedging relationship was discontinued because of a decrease in the hedged quantities of forecast transactions (ie the volume that remains highly probable of occurring falls or is expected to fall below the volume designated as the hedged item). Under IAS 39 this had resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the volume designated as the hedged item in its entirety. The 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 to propose in its exposure draft that hedge accounting should be discontinued only for the volume that was no longer highly probable of occurring and that the remaining volume that was still highly probable of occurring should be accounted for as a continuation of the original hedging relationship. In the Board's view, this would more closely align hedge accounting with risk management and provide more useful information.
- BC6.217 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 also propose to clarify that a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur would call into question the entity's ability to predict similar forecast transactions accurately. This would affect the assessment of whether similar forecast transactions are highly probable and hence their eligibility as hedged items.
- BC6.218 In view of its aim to better link hedge accounting to risk management and provide more useful hedge accounting information, 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 hedge accounting to be discontinued even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective that was part of the qualifying criteria that initially allowed the entity to achieve hedge accounting. The Board considered that, in such situations, voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. Hence, the Board decided to propose 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 for that particular hedging relationship, discontinuation of hedge accounting was not a choice but was required because the qualifying criteria would no longer be met. The Board considered that applying hedge accounting without a risk management objective would not provide useful information.
- BC6.219 In its deliberations leading to the exposure draft, 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 was a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.

- BC6.220 The responses to the proposals on the discontinuation of hedge accounting in the exposure draft provided mixed views. Those who agreed thought that the proposals would strengthen the reliability of financial reporting because the ability to change accounting for no valid reason would be reduced.
- BC6.221 More specifically, those who agreed also thought that the model in IAS 39 provided an opportunity for structuring. They noted that allowing a hedging relationship to be arbitrarily discontinued at any point in time is not conceptually sound and does not result in useful information.
- BC6.222 Even though many respondents agreed with the proposals, there were also requests that the Board provide additional guidance on the meaning of 'risk management' and at what level it should be considered for the purpose of hedge accounting.
- BC6.223 Generally, those who disagreed with the proposals argued that if starting hedge accounting was voluntary, ceasing it should also be voluntary. Some respondents who disagreed did so because they believed that voluntary discontinuation was necessary in scenarios where an entity decided to terminate a hedging relationship on the basis that the hedge was no longer cost efficient (for example, a high administrative burden makes it too onerous and costly to apply hedge accounting). Some of these respondents raised the concern that voluntary discontinuation was an important tool in the current hedge accounting model for financial institutions that normally run hedging programmes based on portfolios of items on a macro basis. Those portfolios were subject to constant changes and entities removed the hedge designation with the aim of adjusting the hedging relationship for new hedged items and hedging instruments.
- BC6.224 Others who disagreed argued that not allowing voluntary discontinuation was not consistent with the mechanics of cash flow hedge accounting. For example, when an entity entered into a cash flow hedge for forecast sales in a foreign currency, the risk management strategy aimed to protect the cash flows until settlement of the invoice. However, hedge accounting was only applied until the moment when the sales invoice became an on-balance-sheet item, after which the entity obtained a natural offset in the statement of profit or loss and other comprehensive income because of the translation of the hedged item in accordance with IAS 21 and the accounting for the hedging instrument at fair value through profit or loss. Those respondents thought that voluntary discontinuation of the hedging relationship was necessary at the time the forecast transaction became an on-balance-sheet item (for example, a trade receivable).
- BC6.225 Based on this feedback, the Board in its redeliberations considered:
- (a) whether voluntary discontinuation should be allowed given that hedge accounting remained optional; and
 - (b) how the link of the proposed discontinuation requirements to the risk management objective and strategy would work.
- BC6.226 The Board noted that even though the application of hedge accounting remained optional, it facilitated the provision of useful information for financial reporting purposes (ie how hedging instruments are used to manage risk). The Board considered that this purpose could not be ignored when considering voluntary

discontinuation of hedge accounting. If an entity chose to apply hedge accounting, it did so with the aim of using that particular accounting to represent in the financial statements the effect of pursuing a particular risk management objective. If the risk management objective had not changed and the other qualifying criteria for hedge accounting were still met, the ability to discontinue hedge accounting would undermine the aspect of consistency over time in accounting for and providing information about that hedging relationship. The Board noted that a free choice to discontinue hedge accounting reflected a view that hedge accounting is a mere accounting exercise that does not have a particular meaning. Consequently, the Board considered that it was not valid to argue that because hedge accounting was voluntary, the discontinuation of hedge accounting should also be voluntary.

- BC6.227 In addition, the Board noted that other optional accounting treatments of IFRSs do not allow the entity to overturn its initial election:
- (a) the fair value option in IAS 39 and IFRS 9; and
 - (b) the lessee's option to account for a property interest held under an operating lease as an investment property, which is available (irrevocably) on a property-by-property basis.
- BC6.228 The Board also did not think that the ability to voluntarily discontinue hedge accounting was necessary for hedge accounting to work as intended in particular situations mentioned in the feedback (see paragraphs BC6.223 and BC6.224). The Board considered that the impression of some respondents that voluntary discontinuation was necessary in those situations resulted from a lack of clarity about the distinction between the notions of risk management strategy and risk management objective. The Board noted that that distinction was important for determining when the discontinuation of a hedging relationship was required (or not allowed). The Board also noted that the term 'risk management strategy' was used in the exposure draft as a reference to the highest level at which an entity determines how it manages risk. In other words, the risk management strategy typically identified the risks to which the entity was exposed and set out how the entity responded to them. Conversely, the exposure draft used the term 'risk management objective' (for a hedging relationship) to refer to the objective that applies at the level of that particular hedging relationship (instead of what the entity aims to achieve with the overall strategy). In other words, it related to how the particular designated hedging instrument is used to hedge the particular exposure designated as the hedged item.
- BC6.229 The Board noted that a risk management strategy could (and often would) involve many different hedging relationships whose risk management objectives relate to executing that risk management strategy. Hence, the risk management objective for a particular hedging relationship could change even though an entity's risk management strategy remained unchanged. The Board's intention was to prohibit voluntary discontinuation of hedge accounting when the risk management objective at the level of a particular hedging relationship (ie not only the risk management strategy) remained the same and all other qualifying criteria were still met.
- BC6.230 Consequently, the Board decided to prohibit voluntary discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same and all the other qualifying criteria are still met. However, the Board also decided to add additional guidance on how the risk

management objective and the risk management strategy relate to each other using examples contrasting these two notions.

Fair value hedges

Accounting for fair value hedges

- BC6.231 In its deliberations leading to the exposure draft, 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 would align fair value hedge accounting and cash flow hedge accounting, resulting in a single method for hedge accounting.
 - (c) be an expeditious approach to finalise this phase of the project to replace IAS 39. Such an approach would draw on the existing mechanics of cash flow hedge accounting in IAS 39, and consequently such an approach would not require much further development.
- BC6.232 However, during its outreach activities before publishing the exposure draft, the Board received mixed views on this 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, others raised concerns that such an approach:
- (a) would not reflect the underlying economics. They argued that if an entity applies a fair value hedge, the hedged item exists and hence there is an actual gain or loss on the hedged item (not just an anticipated gain or loss on a forecast transaction that does not yet exist). Consequently, hedge accounting should not cause 'artificial' volatility in other comprehensive income and equity.
 - (b) would make the movements in other comprehensive income less understandable.
 - (c) would make it difficult to identify the type of risk management strategy that the entity employs.
 - (d) could result in scenarios in which equity would be significantly reduced or even negative because of losses on the hedging instrument deferred in

other comprehensive income. This could have serious implications in terms of solvency and regulatory requirements.

- BC6.233 In the light of the views received, the Board decided to propose a different approach in the exposure draft. The Board proposed to continue to account for fair value hedges differently from cash flow hedges. However, the Board proposed some changes to the presentation and mechanics of fair value hedge accounting:
- (a) gain or loss on remeasuring the hedging instrument—IAS 39 required the gain or loss to be recognised in profit or loss. The Board proposed to require the recognition of the gain or loss in other comprehensive income.
 - (b) gain or loss on the hedged item—IAS 39 required such a gain or loss to result in an adjustment to the carrying amount of the hedged item and to be recognised in profit or loss. The Board proposed to require the gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position and in other comprehensive income. That separate line item would have been presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).
- BC6.234 The Board noted that the separate line item represented 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 mechanics.
- BC6.235 However, the Board decided to propose these changes because they would:
- (a) eliminate the mixed measurement for the hedged item (for example, an amount that is amortised cost with a partial fair value adjustment).
 - (b) avoid volatility in other comprehensive income and equity that some consider artificial.
 - (c) present in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges).
 - (d) provide information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges.
- BC6.236 Most respondents supported providing the information proposed in the exposure draft, but many disagreed with providing this information on the face of the financial statements.
- BC6.237 With respect to recognising gains or losses on the hedging instrument and hedged item in other comprehensive income, many respondents thought that the use of other comprehensive income should be limited until the Board completed a project on what 'other comprehensive income' represents. Many respondents expressed a preference for the approach in IAS 39 (ie presenting the gain or loss on the hedging instrument and the hedged item in profit or loss). As an alternative, those respondents suggested that the gain or loss on the hedging instrument and the hedged item should be disclosed in the notes to the financial statements.

- BC6.238 With respect to presenting separate line items in the statement of financial position, many respondents expressed concern about the excessive number of additional line items in the statement of financial position that could result from the proposals in the exposure draft. Those respondents thought that the statement of financial position would appear too cluttered. As an alternative, those respondents suggested that entities disclose the accumulated adjustment made to the carrying amount of the hedged item in the notes to the financial statements.
- BC6.239 In the light of this feedback, the Board in its redeliberations decided to retain the fair value hedge accounting mechanics that were in IAS 39. However, the Board also decided that it would require information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the financial statements and that all hedge accounting disclosures are presented in a single note or separate section in the financial statements (those disclosure requirements were included in IFRS 7).

Linked presentation for fair value hedges

- BC6.240 During its outreach activities before publishing the exposure draft, 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 liabilities are related. Linked presentation is not the same as offsetting, which presents a net asset or liability. Linked presentation displays the 'gross' amount of related items in the statement of financial position (while the net amount is included in the total for assets or liabilities).
- BC6.241 The industry was concerned that the presentation resulting from fair value hedge accounting would not reflect the economic effects of hedges of foreign currency risk. For example, an entity that has a large firm commitment for a sale denominated in a foreign currency enters into currency forward contracts to hedge the foreign currency risk of that firm commitment (the forward contract and the firm commitment could be considered 'linked transactions'). The fair value of the derivative liability (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 sought to reduce risk.
- BC6.242 That industry argued that linked presentation of the firm commitment (recognised as a result of fair value hedge accounting) and the hedging instrument could present the effect of an entity's hedging activity and the relationship of the hedged item and the hedging instrument. Linked presentation would not require

changing the requirements of offsetting in IAS 32 *Financial Instruments: Presentation* or other requirements in IAS 39 and IFRS 9.

- BC6.243 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.
- BC6.244 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 (for example, only the currency risk but not the 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 believed that disclosures about hedging would be a better alternative for providing information that allows users of financial statements to assess the relevance of the information for their own analysis.
- BC6.245 Consequently, the Board decided not to propose the use of linked presentation for the purposes of hedge accounting.
- BC6.246 Most respondents to the exposure draft agreed with the Board's conclusion not to allow linked presentation. Some respondents also thought that linked presentation is not an appropriate topic for a project on hedge accounting, but rather that it should be considered either as a separate project or as part of a project on financial statement presentation or a project on the *Conceptual Framework*.
- BC6.247 However, those respondents that supported linked presentation argued that, without it, entities that use hedge accounting would be perceived to be riskier than those that do not, and that the true economic effects of hedges of foreign currency risk of firm commitments would not be reflected.
- BC6.248 The Board noted that in the absence of a clear principle for linked presentation, it should be considered in a broader context than just hedge accounting. Consequently, the Board decided not to require or allow the use of linked presentation for the purpose of hedge accounting.

Cash flow hedges

The 'lower of' test

- BC6.249 When a hedge accounting relationship is fully effective, the fair value changes of the hedging instrument perfectly offset the value changes of the hedged item. Hedge ineffectiveness arises when the value changes of the hedging instrument

exceed those of the hedged item, or when the value changes of the hedging instrument are less than those of the hedged item.

- BC6.250 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.
- BC6.251 IAS 39 required a 'lower of' test for determining the amounts that were recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. In contrast, the 'lower of' test did not apply to fair value hedges because, for that type of hedge, the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRSs, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.
- BC6.252 In its deliberations leading to the exposure draft, 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 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. On the other hand, the Board considered that the nature of fair value hedges is different from that of cash flow hedges. Applying the 'lower of' test also to fair value hedges even though that test was designed to address only the specific characteristics of cash flow hedges, was not justified. Consequently, the Board decided to retain the 'lower of' test for cash flow hedges and not to introduce it for fair value hedges.

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

- BC6.253 A forecast transaction could subsequently result in the recognition of a non-financial asset or a non-financial liability. Similarly, a forecast transaction for a non-financial asset or non-financial liability could subsequently result in the recognition of a firm commitment for which fair value hedge accounting is applied. In these cases IAS 39 permitted an entity an accounting policy choice:
- (a) to reclassify the associated gains or losses that were recognised in other comprehensive income to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or
 - (b) to remove the associated gains or losses that were recognised in other comprehensive income and include them in the initial cost or other carrying

amount of the asset or liability. This approach was commonly referred to as a 'basis adjustment'.

- BC6.254 In its deliberations leading to the exposure draft, the Board considered whether to continue allowing this accounting policy choice. The Board noted that if an entity was precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging relationship had ended) and to match them to the period or periods in which the non-financial item that had resulted from the hedged transaction affected profit or loss. The entity would also need to consider whether or not the remaining amount in other comprehensive income was recoverable in one or more future periods. In contrast, if an entity applied a basis adjustment, the hedging gain or loss was included in the carrying amount of the non-financial item and automatically recognised in profit or loss in the period in which the related non-financial item affected profit or loss (for example, through depreciation expense for items of property, plant and equipment or cost of sales for inventories). It would also be automatically considered when an entity tested a non-financial asset for impairment. The 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).
- BC6.255 The Board acknowledged that there were different views on whether a basis adjustment would achieve or reduce comparability. One view was that two identical assets purchased at the same time and in the same way (except for the fact that one was hedged) should have the same initial carrying amount. From this viewpoint, basis adjustments would impair comparability.
- BC6.256 The other view was that basis adjustments allowed identical assets for which the acquisitions are subject to the same risk to be measured so that they had the same initial carrying amount. For example, Entity A and Entity B want to purchase the same asset from a supplier that has a different functional currency. Entity A is able to secure the purchase contract denominated in its functional currency. Conversely, while Entity B also wants to fix the purchase price in its functional currency, it has to accept a purchase contract denominated in the functional currency of the supplier (ie a foreign currency) and is therefore exposed to the variability in cash flows arising from movements in the exchange rate. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract which, in effect, fixes the price of the purchase in its functional currency. When taking into account the currency forward contract, Entity B has, in effect, the same foreign currency risk exposure as Entity A. From this viewpoint, basis adjustments would enhance comparability.
- BC6.257 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 BC6.183–BC6.188). 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 hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for these firm commitments was tantamount to a basis adjustment. The Board thought that, in this context, basis adjustments would also enhance comparability.
- BC6.258 Consequently, the Board decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The Board decided that when the entity

removes the associated gain or loss that was recognised in other comprehensive income in order to include it in the initial cost or other carrying amount of the asset or liability, that gain or loss should be directly applied against the carrying amount of the asset or liability. This means it would not be a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence would not affect other comprehensive income when removing it from equity and adding it to, or deducting it from, the asset or liability. The 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 other comprehensive income) in the period in which the non-financial item is recognised; and
- (b) then again in the later periods when the non-financial item affects profit or loss (for example, through depreciation expense or cost of sales).

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

BC6.259 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 over the total period of not using a reclassification adjustment.

BC6.260 The Board retained its original decision during the redeliberations of its exposure draft.

Hedges of a net investment in a foreign operation

BC6.261 In its deliberations leading to the exposure draft, the Board decided not to address a hedge of a net investment in a foreign operation as part of its hedge accounting project. The Board noted that a net investment in a foreign operation was determined and accounted for in accordance with IAS 21. The Board also noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similar to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC6.60) the Board considered that comprehensively addressing this type of hedge would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements. 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.

BC6.262 Consequently, the Board proposed retaining the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

BC6.263 The Board retained its original decision during the redeliberations of its exposure draft.

Accounting for the time value of options

BC6.264 IAS 39 allowed an entity a choice:

- (a) to designate an option-type derivative as a hedging instrument in its entirety; or
- (b) to separate the time value of the option and designate as the hedging instrument only the intrinsic value element.

BC6.265 The Board noted that under the IAS 39 hedge accounting model entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from the risk management view, whereby entities typically consider the time value of an option (at inception, ie included in the premium paid) as a cost of hedging. It is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes.

BC6.266 Against this background, the Board, in its deliberations leading to the exposure draft, considered how best to portray the time value of options (in the context of hedging exposures only against changes to one side of a specified level—‘a one-sided risk’). The Board noted that the standard-setting debate about accounting for the time value of options had historically been focused on hedge ineffectiveness. Many typical hedged transactions (such as firm commitments, forecast transactions or existing items) do not involve a time value notion because they are not options. Hence, such hedged items do not have a change in their value that offsets the fair value change related to the time value of the option that is used as a hedging instrument. The Board concluded that, unless the time value of the option was excluded from the designation as the hedging instrument, hedge ineffectiveness would arise.

BC6.267 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).

BC6.268 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 as similar to an insurance premium. In order to protect themselves against the downside of an exposure (an adverse outcome) while retaining the upside, they have to compensate someone else for assuming the inverse asymmetrical position, which has only the downside but not the upside. The time value of an option is subject to ‘time decay’. This means that it loses its value over time as the option approaches expiry, which occurs at an increasingly rapid rate. At expiry the option’s time value reaches zero. Hence, entities that use purchased options to hedge one-sided risks know that over the life of the option they will lose the time value that they paid. This explains why entities typically view the premium paid as being similar to an insurance premium and hence as a cost of using this hedging strategy.

BC6.269 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 were treated as transaction costs that were capitalised into the costs of the insured asset (for example, freight insurance paid by the buyer in accordance with IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*), whereas costs of insuring some other risks were recognised as expenses over the period for which the entity was insured (for example, fire insurance for a building). Hence, the 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.

- BC6.270 The Board took the view that, like the distinction of the different types of costs of insuring risk, the time value of options should be distinguished by the type of hedged item that the option hedges, into time value that is:
- (a) transaction related (for example, the forecast purchase of a commodity); or
 - (b) time-period related (for example, hedging an existing commodity inventory for commodity price changes).
- BC6.271 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 in a way similar to that 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).
- BC6.272 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 as an expense over the relevant period on a systematic and 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 by transferring each period an amount to profit or loss. The Board considered that the amortisation pattern should be determined on a systematic and rational basis, which would best reflect principle-based standard-setting.
- BC6.273 The Board also considered situations in which 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 relates to the hedged item (and therefore should be treated as costs of hedging) and which part does not?
 - (b) How should any part of the time value that does not relate to the hedged item be accounted for?
- BC6.274 The Board proposed in the exposure draft that the part of the time value of the option that relates to the hedged item should be determined as the time value that would have been paid for an option that perfectly matches the hedged item (for example, with the same underlying, maturity and notional amount). The 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).

- BC6.275 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 that which reflects the 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.
- BC6.276 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.
- BC6.277 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 remains in accumulated other comprehensive income should be immediately recognised in profit or loss when the hedging relationship is discontinued. That would reflect that the reason for amortising the amount would no longer apply after the insured risk (ie the hedged item) no longer qualifies for hedge accounting. The Board noted that impairment of the hedged item affects the criteria for qualifying hedges and if those are no longer met it would result in an impairment loss for the remaining unamortised balance of the time value of the option.
- BC6.278 Most of the respondents to the exposure draft agreed with the 'insurance premium' view. They thought that the proposal provided a better representation of the performance and effect of the entity's risk management strategy than under IAS 39. In their view, the proposals alleviated undue profit or loss volatility and reflected the economic substance of the transaction. They also thought that the costs of hedging should be associated with the hedged item rather than being mischaracterised as hedge ineffectiveness.
- BC6.279 However, there were mixed views regarding the complexity of the proposals. Some respondents had concerns about the complexity related to:
- (a) the requirement to differentiate between transaction related and time-period related hedged items; and
 - (b) the requirement to measure the fair value of the aligned time value. Those concerns included that the costs of implementing the proposals could outweigh the benefits, for instance, for less sophisticated (for example, smaller) entities.

- BC6.280 Some respondents did not agree with the proposed accounting for transaction related hedged items. Some argued that time value should always be expensed over the option period.
- BC6.281 In the light of this feedback the Board considered in its redeliberations:
- (a) whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the exposure draft;
 - (b) whether it should remove the differentiation between transaction related and time-period related hedged items and replace it with a single accounting treatment; and
 - (c) whether it should simplify the requirement to account for the fair value of the aligned time value.
- BC6.282 The Board discussed whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the exposure draft. The Board noted that such an accounting treatment would have outcomes that would be inconsistent with the notion of the time value being regarded as costs of hedging. This is because it could result in recognising an expense in periods that are unrelated to how the hedged exposure affects profit or loss.
- BC6.283 The Board also reconsidered whether it was appropriate to defer in accumulated other comprehensive income the time value of options for transaction related hedged items. The Board noted that the deferred time value does not represent an asset in itself, but that it was an ancillary cost that is capitalised as part of the measurement of the asset acquired or liability assumed. This is consistent with how other IFRSs treat ancillary costs. The Board also noted that the exposure draft included an impairment test to ensure that amounts that are not expected to be recoverable are not deferred.
- BC6.284 The Board also discussed whether the proposals in the exposure draft could be simplified by removing the differentiation between transaction related and time-period related hedged items. However, the Board noted that a single accounting treatment would be inconsistent with other IFRSs because it would not distinguish situations in a similar way (see paragraphs BC6.269 and BC6.270). Hence, the Board considered that the suggested single accounting treatment would essentially treat unlike situations as alike. The Board noted that this would actually diminish comparability and hence not be an improvement to financial reporting.
- BC6.285 The Board also considered whether it should paraphrase the requirements as a single general principle to clarify the accounting for transaction related and time-period related hedged items, rather than having requirements that distinguish by those two types of hedged items. However, on balance the Board decided that this approach risked creating confusion, in particular because it would still involve the two different types of accounting treatments.
- BC6.286 The Board also discussed possible ways to simplify the requirements to account for the fair value of the aligned time value. As part of those discussions the Board considered:
- (a) Applying the proposed accounting treatment for the time value of options to the entire amount of the time value paid even if it differs from the aligned time value. This means that entities would not need to compute a separate

valuation for the fair value of the aligned time value. However, the Board considered that only the time value that relates to the hedged item should be treated as a cost of hedging. Hence, any additional time value paid should be accounted for as a derivative at fair value through profit or loss.

- (b) Providing entities with a choice (for each hedging relationship or alternatively as an accounting policy choice) to account for the time value of options either as proposed in the exposure draft or in accordance with the treatment in IAS 39. In the latter case, the amount recognised in profit or loss as a 'trading instrument' is the difference between the change in the fair value of the option in its entirety and the change in fair value of the intrinsic value. In contrast, the proposals in the exposure draft would require two option valuations (ie the change in fair value of the actual time value of the option and the aligned time value of the option). However, the Board noted that the accounting treatment in accordance with IAS 39 would, in effect, present the change in fair value of the time value as a trading profit or loss. This accounting treatment would not be consistent with the character of the changes in the time value that the Board is seeking to portray, ie that of costs of hedging. In addition, the Board noted that providing a choice would reduce comparability between entities and it would make financial statements more difficult to understand.

BC6.287 Consequently, the Board decided to retain the accounting requirements related to the time value of options proposed in the exposure draft (ie that the accounting would depend on the nature of the hedged item and that the new accounting treatment only applied to the aligned time value).

Zero cost collars

BC6.288 The proposed accounting treatment for the time value of options in the exposure draft only addressed situations in which the option had a time value (other than nil) at inception. That proposed accounting would not have applied to situations in which there was a combination of a purchased and a written option (one being a put option and one being a call option) that at inception of the hedging relationship had a net time value of nil (colloquially often referred to as 'zero-cost collars' or 'zero premium collars').

BC6.289 Many respondents to the exposure draft commented that the proposed accounting for purchased options should also apply to all zero-cost collars. They thought that without generally aligning the accounting treatment for time value of zero-cost collars and options, it would encourage entities to undertake particular types of transactions and replace zero-cost collars with collars with a nominal cost only to achieve a desired accounting outcome.

BC6.290 Furthermore, those respondents noted that even though the zero-cost collar had no net time value at inception, the time value of the collar would fluctuate during the life of the hedge. They noted that time value was subject to 'time decay' and that both the purchased and the written option would lose their time value over time as the collar approaches expiry. They argued that the time value of zero-cost collars should also be recognised in other comprehensive income during the life of the hedging relationship. They considered it unjustified to limit the proposed accounting to options that have an initial time value of greater than nil, given that one of the main concerns being addressed by the proposal was the volatility resulting from changes in time value over the life of the hedge.

BC6.291 In the light of those arguments, the Board decided to align the accounting treatment for changes in the time value of options and zero-cost collars.

Accounting for the forward element of forward contracts

BC6.292 IAS 39 allowed an entity a choice between:

- (a) designating a forward contract as a hedging instrument in its entirety; or
- (b) separating the forward element and designating as the hedging instrument only the spot element.

BC6.293 If not designated, the forward element was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss.

BC6.294 The Board noted that the characteristics of forward elements depended on the underlying item, for example:

- (a) For foreign exchange rate risk, the forward element represents the interest differential between the two currencies.
- (b) For interest rate risk, the forward element reflects the term structure of interest rates.
- (c) For commodity risk, the forward element represents what is called the 'cost of carry' (for example, it includes costs such as storage costs).

BC6.295 Respondents to the exposure draft as well as participants in the Board's outreach activities requested that the Board consider extending the proposal on the accounting for time value of options (see paragraphs BC6.264-BC6.291) to forward elements.

BC6.296 The Board noted that even though under IAS 39 the hedge accounting requirements were identical for forward elements and options, the actual accounting implications were different. In contrast to many typical situations in which options were used to hedge transactions that did not involve a time value notion because they were not options (see paragraph BC6.266), in situations in which forward contracts were used the value of hedged items typically did have a forward element that corresponded to that of the hedge. The Board noted that this meant that an entity could choose to designate the forward contract in its entirety and use the 'forward rate method' to measure the hedged item.

BC6.297 Using the forward rate method, the forward element is essentially included in the hedging relationship by measuring the change in the value of the hedged item on the basis of forward prices or rates. An entity can then recognise the forward element as costs of hedging by using the forward rate method for example resulting in:

- (a) capitalising the forward element into the cost of the acquired asset or liability assumed; or
- (b) reclassifying the forward element into profit or loss when the hedged item (for example, hedged sales denominated in a foreign currency) affects profit or loss.

BC6.298 Consequently, changes in forward elements are not recognised in profit or loss until the hedged item affects profit or loss. The Board noted that this outcome was equivalent to what it had proposed in its exposure draft for accounting for the time value of options that hedge transaction related hedged items. Hence,

the Board considered that, for situations similar to hedges of transaction related hedged items using options, applying the forward rate method would, in effect, achieve an accounting outcome that treated the forward element like costs of hedging. This would be consistent with the Board's overall approach to accounting for the costs of hedging and therefore not require any amendments to its exposure draft.

BC6.299 However, the Board acknowledged that in situations that were equivalent to those addressed by its decision on the accounting for time-period related hedged items that were hedged using options, its proposals in the exposure draft (like IAS 39) would prevent an entity from achieving an equivalent accounting outcome for the forward element of a forward contract. The reason was that, like IAS 39, the proposals in the exposure draft did not allow the forward element to be amortised. For example, if an entity hedged the fair value changes resulting from price changes of its existing commodity inventory (ie a time-period related hedged item) it could, under the proposals in the exposure draft (like IAS 39), either:

- (a) use the forward rate method (ie forward elements are capitalised into the cost of inventory, rather than accounted for as at fair value through profit or loss over the time of the hedge); or
- (b) designate as the hedging instrument only changes in the spot element (ie fair value changes in the forward element of the forward contract are recognised in profit or loss).

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

BC6.300 The Board also noted that the accounting for monetary financial assets and liabilities denominated in a foreign currency had an important consequence. Like IAS 39, IFRS 9 (see paragraph B5.7.2) requires an entity to apply IAS 21 to those instruments, which means they are translated into the entity's functional currency by using the spot exchange rate. Hence, the forward rate method does not provide a solution when entities hedge monetary financial assets and liabilities denominated in a foreign currency.

BC6.301 Consequently, the Board acknowledged that aligning the accounting for forward elements with the accounting for time value of options was a particular concern to entities that, for example, had more funding in their functional currency than they could invest in financial assets in their functional currency. To generate an economic return on their surplus funds, such entities exchange these funds into a foreign currency and invest in assets denominated in that foreign currency. To manage their exposure to foreign exchange risk (and to stabilise their net interest margin), such entities commonly enter into foreign exchange derivatives. Such transactions usually involve the following simultaneously:

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

- BC6.302 The difference between the forward rate and the spot rate (ie the forward element) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency by the forward points (ie the forward element of the foreign exchange derivative) and then deducting the interest expense. The combination of the three transactions described above allows the entity to, in effect, 'lock in' a net interest margin and generate a fixed economic return over the investment period.
- BC6.303 Respondents argued that risk management viewed the forward elements as an adjustment of the investment yield on foreign currency denominated assets. They believed that, as in the case of the accounting for time value of options, it gave rise to a similar need for adjusting profit or loss against other comprehensive income to represent the cost of achieving a fixed economic return in a way that is consistent with the accounting for that return.
- BC6.304 In the light of the arguments raised by respondents, the Board decided to permit forward points that exist at inception of the hedging relationship to be recognised in profit or loss over time on a systematic and rational basis and to accumulate subsequent fair value changes through other comprehensive income. The Board considered that this accounting treatment would provide a better representation of the economic substance of the transaction and the performance of the net interest margin.

Hedges of a group of items

- BC6.305 IAS 39 restricted the application of hedge accounting for groups of items. For example, hedged items that together constitute an overall net position of assets and liabilities could not be designated into a hedging relationship with that net position as the hedged item. Other groups were eligible if the individual items within that group had similar risk characteristics and shared the risk exposure that was designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group had to be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of these restrictions was that a group would generally qualify as a hedged item only if all the items in that group would qualify for hedge accounting for the same hedged risk on an individual basis (ie each as an individual hedged item).
- BC6.306 In response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to achieve hedge accounting for groups of items, including net positions, had resulted in a hedge accounting model that was inconsistent with the way in which an entity actually hedges (ie for risk management purposes). Similar concerns about the restrictions of IAS 39 for applying hedge accounting to groups of items were raised as part of the Board's outreach activities for its hedge accounting project.
- BC6.307 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 or risks that result in a net position.

- BC6.308 The group hedging approach involves identifying the risk from particular groups of items (including a net position), and then hedging some or all of that risk with one or more hedging instruments. The group hedging approach views the risk at a higher aggregated level. The reasons for taking this approach include:
- (a) items in the group have some offsetting risk positions that provide a natural hedge for some of those risks and therefore those offsetting risks do not need to be separately hedged;
 - (b) hedging derivatives that hedge different risks together can be more readily available than individual derivatives that each hedge a different risk;
 - (c) it is more expedient (cost, practicality, etc) to enter into fewer derivatives to hedge a group rather than hedging individual exposures;
 - (d) the minimisation of counterparty credit risk exposure, because offsetting risk positions are hedged on a net basis (this aspect is particularly important for an entity that has regulatory capital requirements); and
 - (e) the reduction of gross assets/liabilities in the statement of financial position, because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.
- BC6.309 The restrictions in IAS 39 prevented an entity that hedges on a group or net basis from presenting its activities in a manner that is consistent with its risk management practice. For example, an entity may hedge the net (ie residual) foreign currency risk from a sequence of sales and expenses that arise over several reporting periods (say two years) using a single foreign currency derivative. Such an entity could not designate the net position of sales and expenses as the hedged item. Instead, if it wanted to apply hedge accounting it had to designate a gross position that best matched its hedging instrument. However, the Board noted there were 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 gross exposure from the sequence of sales and expenses, that item would be portrayed as the only hedged item and would be presented at the hedged rate. All other transactions (for instance, in earlier reporting periods) would appear unhedged and would be recognised at the prevailing spot rates, which would give rise to volatility in some reporting periods.
 - (c) If the designated hedged transaction did not arise, but the net position remained the same, hedge ineffectiveness would be recognised for accounting purposes even though it does not exist from an economic perspective.
- BC6.310 Consequently, in its exposure draft, the Board proposed that groups of items (including net positions) should be eligible for hedge accounting. However, the Board also proposed limiting the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC6.320–BC6.325).
- BC6.311 Respondents to the exposure draft supported the proposal to allow hedge accounting for groups and net positions and most supported the Board's rationale for doing so. However, some disagreed with specific aspects of the

Board's proposals in the exposure draft. Their concerns focused on the proposals related to cash flow hedges of net positions.

BC6.312 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

BC6.313 An individual hedge approach involves an entity entering into one or more hedging instruments to manage a risk exposure from an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, for a group hedge approach an entity seeks to manage the risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument.

BC6.314 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 proposed that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions were retained for cash flow hedges of net positions.

BC6.315 The Board retained its original decision during the redeliberations of its exposure draft.

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

BC6.316 The Board proposed in its exposure draft that an entity could designate a layer component of a nominal amount (a layer) of a single item in a hedging relationship. The Board also considered whether it would be appropriate to extend that decision on single items to groups of multiple items and hence allow the designation of a layer of a group in a hedging relationship.

BC6.317 The Board considered 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 BC6.107–BC6.111). In addition, the Board also noted other reasons that support the use of components for groups of items:

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

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

- BC6.318 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 even impossible. The Board considered that it is not appropriate to define the cases in which the proposed conditions were satisfied because it would depend on the specific facts and circumstances. The Board considered a criteria-based approach would be more operational and appropriate. That would allow hedge accounting to be applied in situations in which the criteria are easy to meet as well as in cases in which, although the criteria are more challenging to meet, an entity is prepared to undertake the necessary efforts (for example to invest in systems in order to achieve compliance with the hedge accounting requirements).
- BC6.319 The Board retained its original decision during the redeliberations of its exposure draft.

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

- BC6.320 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred in other comprehensive income to be reclassified later from accumulated other comprehensive income to profit or loss when the hedged item affects profit or loss. For hedges of net positions, items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group (ie the gains on some items offset the losses on others). Hence, for a cash flow hedge of a net position that is a group of forecast transactions, the cumulative change in value (from the inception of the hedge) that arises on some forecast transactions (to the extent that it is effective in achieving offset) must be deferred in other comprehensive income. This is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss in the later phase until the last hedged item in the net position affects profit or loss.
- BC6.321 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 might 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 in other comprehensive income. This is required in order to ensure that the effect of the sales on profit or loss is based on the hedged exchange rate.
- BC6.322 Hence, in its deliberations leading to the exposure draft, the Board noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in accumulated other comprehensive income of cumulative gains and losses on some forecast transactions, from the time they occurred until some other forecast transactions would affect profit or loss in later periods. The Board considered that this would be tantamount to measuring the transactions that occurred first at a different amount from the transaction amount (or other amount that would be required under general IFRS requirements) in contemplation of other forecast transactions that were expected to occur in the

future and that would have an offsetting gain or loss. When those other transactions occurred, their measurement would be adjusted for the amounts deferred in accumulated other comprehensive income on forecast transactions that had occurred earlier.

- BC6.323 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 occurred. However, the Board considered that this approach would be a significant departure from general IFRSs regarding the items that resulted from the forecast transactions. The Board noted that this departure would affect the forecast transactions:
- (a) that occurred in the early phases of the hedging relationship, ie those for which gains and losses were deferred when the transaction occurred; and
 - (b) those that occurred in the later phases of the hedging relationship and were adjusted for the gains or losses that had been deferred on the forecast transactions as they had occurred in the early phases of the hedging relationship.
- BC6.324 The Board noted that the accounting for the forecast transactions that occurred in the later phases of the hedging relationship was comparable to that of forecast transactions that were hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occurred in the early phases of the hedging relationship would be more similar to that of a hedging instrument than 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.
- BC6.325 Consequently, in its exposure draft, the Board proposed that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting risk positions would affect profit or loss in different periods. The Board noted that when the offsetting risk positions affected profit or loss in the same period those concerns would not apply in the same way as no deferral in accumulated other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the Board proposed that such net positions should be eligible as hedged items.
- BC6.326 Some respondents to the exposure draft agreed with the Board's rationale for not allowing the application of cash flow hedge accounting to net positions that consist of forecast transactions that would affect profit or loss in different reporting periods. They believed that without this restriction the potential for earnings management would arise. Despite agreeing with the proposals, some respondents asked the Board to provide additional guidance on the treatment of the amounts deferred in accumulated other comprehensive income if, in a cash flow hedge of a net position, the offsetting risk positions that were initially expected to affect profit or loss in the same reporting period subsequently changed and as a result were expected to affect profit or loss in different periods.
- BC6.327 Others requested the Board to reconsider the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. These respondents believed that this restriction would not allow entities to properly reflect their risk management activities. In addition, some respondents requested that the Board consider the annual reporting period as the basis for this restriction (if retained) instead of any reporting period (ie including an interim

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

BC6.328 The Board noted that the feedback on its proposals in the exposure draft reflected two different perspectives.

- (a) A treasury perspective—this is a cash flow perspective. The respondents who provided comments from this perspective typically look at cash inflows and outflows arising from both sides of the net position. The treasury view stops at the level of the cash flows and does not take into account the time lag that might exist between the cash flow and the recognition of related income or expense in profit or loss. From this perspective, once the first forecast transaction is recognised, the natural hedge lapses and the remainder of the net position will be hedged by entering into an additional derivative (or alternatively by using, for example, the foreign currency denominated cash instrument that arises as a result of the occurrence of the first forecast transaction). Subsequently (ie at the time of settlement of the second forecast transaction), the cash flows from the financial instrument being used as a hedging instrument will be used to settle the payments resulting from the forecast transaction.
- (b) An accounting perspective—this perspective focuses on how to present the effect of the two forecast transactions in profit or loss and in which accounting period. This goes beyond the cash flow view of the treasury perspective. This is because the way in which the item affects profit or loss can be different, while the cash flow is a point-in-time event. For example, while the purchase of services and sales of goods can be designated as part of a net position in a way that they will affect profit or loss in one reporting period, purchases of property, plant and equipment affect profit or loss over several different reporting periods through the depreciation pattern. Similarly, if inventory is sold in the period after it was purchased, the cash flow and the related effect on profit or loss occur in different periods.

BC6.329 In the light of the comments received, the Board reconsidered the restriction on cash flow hedges of net positions with offsetting risk positions that affect profit or loss in different reporting periods, as proposed in the exposure draft. The Board did not think that it was appropriate to completely remove the restriction. However, the Board considered whether there was an alternative approach that could better reflect an entity's risk management activities but that would also address the earnings management concerns that had been raised.

BC6.330 The Board noted that entities would only be able to reflect their risk management activities if it removed the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. However, the Board noted that it could address the concerns about earnings management by introducing some requirements for documenting the hedging relationship instead of prohibiting the designation altogether.

BC6.331 The Board noted that the potential for earnings management could be addressed if the recognition pattern for profit or loss arising from the hedged net position for all periods affected was set at the inception of the hedge, in such a way that it was clear what amounts would affect profit or loss, when they would affect profit or loss and to which hedged volumes and types of items they related.

- BC6.332 However, the Board had concerns about applying cash flow hedges for net positions to many different types of risks because it might have unintended consequences for some risks. The Board noted that foreign currency risk was the risk most commented on by respondents and the risk that the Board intended to address by this type of hedge.
- BC6.333 Consequently, the Board decided that cash flow hedges of net positions would only be available for hedges of foreign currency risk (but no other risks). In addition, the Board decided to remove the restriction that the offsetting risk positions in a net position must affect profit or loss in the same reporting period. However, the Board was concerned that without sufficiently specific documentation of the items within the designated net position, an entity could use hindsight to allocate the hedging gains or losses to those items so as to achieve a particular result in profit or loss (selection effect). Consequently, the Board decided that for all items within the designated net position for which there could be a selection effect, an entity must specify each period in which the transactions are expected to affect profit or loss as well as the nature and volume of each type of forecast transaction in such a way that it eliminates the selection effect. For example, depending on the circumstances, eliminating a selection effect could require that specifying the nature of a forecast purchase of items of property, plant and equipment includes aspects such as the depreciation pattern for items of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items (eg different useful lives because of being used in different production processes). The Board noted that this would also address the issue that some respondents had raised regarding changes in the original expectations of when the risk positions would affect profit or loss resulting in items affecting profit or loss in different periods (see paragraph BC6.326).

Presentation for groups of items that are a net position

- BC6.334 For cash flow hedges of groups of items with offsetting risk positions (ie net positions) the hedged items might affect different line items in the statement of profit or loss and other comprehensive income. Consequently, for a cash flow hedge of such a group, that raises the question of how hedging gains or losses should be presented. In its deliberations leading to the exposure draft, the Board noted that hedging gains or losses would need to be grossed up to offset each of the hedged items individually.
- BC6.335 The Board noted that if it proposed to adjust (gross up) all the affected line items in the statement of profit or loss and other comprehensive income it would result in the recognition of gross (partially offsetting) gains or losses that did not exist, and that this would not be consistent with general accounting principles. Consequently, in its exposure draft, the Board decided not to propose adjusting (grossing up) all affected line items in the statement of profit or loss and other comprehensive income.
- BC6.336 Instead, the Board proposed in its exposure draft that in the statement of profit or loss or other comprehensive income hedging gains or losses for cash flow hedges of a net position should be presented in a separate line item. This would avoid the problem of distorting gains or losses with amounts that did not exist. However, the Board acknowledged that this results in additional disaggregation of information in the statement of profit or loss and other comprehensive income.

This would also result in hedges of net positions being presented differently from hedges of gross positions.

- BC6.337 In a fair value hedge, changes in the fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in the statement of profit or loss and other comprehensive income. Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the Board did not believe any changes to the fair value hedge accounting mechanics were necessary to accommodate net positions. However, in situations where some hedging gains or losses are considered a modification of revenue or an expense (for example, when the net interest accrual on an interest rate swap is considered a modification of the interest revenue or expense on the hedged item), those gains or losses should be presented in a separate line when the hedged item is a net position. In the Board's view, in those situations the same reasons applied that it had considered for cash flow hedges in relation to their presentation in the statement of profit or loss and other comprehensive income.
- BC6.338 Most of the respondents to the exposure draft supported the Board's proposal to require the hedging gains or losses to be presented in a separate line item for a hedging relationship that includes a group of items with offsetting risks that affect different line items in the statement of profit or loss and other comprehensive income.
- BC6.339 The Board decided to retain the proposal in the exposure draft, as it would make transparent that an entity is hedging on a net basis and would clearly present the effect of those hedges of net positions on the face of the statement of profit or loss and other comprehensive income.

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

- BC6.340 The Board considered in its deliberations leading to the exposure draft how an entity that applies hedge accounting to net positions should identify the hedged item. The 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 proposed that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item.
- BC6.341 The Board retained its original decision during the redeliberations of its exposure draft.

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

- BC6.342 In its deliberations leading to the exposure draft, the Board noted that when an entity managed and hedged risks on a net basis, the proposals would allow the entity to designate the net risk from hedged items into a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the Board acknowledged that there might be circumstances in which, by coincidence, the net position of hedged items for a particular period was nil.
- BC6.343 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.

- BC6.344 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 hedged (with eligible hedging instruments) and applied hedge accounting on a net basis. For example:
- (a) in periods in which hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument), the transactions would affect profit or loss at an overall hedged rate or price; whereas
 - (b) in periods in which hedge accounting would not be permitted (because the net position is nil), transactions would affect profit or loss at prevailing spot rates or prices.
- BC6.345 Consequently, the Board proposed that nil net positions should qualify for hedge accounting. However, the Board noted that such situations would be coincidental and hence it expected that nil net positions would be rare in practice.
- BC6.346 The Board retained its original decision during the redeliberations of its exposure draft.

Hedging credit risk using credit derivatives

The Board's deliberations leading to the exposure draft

The issue

- BC6.347 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 (for example, a facility for a particular client) or the bank's overall lending portfolio.
- BC6.348 However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, the credit risk cannot be isolated in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable (see also paragraph BC6.381).
- BC6.349 As an alternative to hedge accounting, IFRS 9 permits an entity to designate, as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of 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 for instruments that are within the scope of IFRS 9. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37, not IFRS 9. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of its restrictions and scope.

- BC6.350 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 IFRS 9). 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.
- BC6.351 In the exposure draft, the Board proposed that a risk component should be separately identifiable and reliably measurable in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate an equivalent to hedge accounting when entities hedge credit risk, a different accounting requirement would have to be developed specifically for this type of risk, or the proposed hedge accounting requirements would have to be significantly modified (for example, in relation to eligible hedged items and effectiveness testing).

Alternatives considered by the Board in its deliberations leading to the exposure draft

BC6.352 In its deliberations leading to the exposure draft, the Board considered three alternative approaches to hedge accounting in order 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 (for example, a bond, loan or loan commitment):

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

- (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is amortised or deferred);
- (ii) to designate a component of nominal amounts; and
- (iii) to discontinue fair value through profit or loss accounting.

BC6.353 The election of fair value through profit or loss would be available for a financial instrument (or a proportion of it) that is managed in such a way that an economic relationship on the basis of the same credit risk exists with credit derivatives (measured at fair value through profit or loss) that causes offset between changes in fair value of the financial instrument and the credit derivatives. This would also apply to financial instruments that fall outside the scope of IFRS 9, for example, loan commitments. Instead of the qualifying criteria for hedge accounting (see paragraphs BC6.137–BC6.178), the Board considered the following qualifying criteria for electing fair value through profit or loss:

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

BC6.354 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 separately identified and hence is not a risk component that meets the eligibility criteria for hedged items. The qualification criteria above are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions. However, using name matching as a qualifying criterion means that index-based credit default swaps would not meet that criterion.

BC6.355 For discontinuation, the Board considered the following criteria:

- (a) the qualifying criteria are no longer met; and
- (b) retaining the measurement at fair value through profit or loss is not needed because of any other requirements.

BC6.356 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 using credit derivatives). The Board noted that in circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the Board considered that it would be logical to make the discontinuation of fair value through profit or loss accounting mandatory (rather than optional) if the discontinuation criteria are fulfilled.

BC6.357 Alternative 1 permits electing fair value through profit or loss for a component of the nominal amount of the financial instrument if qualifying criteria are met. This is available only at initial recognition. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with alternative 1, at the date of discontinuation of fair value through profit or loss accounting 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.

- BC6.358 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 after 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.
- BC6.359 In addition to the election of fair value through profit or loss at initial recognition in accordance with alternative 1, alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was previously deteriorating and was then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.
- BC6.360 The Board noted that when the financial instrument is elected for measurement as at fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and its fair value. This difference is a result of the change in the measurement basis (for example, from amortised cost to fair value for a loan). The 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.
- BC6.361 A significant advantage of alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.
- BC6.362 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.

- BC6.363 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as alternative 2. Consequently, it also allows to achieve an accounting outcome that reflects the credit risk management strategy of financial institutions.
- BC6.364 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.
- BC6.365 As in alternative 2, a significant advantage of alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives. An advantage of alternative 3 over alternative 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.
- BC6.366 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; or
 - (c) in other comprehensive income.
- BC6.367 The Board noted that disclosures could provide transparency on the measurement change adjustment.
- BC6.368 However, in the light of the complexities that these three alternatives would introduce, the Board decided that the exposure draft should not propose allowing elective fair value accounting for hedged credit exposures (such as loans and loan commitments).

The feedback received on the exposure draft

- BC6.369 Many respondents to the exposure draft were of the view that the Board should consider how to accommodate hedges of credit risk using credit derivatives under IFRSs. Respondents commented that hedges of credit risk using credit

derivatives are becoming an increasingly significant practice issue in the application of IFRSs. They noted that this issue is just as significant as other issues that had been addressed in the exposure draft (for example, the time value of options, hedges of aggregated exposures and risk components of non-financial items). They also noted that financial reporting under IFRSs should allow entities to reflect the effects of such activities in the financial statements consistently with the overall hedge accounting objective to better reflect risk management activities.

- BC6.370 Respondents also commented that IFRSs today fail to represent the effect of credit risk management activities and distort the financial performance of financial institutions. They noted that, because of the accounting mismatch between loans and loan commitments on the one hand and the related credit derivatives on the other hand, the profit or loss under IFRSs is significantly more volatile for financial institutions that hedge their credit risk exposures than for financial institutions that do not hedge.
- BC6.371 Many respondents noted that the objective of hedge accounting would not be met if IFRSs would not provide a way to account for hedges of credit risk so that financial statements can reflect the credit risk management activities of financial institutions.
- BC6.372 Most users commented that the Board should address this issue. Many users also noted that the financial statements currently reflect accounting-driven volatility when credit risk is hedged and that those financial statements do not align with those risk management activities.
- BC6.373 Participants in the outreach provided the same feedback. Most of them were also of the view that this is an important practice issue that the Board should address.
- BC6.374 However, the feedback was mixed on how the Board should address or resolve this issue. Many respondents were of the view that it was difficult to reliably measure credit risk as a risk component for the purposes of hedge accounting. However, some respondents suggested that for some types of instruments the credit risk component of financial instruments could be reliably measured on the basis of credit default swap (CDS) prices, subject to some adjustments.
- BC6.375 Many agreed that the alternatives set out in the Basis for Conclusions of the exposure draft (see paragraph BC6.352) were too complex, although some respondents supported elective fair value through profit or loss accounting as an alternative to hedge accounting. Of the three fair value through profit or loss alternatives, most respondents supported alternative 3.
- BC6.376 Respondents who supported elective fair value through profit or loss accounting thought that it would be operational and believed that it would be no more complex than the other possible approaches, for example, identifying risk components. Most preferred alternative 3 of the three alternatives as it would align most closely with the dynamic credit risk management approach of many financial institutions. Some users supported elective fair value through profit or loss accounting because they thought that the benefits of providing a better depiction of the economics of the risk management activities would outweigh the complexity.

The Board's redeliberations of the exposure draft

BC6.377 In the light of the feedback received on its exposure draft, the Board decided to specifically address the accounting for hedges of credit risk using credit derivatives. In its redeliberations the Board explored various accounting alternatives.

Treating credit risk as a risk component

BC6.378 The Board noted that for credit risk there are unique differences between how the relevant risk might affect the hedging instrument and the hedged risk exposure when compared to other risk components.

BC6.379 The Board noted that there is sometimes uncertainty about whether voluntary debt restructurings constitute a credit event under a standard credit default swap contract. Whether an event constitutes a credit event is determined by a committee consisting of representatives of banks and fund entities. This can (and in practice did) result in situations in which the fair value of a debt instrument has decreased reflecting the market view of credit losses on those instruments while any payout on credit default swaps for those instruments depends on how the difficulties of the debtor will be resolved and what related measures might be considered a credit event. This is a factor that affects credit default swaps in a different way than the actual underlying debt. It is an additional factor inherent in credit default swaps that is not inherent in the debt as such. Hence, there could be scenarios in which, for example, an impairment loss on a loan might not be compensated by a payout from a credit default swap that is linked to the obligor of that debt. Also, market liquidity and the behaviour of speculators trying to close positions and taking gains affect the credit default swap and the debt market in different ways.

BC6.380 The Board also noted that when a financial institution enters into a credit default swap to hedge the credit exposure from a loan commitment it might result in a situation in which the reference entity defaults while the loan commitment remains undrawn or partly undrawn. In such situations the financial institution receives compensation from the payout on the credit default swaps without actually incurring a credit loss.

BC6.381 Furthermore, the Board considered the implications of the fact that, upon a credit event, the protection buyer receives the notional principal less the fair value of the reference entity's obligation. Hence the compensation received for credit risk depends on the fair value of the reference instrument. The Board noted that, for a fixed rate loan, the fair value of the reference instrument is also affected by changes in market interest rates. In other words, on settlement of the credit default swap, the entity also settles the fair value changes attributable to interest rate risk—and not solely fair value changes attributable to the credit risk of the reference entity. Hence, the way credit default swaps are settled reflects that credit risk inextricably depends on interest rate risk. This in turn reflects that credit risk is an 'overlay' risk that is affected by all other value changes of the hedged exposure because they determine the value of what is lost in case of a default.

BC6.382 Hence, the Board considered that credit risk is not a separately identifiable risk component and thus does not qualify for designation as a hedged item on a risk component basis.

Exception to the general risk component criteria

- BC6.383 The Board then considered whether it should provide an exception to the general risk component criteria specifically for credit risk.
- BC6.384 Some respondents suggested that, as an exception to the general risk component criteria, the Board should consider an approach that would provide a reasonable approximation of the credit risk. This approach could be based on the guidance in IFRS 7 and IFRS 9 for measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss. Those respondents noted that if this method of determining own credit risk for such liabilities is acceptable in IFRS 7 and IFRS 9, the Board should provide the same 'relief' for measuring the credit risk component for the purposes of hedge accounting.
- BC6.385 The Board noted that, in finalising the requirement for the fair value option for financial liabilities in IFRS 9, it retained the default method in the application guidance in IFRS 7 to determine the effects of changes in the liability's credit risk. The Board received comments on its exposure draft *Fair Value Option for Financial Liabilities* that determining the effects of changes in a liability's credit risk can be complex, and that it was therefore necessary to allow some flexibility in how a liability's credit risk could be measured. Respondents to that exposure draft, like the Board, acknowledged that the default method was imprecise but considered the result a reasonable proxy in many cases. Moreover, the Board noted that respondents to that exposure draft did acknowledge that the 'IFRS 7 method' did not isolate changes in a liability's credit risk from other changes in fair value (for example, general changes in the price of credit or changes in liquidity risk). Those respondents said that it was often very difficult or impossible to separate those items.
- BC6.386 The Board noted that the 'IFRS 7 method' (which was incorporated into IFRS 9) involves the use of an observed market price at the beginning and end of the period to determine the change in the effects of credit. That method requires entities to deduct any changes in market conditions from changes in the fair value of the instrument. Any residual amount is deemed to be attributable to changes in credit. The Board noted that the loans and loan commitments for which the credit risk is hedged very often have no observable market price and that, in order to achieve a close approximation of the credit risk, complex modelling would be involved to arrive at a 'market price'. Applying the 'IFRS 7 method' would then require deducting valuations for parts of the instrument and analysing them for changes in market conditions to arrive at a credit risk component. This would also be complex when trying to achieve a close approximation of the credit risk.
- BC6.387 Furthermore, the Board noted that the loans and loan commitments for which the credit exposure is hedged often have embedded options whose fair value depends on both market and non-market conditions. For example, the exercise of prepayment options could be because of changes in general interest rates (a market condition) while loans are typically refinanced (exercise of the prepayment option) well in advance of the scheduled maturity, irrespective of movements in general interest rates. Hence, in order to achieve a close approximation of the credit risk isolating the changes for market conditions on these embedded options could involve significant judgement and could become extremely complex.

- BC6.388 The Board also considered that applying the 'IFRS 7 method' in a way that was operational (ie so that the approximation would provide relief) would mean using many of the same simplifications that some commentators had suggested for applying the general risk component criteria to credit risk (for example, using a standardised haircut for prepayment and term out options, and ignoring immaterial options).
- BC6.389 The Board considered that for exchange traded bonds without embedded options for which market prices are readily observable and that do not have embedded options, the 'IFRS 7 method' might result in an approximation or proxy for the credit risk component in some circumstances. However, the Board was concerned that for loans and loan commitments that are not actively traded, the 'IFRS 7 method' could become a complicated 'circular' pricing exercise and in any case it would very likely result in only a rough approximation or imprecise measurement of the credit risk component.
- BC6.390 The Board further noted that it had acknowledged the shortcomings of the approach used for IFRS 7 and IFRS 9 and that the approach was only a proxy for measuring credit risk. Hence, the Board had actively sought to limit the application of this approach by retaining the bifurcation requirement for hybrid financial liabilities, even though bifurcation of financial assets was eliminated. Hence, the approach was only applied to financial liabilities designated as at fair value through profit or loss.
- BC6.391 The Board acknowledged that in order to ensure that hedge ineffectiveness is recognised the qualifying criteria for risk components use a higher degree of precision than a mere proxy. Also, for classification and measurement of financial liabilities the Board sought to minimise the application of this proxy by retaining the separation of embedded derivatives. Consequently, the Board decided that using the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss also for the purpose of measuring credit risk as a hedged item would be inappropriate.
- BC6.392 The Board also considered whether it should permit 'residual risks' as an eligible hedged item. Such an approach would allow designating as the hedged item those changes in cash flows or fair value of an item that are not attributable to a specific risk or risks that meet the separately identifiable and reliably measurable criteria for risk components. For example, an entity could designate the fair value changes of a loan that are attributable to all risks other than interest rate risk.
- BC6.393 The Board noted that that approach would have the advantage of not requiring an entity to directly measure credit risk. However, the Board noted that this approach would entail similar complexity as the IFRS 7 method for financial instruments with multiple embedded options. Hence, determining the part of fair value changes that is attributable to a specific risk (for example, interest rate risk) could be complex.
- BC6.394 The Board also noted that that approach had other disadvantages:
- (a) the problem that credit risk inextricably depends on interest rate risk because of the nature of credit risk as an 'overlay' risk (see paragraphs BC6.381 and BC6.382) would remain; and
 - (b) entities would struggle with the hedge effectiveness assessment of the new hedge accounting model as it would be difficult to establish and

demonstrate a direct economic relationship between the ‘residual’ risk and the hedging instrument (ie the credit default swap), which gives rise to offset—a requirement to qualify for hedge accounting.

BC6.395 Consequently, the Board decided against permitting ‘residual risks’ as an eligible hedged item.

Applying financial guarantee contract accounting

BC6.396 The Board considered whether the accounting for financial guarantee contracts in IFRS 9 could be applied to credit derivatives.

BC6.397 The Board noted that credit derivatives, such as credit default swaps, typically do not meet the definition of a financial guarantee contract in IFRS 9 because:

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

BC6.398 The Board noted that it would have to broaden the definition of a financial guarantee contract in order to include such credit derivatives. The Board also noted that accounting for credit default swaps as financial guarantee contracts would mean that credit default swaps would not be measured at fair value but at ‘cost’, ie it would result in applying accrual accounting to a derivative financial instrument.

BC6.399 The Board therefore rejected this alternative.

Applying the accounting for the time value of options

BC6.400 Some respondents to the exposure draft suggested that the premium paid on credit default swaps is similar to buying protection under an insurance contract and, accordingly, the premium should be amortised to profit or loss. Those respondents supported applying to credit default swaps the accounting treatment for the time value of options that was proposed in the exposure draft. They argued that, from a risk management perspective, changes in the fair value of the derivative during the period were irrelevant, as long as the issuer (of the debt) was solvent because if there was no credit event the fair value of the credit default swap on maturity would be zero. Hence, those respondents believed that ‘interim’ fair value changes could be recognised in other comprehensive income similar to the accounting treatment proposed in the exposure draft for the time value of options.

BC6.401 The Board noted that in contrast to (‘normal’) options for which the time value paid is known from the beginning (hence the amount to be amortised or deferred is known), for a credit default swap the premium is contingent on the occurrence of a credit event and hence the total premium that is ultimately paid is not known at the outset. This is because the premium for a credit default swap, or at least a large part of the premium, is paid over time—but only until a credit event occurs.

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

- BC6.402 The Board also noted that applying to credit default swaps the same accounting treatment as for the time value of options would require splitting the fair value of the credit default swap into an intrinsic value and a time value. This raises the question whether the credit default swap would only have time value (and hence no intrinsic value) until a credit event occurs, ie whether before a credit event occurs the entire fair value of the credit default swap should be deemed to be its time value.
- BC6.403 The Board considered that it would be inappropriate to simply attribute the entire fair value of the credit default swap before a credit event to time value. The Board noted that hedged items such as bonds or loans have ‘intrinsic’ value but not an equivalent to time value. In an effective economic hedge, the changes in the ‘intrinsic’ value in the hedged item would offset the changes in the intrinsic value of the hedging instrument. During times of financial difficulty (but before a credit event, for example, before an actual default) the fair value of the loan would have decreased because of credit deterioration. Also, the fair value of the related credit default swap would increase because of the higher risk of default. Hence, the Board considered that the increase in fair value of the credit default swap includes some intrinsic value element even though it would be difficult to isolate and separately quantify it.
- BC6.404 The Board also noted that if the entire fair value on a credit default swap was treated as time value before default, there could be a mismatch when an entity recognised an impairment loss on the loan or loan commitment before default. This is because all fair value changes from the credit default swap would still be recognised in other comprehensive income. One solution might be to recycle the amount recognised as an impairment loss on the loan or loan commitment from other comprehensive income to profit or loss and hence to simply deem the amount of the impairment loss to be the intrinsic value of the credit default swap. The Board considered that this would give rise to the same problems as other approximations it had discussed when it rejected an exception to the general risk component criteria, namely that any mismatch of economic gains or losses from the hedge would not be recognised as hedge ineffectiveness. Instead, under this approach profit or loss recognition for the credit default swap would be the same as accrual accounting while assuming perfect hedge effectiveness.
- BC6.405 The Board therefore rejected this alternative.

Applying an ‘insurance approach’

- BC6.406 Some respondents to the exposure draft supported an ‘insurance approach’ or accrual accounting for credit derivatives. They argued that such an approach would best address the accounting mismatch between loans and loan commitments versus credit derivatives and would reflect the risk management of financial institutions.

- BC6.407 The Board considered that under an insurance approach the following accounting could be applied to a credit default swap that is used to manage credit exposures:
- (a) any premium paid at inception of the credit default swap (or its fair value if an existing contract is used) would be amortised over the life of that contract;
 - (b) the periodic premium would be expensed as paid each period (including adjustments for premium accruals);
 - (c) the fair value of the credit default swap would be disclosed in the notes; and
 - (d) in the assessment of impairment, the cash flow that might result from the credit default swap in case of a credit event is treated in the same way as cash flows that might result from the collateral or guarantee of a collateralised or guaranteed financial asset. In other words, the loan or loan commitment for which credit risk is managed using the credit default swap is treated like a collateralised or guaranteed financial asset with the credit default swap accounted for like collateral or a guarantee.
- BC6.408 The Board noted that the insurance approach is a simple and straightforward solution if a credit default swap is used as credit protection for one particular credit exposure with a matching (remaining) maturity. Also, situations in which the maturity of the credit default swap exceeds that of the credit exposure could be addressed by using an 'aligned' credit default swap (similar to the notion of 'aligned' time value that is used for the new accounting treatment for the time value of options—see paragraphs BC6.264–BC6.287). However, the aligned credit default swap would only address maturity mismatches. It would not capture other differences between the actual credit default swap and the hedged credit exposure (for example, that a loan might be prepayable) because the insurance approach only intends to change the accounting for the credit default swap instead of adjusting the credit exposure for value changes that reflect all of its characteristics.
- BC6.409 The Board considered that the insurance approach would have a simple interaction with an impairment model as a result of treating the credit default swap like collateral or a guarantee, which means it would affect the estimate of the recoverable cash flows. Hence, this interaction would be at the most basic level of the information that any impairment model uses so that the effect would not differ by type of impairment model (assuming only credit derivatives with a remaining life equal to, or longer than, the remaining exposure period would qualify for the insurance approach).
- BC6.410 However, the Board noted that difficulties would arise when the insurance approach was discontinued before maturity of the credit exposure. In such a situation the consequences of using accrual (or 'as-you-go') accounting for the credit default swap would become obvious, ie it would be necessary to revert from off-balance-sheet accounting to measurement at fair value.
- BC6.411 The Board also noted that under the insurance approach neither the credit derivative nor the loan or loan commitment would be recognised in the balance sheet at fair value. Hence, any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between the loan or loan commitment versus the credit derivative would not be recognised in profit or loss. In addition, it would result in omitting the fair value of the credit default swap from the balance

sheet even though fair value provides important and relevant information about derivative financial instruments.

BC6.412 The Board therefore rejected this alternative.

Applying a ‘deemed credit adjustment approach’

BC6.413 The Board also considered an approach that would adjust the carrying amount of the hedged credit exposure against profit or loss. The adjustment would be the change in the fair value of a credit default swap that matches the maturity of the hedged credit exposure (‘aligned’ credit default swap value). The mechanics of this would be similar to how, in a fair value hedge, the gain or loss on the hedged item attributable to a risk component adjusts the carrying amount of the hedged item and is recognised in profit or loss. Essentially, the cumulative change in fair value of the aligned credit default swap would be deemed to be the credit risk component of the exposure in a fair value hedge of credit risk (ie act as a proxy for credit risk—‘deemed credit adjustment’). When the deemed credit adjustment approach is discontinued before the credit exposure matures an accounting treatment that is similar to that used for discontinued fair value hedges could be used.

BC6.414 The Board noted that the deemed credit adjustment approach would retain the measurement of credit default swaps at fair value through profit or loss. Hence, in contrast to the insurance approach (see paragraphs BC6.406–BC6.412), an advantage of this approach would be that the accounting for the credit default swap would not be affected by any switches between periods for which the credit derivative is used and those for which it is not used to manage a particular credit exposure.

BC6.415 However, the Board was concerned that the interaction of the deemed credit adjustment approach with impairment accounting would be significantly more complex than under the insurance approach because the deemed credit adjustment and the impairment allowance would be ‘competing mechanisms’ in accounting for impairment losses. This would also involve the danger of double counting for credit losses. The interaction would depend on the type of impairment model and would be more difficult in conjunction with an expected loss model.

BC6.416 The Board therefore rejected this alternative.

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

BC6.417 Because the discussions of those various alternatives did not identify an appropriate solution, the Board reconsidered the alternatives it had contemplated in its original deliberations leading to the exposure draft (see paragraph BC6.352).

BC6.418 The Board considered that only alternatives 2 and 3 of allowing an entity to elect fair value through profit or loss accounting for the hedged credit exposure would be viable. Given that alternative 1 would be limited to an election only on initial recognition of the credit exposure (or when entering into a loan commitment), the Board was concerned that, in many situations in practice (when an entity obtains credit protection for an exposure after the initial recognition of that exposure or entering into the loan commitment), this alternative would not be aligned with the credit risk management strategy and would therefore fail to resolve the problem (ie that no useful information is provided).

- BC6.419 The Board noted that alternative 3 would involve amortising the measurement change adjustment (ie the difference between the carrying amount, or nil for an unrecognised loan commitment, and the fair value of the financial instrument when it is elected for measurement at fair value through profit or loss after initial recognition or after entering into a loan commitment) over the life of the financial instrument hedged for credit risk. As a consequence, to ensure that the measurement change adjustment is not inappropriately deferred but recognised immediately in profit or loss when impaired, the measurement change adjustment would require an impairment test. This would result in interaction with the impairment model.
- BC6.420 The Board was concerned that the interaction of alternative 3 with the impairment model could create a compatibility problem and might be a potential restriction regarding the impairment phase of its project to replace IAS 39.
- BC6.421 Hence, the Board reconsidered alternative 2. The Board noted that:
- (a) the status quo under IAS 39, in which credit default swaps are accounted for at fair value through profit or loss while credit exposures are at amortised cost or unrecognised (eg loan commitments in many cases), is clearly misleading. It results in recognising gains on credit default swaps while the impairment is recognised on a different measurement basis and with a time lag because of the impairment models. Hence, in a situation in which the situation of a lender deteriorates but it has protected itself, gains are shown even though the protection keeps the situation 'neutral' at best.
 - (b) Alternative 2 would use fair value accounting for both the credit default swap and the credit exposure. This would best capture all economic mismatches but would come at the expense of inevitably including in the remeasurement interest rate risk in addition to credit risk. Alternative 2 would have the clearest objective of all approaches considered (fair value measurement) and, as a result, it would require the least guidance. The Board noted that under alternative 2 there could be concerns about earnings management because on electing fair value accounting the difference to the previous carrying amount of the credit exposure would be immediately recognised in profit or loss. However, the Board also noted that some would consider that outcome as relevant because it would signal a different approach to managing credit risk and this difference would often be a loss that is a reflection of any lag in the impairment model behind the 'market view'. To be consistent, this should be removed by changing the measurement basis when switching to a fair value based credit risk management.
 - (c) The accounting under alternative 2 is completely de-linked from the impairment model and has therefore the least interaction with impairment of all approaches considered.
 - (d) Alternative 2 is operationally the least complex of all approaches considered.
- BC6.422 The Board considered that, on balance, the advantages of alternative 2 outweighed its disadvantages and, overall, that this alternative was superior to all other approaches. Hence, the Board decided to include alternative 2 in the final requirements.
- BC6.423 In response to feedback received on the exposure draft, the Board also decided to align the accounting on discontinuation of fair value through profit or loss

accounting for loan commitments with that for loans (ie use amortisation unless a higher liability is required by IAS 37, instead of simply reverting to that standard as contemplated during the Board's initial deliberations—see paragraphs BC6.360 and BC6.357). The Board's reasons for using an amortisation approach also for loan commitments were:

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

Effective date and transition (chapter 7)

After paragraph BC7.9E of IFRS 9 (2010), as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011, the heading and paragraph BC7.9F are added.

Requirements added to IFRS 9 in [Date] 2012

BC7.9F The Board decided that the hedge accounting requirements should become effective for annual periods beginning on or after 1 January 2015. This aligns the effective date of the hedge accounting requirements with the effective date for the classification and measurement phase of IFRS 9, as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011. It also addresses feedback on the request for views *Effective Dates and Transition Methods* regarding the expected time and effort involved in properly adapting to the new financial reporting requirements of the major projects on the Board's agenda at the time. The Board decided that earlier application is permitted to ensure consistency with previous phases of IFRS 9. However, in conformity with earlier decisions, an entity can apply the proposed hedge accounting requirements only if it has adopted all of the existing IFRS 9 requirements, or adopts them at the same time as the proposed hedge accounting requirements are adopted.

After paragraph BC7.34M of IFRS 9 (2010), as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011, the heading and paragraphs BC7.35–BC7.46 are added.

Transition related to the hedge accounting requirements added to IFRS 9 in [Date] 2012

- BC7.35 IAS 8 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, the classification and measurement chapters of IFRS 9 require retrospective application (with some relief in particular circumstances).
- BC7.36 The proposals in the exposure draft were a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship could be designated only prospectively. Consequently, retrospective application was not applicable. This reflects that retrospective application gives rise to similar concerns about using hindsight as retrospective designation of hedging relationships, which is prohibited.
- BC7.37 In developing the transition requirements proposed in the exposure draft, the Board considered two alternative approaches:
- (a) prospective application only for new hedging relationships; or
 - (b) prospective application for all hedging relationships.
- BC7.38 The Board rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would have required the current hedge accounting model in IAS 39 to be maintained until hedge accounting is discontinued for the hedging relationships established in accordance with IAS 39. Also, the proposed disclosures would be provided only for the hedging relationships accounted for in accordance with the proposed model. This approach entails the complexity of applying the two models simultaneously and also involves a set of disclosures that would be inconsistent and difficult to interpret. Because some hedging relationships are long-term, two hedge accounting models would co-exist for a potentially long period. This would make it difficult for users to compare the financial statements of different entities. Comparability would also be difficult when entities apply the old and the new model in the same financial statements, as well as for information provided over time.
- BC7.39 Consequently, the Board proposed prospective application of the proposed hedge accounting requirements for all hedging relationships, while ensuring that ‘qualifying’ hedging relationships could be moved from the existing model to the proposed model on the adoption date.
- BC7.40 Almost all respondents agreed with prospective application of the new hedge accounting requirements to all hedging relationships because that would avoid the administrative burden of maintaining both the IAS 39 model and the new hedge accounting model and would also mitigate the risk of hindsight arising from retrospective designation of hedging relationships. Respondents also noted

that prospective application is consistent with hedge accounting transition requirements that were used for previous amendments to IAS 39.

- BC7.41 The Board also received feedback that suggested a general provision, whereby hedging relationships designated under IAS 39 would be automatically 'grandfathered', ie entities could continue applying the requirements of IAS 39 to these hedging relationships. However, consistent with its proposal in the exposure draft (see paragraph BC7.38), the Board decided not to allow the grandfathering of the application of IAS 39. Instead, the Board retained its original decision that the new hedge accounting requirements are applied to hedging relationships that qualify for hedge accounting in accordance with IAS 39 and this IFRS and that those are treated as continuing hedging relationships.
- BC7.42 Some respondents supported varying forms of retrospective application. However, consistent with previous hedge accounting transition requirements in IAS 39 and the exposure draft, the Board decided not to allow retrospective application in situations that would require retrospective designation because that would involve hindsight.
- BC7.43 Some responses to the exposure draft suggested using retrospective application in two particular situations in which the outcomes under IAS 39 and the new hedge accounting model significantly differ but retrospective designation would not be necessary. The particular situations are when an entity under IAS 39 designated as the hedging instrument only changes in the intrinsic value (but not the time value) of an option or changes in the spot element (but not the forward element) of a forward contract. The Board noted that in both circumstances applying the new requirements for accounting for the time value of options or the forward element of forward contracts would not involve hindsight from retrospective designation but instead use the designation that was previously made under IAS 39. The Board also noted that in situations in which mismatches between the terms of the hedging instrument and the hedged item exist there might still be some risk of hindsight related to Level 3 fair value measurements when calculating the 'aligned' time value of an option and the 'aligned' forward element of a forward contract. However, the Board concluded that such hindsight would be limited because hedge accounting was applied to these hedging relationships under IAS 39, meaning that the changes in the intrinsic value of an option or the changes in the value of the spot element of a forward contract had to have a high degree of offset with the changes in value of the hedged risks. Hence, the valuation inputs used for the calculation of the aligned values could not significantly differ from the valuation inputs for the overall fair value of the hedging instruments, which were known from previously applying IAS 39. The Board also noted that retrospective application in these cases would significantly improve the usefulness of the information for the reasons that underpinned the Board's decisions on accounting for the time value of options and the forward element of forward contracts (see paragraphs BC6.264–BC6.304). Consequently, the Board decided to provide for those two particular situations an exception to prospective application of the hedge accounting requirements of this IFRS but only for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. For the forward element of forward contracts retrospective application is permitted but not required because unlike the new treatment for time value of options the new treatment for the forward element of forward contracts is an election. However, in order to address the risk of using

hindsight, the Board decided that on transition this election is only available on an 'all-or-nothing' basis (ie not a hedge-by-hedge basis).

- BC7.44 Some respondents asked the Board to consider allowing discontinuing at the date of initial application of the new hedge accounting requirements hedging relationships designated under IAS 39 and then designating new hedging relationships in a way that is better aligned with the new hedge accounting requirements.
- BC7.45 The Board noted that an entity could revoke designations of hedging relationships without any restriction until the last day of applying IAS 39 in accordance with the requirements in that standard. Hence, the Board considered that any specific transition requirements to address this request were unnecessary. However, in order to address some concerns over potential practical transition issues in the context of prospective application, the Board decided:
- (a) to allow an entity to consider the moment it initially applies the new hedge accounting requirements and the moment it ceases to apply the hedge accounting requirements of IAS 39 as the same point in time. The Board noted that this would avoid any time lag between starting the use of the new hedge accounting model and discontinuing the old hedge accounting model (because the end of the last business day of the previous reporting period often does not coincide with the beginning of the first business day of the next reporting period), which otherwise might involve significant changes in fair values between those points in time and as a result could cause difficulties in applying hedge accounting under the new hedge accounting model for hedging relationships that would otherwise qualify.
 - (b) to require that an entity uses the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship (if applicable) and to recognise any related gain or loss in profit or loss. The Board considered that any change to the hedge ratio that might be required on transition so that a hedging relationship designated under IAS 39 continues to qualify for hedge accounting should not result in an entity having to discontinue that hedging relationship on transition and then newly designating it. The Board decided to require the recognition of any gain or loss on rebalancing in profit or loss in a broadly similar manner for ongoing hedge accounting under the new model to address any concerns that hedge ineffectiveness might otherwise be recognised as a direct adjustment to retained earnings on transition. The accounting is broadly similar to that for ongoing hedge accounting under the new model in that the hedge ineffectiveness in the context of rebalancing is recognised in profit or loss. However, in contrast to ongoing hedge accounting under the new model, rebalancing on transition applies because a different hedge ratio has already been used for risk management purposes (but did not coincide with the designation of the hedging relationship under IAS 39). In other words, rebalancing does not reflect a concurrent adjustment for risk management purposes but results in aligning the hedge ratio for accounting purposes with a hedge ratio that was already in place for risk management purposes.
- BC7.46 The Board decided not to change the requirements of IFRS 1 for hedging accounting. The Board noted that a first-time adopter would need to look at the entire population of possible hedging relationships and assess which ones would

meet the qualifying criteria of the new hedge accounting model. To the extent that an entity wants to apply hedge accounting, those hedging relationships should be documented on or before the transition date. This is consistent with the transition requirements for existing users of IFRSs and the existing transition requirements of IFRS 1, which state that an entity shall discontinue hedge accounting if it had designated a hedging relationship but that hedging relationship does not meet the qualifying criteria in IAS 39.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

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

IFRS 1 First-time Adoption of International Financial Reporting Standards

- BCA1 The footnotes to the reference to 'IAS 39' in paragraphs BC58A, BC63A, BC65, BC66, BC74, BC89 and BC89A and to the heading 'Available-for-sale financial assets' above paragraph BC81 are deleted.
- BCA2 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17(a), and the first references to 'IAS 39' in paragraphs BC20–BC23, BC58A, BC63A, BC74, BC81, BC89 and BC89A are footnoted appropriately as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA3 The first references to 'IAS 39' in paragraphs BC65 and BC66 are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.
- BCA4 The term 'available for sale' in paragraph BC63A, the term 'available-for-sale financial assets' in paragraph BC74(b) and the heading 'Available-for-sale financial assets' above paragraph BC81 are footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, with requirements added in October 2010, eliminated the category of available-for-sale financial assets.
- BCA5 The heading 'Hedge accounting' above paragraph BC75 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39.
- BCA6 Paragraph BC80A is added:
- BC80A In [Date] 2012 the Board amended the examples in the guidance on hedge accounting so that they conformed to IFRS 9, issued in [Date] 2012, which replaced the hedge accounting requirements in IAS 39.

IFRS 2 Share-based Payment

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

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

IFRS 3 Business Combinations

- BCA8 The footnote to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC185 and the first references to ‘IAS 39’ in paragraphs BC244, BC256 and BC437(c) are deleted.
- BCA9 The reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC185 and the first references to ‘IAS 39’ in paragraphs BC246–BC251, BC256, BC354, BC434A and BC437(c) are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA10 The reference to ‘IAS 39’ in paragraph BC244 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.
- BCA11 The first reference to ‘available-for-sale securities’ in paragraph BC389 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA12 The second reference to ‘IAS 39’ in paragraph BC185 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39.

IFRS 4 Insurance Contracts

- BCA13 The footnotes to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC11(a), the first references to ‘IAS 39’ in paragraphs BC22(c), BC28(b), BC41(b), BC47, BC55, BC73(d), BC82 and BC161, the reference to ‘available for sale’ in paragraph BC145(b) and the heading above paragraph BC166 are deleted.
- BCA14 The reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC11(a), the first references to ‘IAS 39’ in paragraphs BC21, BC22(c), BC28(b), BC40–BC54, BC55–BC60, BC62, BC73(d), BC82, BC117, BC146 and BC154–BC165 and the heading ‘Issues related to IAS 39’ above paragraph BC166 are footnoted as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

IFRS 7 Financial Instruments: Disclosures

BCA22 In the rubric below the title a paragraph is added as follows [amendment previously made by IFRS 9 2010]:

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

BCA23 Paragraphs BC14–BC16 are amended to read as follows [amendment previously made by IFRS 9 2010]:

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

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

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

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

BCA24 The heading above paragraph BC23 is amended to read as follows and paragraph BC23B is added [amendment previously made by IFRS 9 2010]:

Reclassification (paragraphs 12B–12D)

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

BCA25 Paragraphs BC33 and BC34 are amended to read as follows [amendment previously made by IFRS 9 2010]:

BC33 Paragraph 20(a) requires disclosure of income statement gains and losses by the measurement classifications in IFRS 9 (which

complement the balance sheet disclosure requirement described in paragraph BC14). The Board concluded that the disclosure is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in IFRS 9.

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

BCA26 Paragraphs BC35A-BC35QQ and related headings are added as follows:

Other Disclosures—Hedge Accounting

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

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

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

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

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

General considerations

Scope of the hedge accounting disclosures

BC35F An entity might enter into a transaction to manage an exposure to a particular risk that might not qualify for hedge accounting (for various reasons), for example, an item that is not eligible to be designated as a hedged item or hedging instrument. Information on such transactions might enable users to understand why an entity has entered into a transaction and how it manages the particular risk, even though those transactions do not qualify for hedge accounting.

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

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

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

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

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

Location of disclosures

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

Disclosures by risk category

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

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

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

- (a) information that is not included in the primary financial statements (see paragraphs BC35P–BC35BB); and
- (b) information that is included in the primary financial statements (see paragraphs BC35CC–BC35QQ).

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

category for foreign exchange risk combined with floating interest rate risk. However, an entity should apply its risk categories consistently throughout all the proposed hedge accounting disclosures.

The risk management strategy

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

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

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

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

The amount, timing and uncertainty of future cash flows

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

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

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

BC35V The Board also proposed that an entity should disclose information about the sources of hedge ineffectiveness of hedging relationships for each particular risk category. In the Board's view this would assist users in identifying the reasons for

hedge ineffectiveness that is recognised in profit or loss. It would also help users to determine how hedging relationships will affect profit or loss.

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

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

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

BC35Z The Board considered that, in those circumstances, providing information about the terms and conditions of the hedging instruments would not be useful given that the hedging instruments are part of a particular hedging relationship for only

a short period at a time and are then designated into a new hedging relationship or left undesignated. In contrast, the disclosure requirement related to the terms and conditions of the hedging instrument was designed to provide information for situations in which an entity hedges a risk that remains broadly the same over the entire hedged period. Consequently, the Board decided to exempt entities from the requirement to disclose the terms and conditions of the hedging instruments in situations in which they use a 'dynamic' hedging process that involves frequent discontinuations and restarts of hedging relationships.

BC35AA The Board was of the view that it was more important for users to understand why entities use hedge accounting in the context of 'dynamic' hedging processes than to provide users with information about the terms and conditions of a hedging instrument that is part of a hedging relationship for only a short period at a time (and the designation of which changes frequently). Consequently, the Board decided that, in such circumstances, an entity should expand its discussion of the risk management strategy by providing the following information about how the entity uses hedge accounting to reflect its risk management strategy:

- (a) information about what the ultimate risk management strategy is (for the dynamic hedging process);
- (b) a description of how it reflects its risk management strategy by using hedge accounting and designating the particular hedging relationships; and
- (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic hedging process.

BC35BB The Board also noted that, because the designated hedging relationships change frequently, the specific relationships at the reporting date might not be representative of the normal volumes during the period. The Board therefore decided to require entities to disclose when the volumes at the reporting date are unrepresentative of normal volumes during the period (similar to the disclosure requirement on sensitivity analyses for market risk in paragraph 42).

The effects of hedge accounting on financial position and performance

BC35CC One function of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures should therefore increase the transparency of how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the entity's statement of profit or loss and other comprehensive income and statement of financial position.

BC35DD To provide information on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the Board proposed disclosures that should be presented in a tabular format that separates the information by risk category and by type of hedge. Providing disclosures in a tabular format allows users to identify clearly the relevant numbers and their effects on the entity's statement of profit or loss and other comprehensive income and statement of financial position.

BC35EE During the Board's initial outreach, users said that they do not analyse an entity's hedging activities by type of hedging relationship (for example, a cash flow hedge or a fair value hedge). They said that it is more important to understand the risks that the entity manages and the results after hedging. However, to provide information effectively on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (for example, cash flow hedge accounting or fair value hedge accounting). The Board believed that if the proposed table is prepared by risk category and by type of hedge, the table would provide sufficient links between the accounting information and the risk management information.

BC35DD The Board did not propose prescribing levels of aggregation or disaggregation for the information that should be disclosed in a tabular format. An entity should apply judgement when it determines the appropriate level of aggregation or disaggregation. However, the Board proposed that an entity should consider other disclosure requirements in IFRS 7 when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to take amounts that are disclosed and measured at fair value and make comparisons between the fair value disclosures and the proposed hedge accounting disclosures.

BC35EE Cash flow hedge accounting requires an entity to defer gains or losses on the hedging instrument in other comprehensive income. The deferred amounts are reflected in the statement of changes in equity in the cash flow hedge reserve. IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. In conformity with its objectives for hedge accounting disclosures, the Board proposed that the reconciliation required by IAS 1 should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of profit or loss and other comprehensive income. The Board also proposed that the reconciliation should be by type of risk. The Board considered that such a disclosure would allow users of financial statements to evaluate the effects of hedge accounting on equity and the statement of profit or loss and other comprehensive income.

BC35FF Many respondents to the exposure draft agreed with the Board's proposal to explain the effects of hedge accounting disclosures using a tabular disclosure format. However, some respondents raised concerns that the proposal seems too prescriptive. Some also commented that they did not think that the tabular disclosure, as proposed, provided a clear enough link between hedged items and hedging instruments for the purpose of explaining hedge ineffectiveness. A few respondents also commented that the disclosures did not allow them to differentiate between financial instruments that have been designated as hedging instruments and those that have not. These respondents believe that it is helpful to understand the purpose and effect of financial instruments if their designation is made clear through disclosures.

BC35GG The Board thinks that providing a tabular disclosure format separated by type of hedge (ie fair value hedges or cash flow hedge), risk category and by risk management strategy provides a sufficient link between the accounting information and the risk management information.

BC35HH The Board did not propose any more specific format other than requiring information to be disclosed in a tabular format. The Board thought that entities should have the freedom to present the disclosures that require a tabular format however they feel is best in order to provide users with the most useful information.

BC35II While the exposure draft on hedge accounting was open for public comment, the Board issued IFRS 13 *Fair Value Measurement*. As a consequence of issuing that standard, the Board moved the fair value disclosures in IFRS 7 to IFRS 13. To improve the usefulness of the hedge accounting disclosures, the Board decided to require entities to use the same level of aggregation or disaggregation it used for other IFRS 7 or IFRS 13 disclosures related to the same underlying information.

BC35JJ In its redeliberations of the exposure draft, the Board also considered a disclosure that would allow understanding how the hedge ineffectiveness that is recognised in the statement of comprehensive income relates to the changes in the values of the hedging instruments and the hedged items. The Board decided to require disclosure of the change in fair value of the hedging instruments and the change in the value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of comprehensive income. Those are the changes in value during the period (after taking into account the effect of the 'lower of' test for cash flow hedges and hedges of a net investment in a foreign operation). This means that the difference between the amount included in the table for hedged items and the amount included in the table for hedging instruments equals the hedge ineffectiveness recognised in the statement of comprehensive income.

BC35KK The Board also did not think that it was necessary to provide a specific disclosure that indicates which financial instruments have been designated as hedging instruments and which have not. The Board thought that such a disclosure would provide potentially misleading information to users of financial statements. This is because users of financial statements might think that all financial instruments not designated as hedging instruments might be held for speculative purposes. This is not necessarily the case. Entities might hold financial instruments for hedging purposes but may decide not to elect hedge accounting. In addition to this, the Board thought that, because entities need to provide the information that requires a tabular format based on the same level of aggregation or disaggregation as in IFRS 13, users of financial statements should be able to identify the financial instruments not designated as hedging instruments by simply comparing the disclosures with each other. In addition, users should be able to understand how an entity manages the risks it is exposed to as a result of financial instruments using the disclosure requirements in IFRS 7 that are not related to the hedge accounting disclosures.

Time value of options accumulated through other comprehensive income

BC35LL The Board proposed accounting requirements that involve other comprehensive income for the time value of an option when an entity elects to separate the time value of the option and designate (as the hedging instrument) only its intrinsic value. Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.

BC35MM 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.

BC35NN However, in its exposure draft, the Board proposed that an entity should differentiate between transaction related hedged items and time-period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.

BC35OO Most respondents agreed with the Board's proposal and consequently, the Board decided to retain the proposal from its exposure draft. However, as a consequence of the Board's decision to also allow an alternative accounting treatment for forward elements, the Board also required that amounts recognised in accumulated other comprehensive income that

relate to forward elements should be separated for the purpose of the IAS 1 reconciliation.

Hedging credit risk using credit derivatives

BC35PP For situations in which entities hedge credit risk using credit derivatives the Board decided to mitigate accounting mismatches in relation to credit derivatives accounted for at fair value through profit or loss by also using fair value through profit or loss accounting for the hedged credit exposure. Consequently, the Board also considered disclosures to provide transparency when entities apply that accounting.

BC35QQ The Board considered that the following information would be useful for understanding the accounting in such situations:

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

BCA27 Paragraphs BC39 and BC39B–BC39E are amended to read as follows [amendment previously made by IFRS 9 2010]:

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

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

using a three-level hierarchy for disclosures that is the same as that in SFAS 157.

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

- (a) ...
- (b) ...
- (c) ...

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

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

BCA28 Paragraph BC73(b) is amended to read as follows [amendment previously made by IFRS 9 2010]:

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

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

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

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

IAS 1 *Presentation of Financial Statements*

BCA30 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC38A, to the reference to 'IAS 39' in paragraph BC38B are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial*

Instruments. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued.

- BCA31 The references to ‘available-for-sale’ in paragraphs BC49 and BC69 are deleted.
- BCA32 The term ‘available-for-sale financial assets’ in paragraphs BC49 and BC69 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.
- BCA33 The term ‘held-to-maturity investments’ in paragraph BC77 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-to-maturity financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

IAS 17 Leases

- BCA34 The footnote to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC21 is replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 17 was issued.

IAS 19 Employee Benefits

- BCA35 The rubric below the title is amended to read as follows:
- The original text has been marked up to reflect the revision of IAS 39 Financial Instruments: Recognition and Measurement in 2003 and the issue of IFRS 2 Share-based Payment in 2004, Improvements to IFRSs in May 2008 and IFRS 9 Financial Instruments in October 2010; new text is underlined and deleted text is struck through. The terminology ...*
- BCA36 Paragraph BC68D(b) is amended and footnoted to read as follows [the reference to the footnote is not shown here]:
- BC68D Supporters of ...
- (b) if offsetting is allowed when condition (c) is not met, this would seem to be equivalent to permitting a net presentation for ‘in-substance defeasance’ and other analogous cases where IAS 32 indicates explicitly that offsetting is inappropriate. The Board has rejected ‘in-substance defeasance’ for financial instruments (see ~~IAS 39 Application Guidance paragraph AG59~~ IFRS 9 paragraph AG3.3.3)* and there is no obvious reason to permit it in accounting for defined benefit plans. In these cases the entity retains an obligation that should be recognised as a liability and

the entity's right to reimbursement from the plan is a source of economic benefits that should be recognised as an asset. Offsetting would be permitted if the conditions in paragraph 3342 of IAS 32 are satisfied;

...

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

BCA37 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC75A and to the references to 'IAS 39' in paragraphs BC68H is replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

BCA38 The footnotes to the reference to 'IAS 39' in paragraph BC68I is deleted.

BCA39 The footnote to the reference to 'available-for-sale financial assets' in paragraph BC48W is replaced with:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 19 was issued.

BCA40 The footnote to the references to 'IAS 25 *Accounting for Investments*' in paragraphs BC69 and BC73 is replaced with:

* superseded by IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

BCA41 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the first reference to 'IAS 39' in paragraph BC3 are footnoted as follows:

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

IAS 27 Consolidated and Separate Financial Statements

BCA42 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and to the references to 'IAS 39' in paragraphs BC65–BC66C are deleted.

- BCA43 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the first references to 'IAS 39' in paragraphs BC65–BC66C are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA44 The first references to the term 'available-for-sale' in paragraphs BC54, BC56 and BC65 are footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA45 In the dissenting opinions on the amendments to IFRS 1 and IAS 27 issued in May 2008 the footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph DO3 is replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 28 *Investments in Associates*

- BCA46 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC9 is deleted.
- BCA47 The footnotes to the reference to 'IAS 39' in the heading above paragraph BC7 and to the first references to 'IAS 39' in paragraphs BC22 and BC26 are replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA48 The first reference to 'IAS 39' in paragraph BC9 is footnoted as follows:
- † In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. IFRS 9 eliminated the category of available-for-sale financial assets and permits entities to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading.
- BCA49 The term 'available-for-sale equity instrument' in paragraph BC26 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IAS 31 Investments in Joint Ventures

- BCA50 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC7 and to the references to 'IAS 39' in paragraphs BC9 and BC17 are deleted.
- BCA51 The heading above paragraph BC7 and the first references to 'IAS 39' in paragraphs BC9 and BC17 are footnoted as follows:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 32 Financial Instruments: Presentation

- BCA52 In the introduction, paragraph IN5A is added as follows:
- IN5A In [Date] 2012 the scope of IAS 32 was conformed to the scope of IAS 39 as amended in [Date] 2012 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).
- BCA53 After paragraph BC3A a heading and paragraph BC3B are added as follows:

Scope

- BC3B In [Date] 2012 the Board amended the scope of IAS 32 so that it conformed to the scope of IAS 39 as amended in [Date] 2012 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).
- BCA54 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and to the first references to 'IAS 39' in paragraph BC26 replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA55 The footnote to the first reference to 'IAS 39' in paragraph BC25 is replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. The requirements of paragraph 43 of IAS 39 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9.
- BCA56 In the dissenting opinion on the issue of IAS 32 in December 2003, the reference to 'IAS 39' in paragraph DO2 is footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 36 Impairment of Assets

BCA57 The footnote to the reference to 'IAS 39' in paragraph BCZ15(d) is replaced with:

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

IAS 39 Financial Instruments: Recognition and Measurement

BCA58 The following paragraphs are added to the rubric:

In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of financial assets within the scope of IAS 39 and relocated them to IFRS 9 Financial Instruments. Accordingly, the following were deleted: paragraphs BC13 and BC14, the heading above paragraph BC25 and paragraphs BC25–BC29, paragraph BC70, the heading above paragraph BC104A and paragraphs BC104A–BC104E, the headings above paragraphs BC125, BC127 and BC129 and paragraphs BC125–BC130, the heading above paragraph BC221 and that paragraph and the heading above paragraph BC222 and that paragraph.

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

BCA59 In the introduction, paragraph IN7A is added as follows:

IN7A In the third phase of its project to replace IAS 39, the Board considered replacing the hedge accounting requirements in IAS 39. As part of those deliberations, the Board considered the accounting for executory contracts that gives rise to accounting mismatches in some situations. In [October] 2012 the scope of this IFRS was amended by extending the fair value option (for situations in which it eliminates or significantly reduces an accounting mismatch) to contracts that meet the 'own use' scope exception.

BCA60 Paragraphs BC11C, BC11E, BC11F, BC13 and BC14, BC25–BC29, BC37–BC104E, BC105–BC107, BC125–BC130, BC221 and BC222 and the headings above BC25, BC37, BC104A, BC105 ('Impairment of investments in equity instruments (paragraph 61)' only), BC221 and BC222 are deleted.

BCA61 Paragraph BC20A is amended to read as follows:

BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on

loan commitments from the scope section to the section on subsequent measurement. The purpose of this change was to rationalise the presentation of this material without making substantive changes.

- BCA62 The headings above paragraphs BC15, BC21 and BC24 are amended to read as follows:

Loan commitments

Financial guarantee contracts

Contracts to buy or sell a non-financial item

- BCA63 Paragraphs BC24A–BC24E are renumbered as paragraphs BC24R–BC24V. After paragraph BC24 a heading and paragraphs BC24A–BC24Q are added as follows:

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

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

BC24B Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell a non-financial item that can be settled net in cash (including net settlement in another financial instrument or by exchanging financial instruments), as if the contracts were financial instruments. In addition, IAS 39 specifies that there are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. For example, a contract is considered to be settleable net in cash even if it is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash.

BC24C However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39. The 'own use' scope exception in IAS 39 mostly applies to contracts for commodity purchases or sales.

BC24D It is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative. Many commodity contracts meet the criteria for net settlement in cash because in many instances commodities are readily convertible to cash. When such a contract is accounted for as a derivative, it is measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the change in the fair value of the commodity contract,

that derivative is also measured at fair value with changes in fair value recognised in profit or loss. Because the changes in the fair value of the commodity contract and the derivative are recognised in profit or loss, an entity does not need hedge accounting.

BC24E However, in situations in which a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sale or purchase contract ('executory contract'). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value arising from a commodity supply contract that is not within the scope of IAS 39, an accounting mismatch is created. This is because the change in the fair value of the derivative is recognised in profit or loss while the change in the fair value of the commodity supply contract is not recognised (unless the contract is onerous).

BC24F To eliminate this accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as a hedged item in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the fair value changes would offset the changes in the fair value of the derivative instruments (to the extent that those are effective hedges). However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts and some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. That net position as a whole is then managed using derivatives to achieve a net position (after hedging) of nil (or close to nil). The net position is typically monitored, managed and adjusted daily. Because of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil by using derivatives, an entity would have to adjust the fair value hedge relationships frequently if the entity were to apply hedge accounting.

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

- (a) allowing an entity to elect to account for commodity contracts as derivatives (ie a free choice); or

- (b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair-value based risk management strategy.

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

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

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

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

BC24J Alternatively, the Board considered applying derivative accounting to commodity contracts if that is in accordance with the entity's underlying business model and how the contracts are managed. Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would consider not only the purpose (based solely on the actual type of settlement) but also how the contracts are managed. As a result, if an entity's underlying business model changes and the entity no longer manages its commodity contracts on a fair value basis, the contracts would revert to the 'own use' scope exception. This would be consistent with the criteria for using the fair value option for financial instruments (ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis).

BC24K Consequently, the Board proposed that derivative accounting would apply to contracts that would otherwise meet the 'own use' scope exception if that is in accordance with the entity's fair-value based risk management strategy. The Board believed that

this approach would faithfully represent the financial position and the performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.

- BC24L Most respondents to the exposure draft supported the Board's approach of using fair value accounting for resolving the accounting mismatch that arises when a commodity contract that is outside the scope of IAS 39 is hedged with a derivative. Those who supported the proposal thought that it would facilitate a better presentation of the overall economic effects of entering into such hedging transactions.
- BC24M However, some respondents were concerned that the proposal would have unintended consequences by creating an accounting mismatch for some entities. They argued that in scenarios in which there are other items that are managed within a fair-value based risk management strategy and those other items are not measured at fair value under IFRSs, applying derivative accounting to 'own use' contracts would introduce (instead of eliminate) an accounting mismatch. For example, in the electricity industry the risk management for some power plants and the related electricity sales is on a fair value basis. If these entities had to apply derivative accounting for customer sales contracts it would create an accounting mismatch. This accounting mismatch would result in artificial profit or loss volatility if the power plant is measured at cost under IAS 16 *Property, Plant and Equipment*. Another example raised by respondents was that of entities risk-managing the 'own-use' contracts, inventory and derivatives on a fair value basis. An accounting mismatch would arise if the inventory is measured in accordance with IAS 2 *Inventories* at the lower of cost and net realisable value while the 'own use' contracts are measured at fair value.
- BC24N Some respondents also requested that the Board remove the precondition that an entity achieves a nil or close to nil net risk position in order to qualify for accounting for executory contracts as derivatives. They argued that if the condition was not removed it would limit the benefits of the proposal. This is because some entities, while generally seeking to maintain a net risk position close to nil, may sometimes take an open position depending on market conditions. These respondents noted that, from an entity's perspective, whether it takes a position or manages its exposure close to nil, it is still employing a fair-value based risk management strategy and that the financial statements should reflect the nature of its risk management activities.
- BC24O Some also requested that the Board clarify whether the proposal required that a fair-value based risk management strategy is adopted at an entity level or whether the business model can be assessed at a level lower than the entity level. These respondents commented that within an entity, a part of the

business may be risk-managed on a fair value basis while other businesses within the entity may be managed differently.

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

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

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

BCA64 The footnotes to the references to 'IAS 39' in paragraphs BC185(d), BC186 and BC189(a) are deleted. The following footnotes are amended to read as follows and added:

To the reference to 'IAS 39' in paragraph BC12 In November 2009 the Board amended the requirements of IAS 39 relating to the classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

To the heading above paragraph BC15 In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

At the end of paragraph IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of

BC16	loans and receivables.
To the heading above paragraphs BC21, BC24, BC40B, BC41 and BC70A	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the reference to 'held-to-maturity' in paragraph BC80A	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
To the reference to 'loans and receivables' in paragraph BC111	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.
At the end of paragraph BC185(d) and to the references to 'required to be paid' in paragraphs BC186 and BC189(a)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the reference to 'held-to-maturity' in paragraph BC201(f)	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
At the end of paragraph BC203(b)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
BCA65	The dissenting opinions from the issue of IAS 39 in December 2003, <i>The Fair Value Option</i> in June 2005 and <i>Reclassification of Financial Assets</i> in October 2008 are deleted.

IAS 40 *Investment Property*

BCA66	The footnotes to the reference to 'IAS 39 <i>Financial Instruments: Recognition and Measurement</i> ' in paragraph BC8 is replaced with: * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 <i>Financial</i>
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Instruments. IFRS 9 applies to all items within the scope of IAS 39. Paragraph BC8 refers to matters relevant when IAS 40 was issued.

- BCA67 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B2 and the references to 'IAS 39' in paragraphs B46(b), B54 and B63(d) are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.
- BCA68 The reference to 'IAS 39' in paragraph B35 is replaced with:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the held-to-maturity category. This paragraph discusses matters relevant when IAS 40 was issued.
- BCA69 The footnote to the reference to 'IAS 39' in paragraph B63(a) is replaced with:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA70 In paragraph B67(a)(i) the footnote to 'IAS 39' is amended to read as follows:
- * Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. In 2009 paragraph 46 of IAS 39 was deleted by IFRS 9 *Financial Instruments*.

IAS 41 Agriculture

- BCA71 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B48 and to the reference to 'IAS 39' in paragraph B54 are replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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

- BCA72 In paragraph BC18 the reference to 'IAS 39' is footnoted as follows:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. Paragraph 49 of IAS 39 was relocated to paragraph 5.4.3 of IFRS 9. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

IFRIC 4 Determining whether an Arrangement contains a Lease

- BCA73 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC14 is replaced with:

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

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

BCA74 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC6 and to the references to 'IAS 39' in paragraphs BC20 and BC24 are replaced with:

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

BCA75 The footnotes to the references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraphs BC11(a) and BC12 are deleted.

BCA76 The first reference to 'IAS 39' in paragraphs BC8(c) BC27 and the heading above paragraph BC11 are footnoted as follows:

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

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

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

IFRIC 10 Interim Financial Reporting and Impairment

BCA77 The footnotes to the references to 'IAS 39' in paragraphs BC2 and BC9 are replaced with:

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

IFRIC 12 Service Concession Arrangements

BCA78 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC43(a) is footnoted as follows:

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

BCA79 The footnotes to the reference to 'IAS 39' in paragraph BC59 and to the heading above paragraph BC60 are replaced with:

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

IFRIC 16 Hedges of a Net Investment in a foreign Operation

BCA80 The reference to IAS 39 in paragraph BC11 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39. However, the requirements regarding hedges of a net investment in a foreign operation were retained from IAS 39 and relocated to IFRS 9.

IFRIC 17 Distributions of Noncash Assets to Owners

BCA81 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22, to the last sentence of paragraph BC28(a), to the reference to 'AG81' in paragraph BC29, to the reference to 'IAS 39' in paragraph BC32 and to the reference to 'available-for-sale' in paragraph BC47(e) are deleted.

BCA82 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the references to 'IAS 39' in paragraphs BC37 and BC50 are footnoted as follows:

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

BCA83 The reference to 'IAS 39' in paragraph BC28(a) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, requires all investments in equity instruments to be measured at fair value.

BCA84 The reference to 'AG81' in paragraph BC29 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, amended paragraphs AG80 and AG81 of IAS 39 so that they apply only to derivatives on unquoted equity instruments. IFRS 9, issued in October 2010, deleted paragraphs AG80 and AG81 of IAS 39.

BCA85 The reference to 'IAS 39' in paragraph BC32 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the requirement in IAS 39 for some assets to be measured using a historical cost basis.

BCA86 The term 'available-for-sale investment' in paragraph BC47(e) is footnoted as follows:

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

BCA87 The reference to 'IAS 39' in paragraph BC47(f) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in [insert date 2012] replaced the hedge accounting requirements in IAS 39.

IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments

BCA88 The references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the references to 'IAS 39' in paragraphs BC10, BC20, BC24, BC31 and BC34(c) are footnoted as follows:

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

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

BCA89 The rubric '*[The original text ... struck through]*' is deleted and replaced with the following rubric:

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

BCA90 Paragraph 14 is amended to read as follows:

- 14 When an Entity ... A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs 3.2.1–3.2.23, 3.3.1–3.3.4, B3.2.1–B3.2.17 and B3.3.1–B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an 'underlying') are subject to IAS 39.*

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

IFRS 9
CHAPTER 6
HEDGE ACCOUNTING
Implementation Guidance

**GUIDANCE ON IMPLEMENTING
IFRS 9 *FINANCIAL INSTRUMENTS***

Illustrative examples

Questions and answers on implementing IFRS 9

**Appendix:
Amendments to the guidance on other IFRSs**

Tables of Concordance

IFRS 9 *Financial Instruments***Illustrative examples**

These examples accompany, but are not part of, IFRS 9

Financial liabilities at fair value through profit or loss

- IE1 The following example illustrates the calculation that an entity might perform in accordance with paragraph B5.7.18 of IFRS 9.
- IE2 On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000¹ and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.
- IE3 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:
- LIBOR has decreased to 4.75 per cent.
 - the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.²
- IE4 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IE5 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<p>[paragraph B5.7.18(a)]</p> <p>First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.</p>
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¹ In this guidance monetary amounts are denominated in 'currency units (CU)'.

² This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

<p>[paragraph B5.7.18(b)]</p> <p>Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B5.7.18(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> • interest: CU12,000^(a) per year for each of years 2–10. • principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.</p> <p>This gives a present value of CU152,367.^(b)</p>
<p>[paragraph B5.7.18(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).</p>	<p>The market price of the liability at the end of the period is CU153,811.^(c)</p> <p>Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.</p>
<p>(a) $CU150,000 \times 8\% = CU12,000$</p> <p>(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$</p> <p>(c) $market\ price = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$</p>	

Hedge accounting for aggregated exposures

IE6 The following examples illustrate the mechanics of hedge accounting for aggregated exposures.

Example 1—combined commodity price risk and foreign currency risk hedge (cash flow hedge/cash flow hedge combination)

Fact pattern

IE7 Entity A wants to hedge a highly probable forecast coffee purchase (which is expected to occur at the end of Period 5). Entity A's functional currency is its Local Currency (LC). Coffee is traded in Foreign Currency (FC). Entity A has the following risk exposures:

- (a) commodity price risk: the variability in cash flows for the purchase price, which results from fluctuations of the spot price of coffee in FC; and
- (b) foreign currency (FX) risk: the variability in cash flows that results from fluctuations of the spot exchange rate between LC and FC.

IE8 Entity A hedges its risk exposures using the following risk management strategy:

- (a) Entity A uses benchmark commodity forward contracts, which are denominated in FC, to hedge its coffee purchases four periods before delivery. The coffee price that Entity A actually pays for its purchase is different from the benchmark price because of differences in the type of coffee, the location and delivery arrangement.³ This gives rise to the risk of changes in the relationship between the two coffee prices (sometimes referred to as 'basis risk'), which affects the effectiveness of the hedging relationship. Entity A does not hedge this risk because it is not considered economical under cost/benefit considerations.
- (b) Entity A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery. Entity A considers the FX exposure from the variable payments for the coffee purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Entity A uses one single FX forward contract to hedge the FX cash flows from a forecast coffee purchase and the related commodity forward contract.

IE9 The following table sets out the parameters used for Example 1 (the 'basis spread' is the differential, expressed as a percentage, between the price of the coffee that Entity A actually buys and the price for the benchmark coffee):

Example 1—Parameters					
Period	1	2	3	4	5
Interest rates for remaining maturity [FC]	0.26%	0.21%	0.16%	0.06%	0.00%
Interest rates for remaining maturity [LC]	1.12%	0.82%	0.46%	0.26%	0.00%
Forward price [FC/lb]	1.25	1.01	1.43	1.22	2.15
Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
FX rate (spot) [FC/LC]	1.3800	1.3300	1.4100	1.4600	1.4300

Accounting mechanics

³ For the purpose of this example it is assumed that the hedged risk is not designated based on a benchmark coffee price risk component. Consequently, the entire coffee price risk is hedged.

IE10 Entity A designates as cash flow hedges the following two hedging relationships:⁴

- (a) A commodity price risk hedging relationship between the coffee price related variability in cash flows attributable to the forecast coffee purchase in FC as the hedged item and a commodity forward contract denominated in FC as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the end of Period 1 with a term to the end of Period 5. Because of the basis spread between the price of the coffee that Entity A actually buys and the price for the benchmark coffee, Entity A designates a volume of 112,500 pounds (lbs) of coffee as the hedging instrument and a volume of 118,421 lbs as the hedged item.⁵
- (b) An FX risk hedging relationship between the aggregated exposure as the hedged item and an FX forward contract as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 2 with a term to the end of Period 5. The aggregated exposure that is designated as the hedged item represents the FX risk that is the effect of exchange rate changes, compared to the forward FX rate at the end of Period 2 (ie the time of designation of the FX risk hedging relationship), on the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship, which are the forecast coffee purchase and the commodity forward contract. Entity A's long-term view of the basis spread between the price of the coffee that it actually buys and the price for the benchmark coffee has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Entity A enters into (the nominal amount of the FX forward contract of FC140,625) reflects the cash flow exposure associated with a basis spread that had remained at -5 per cent. However, Entity A's actual aggregated exposure is affected by changes in the basis spread. Because the basis spread has moved from -5 per cent to -5.5 per cent during Period 2, Entity A's actual aggregated exposure at the end of Period 2 is FC140,027.

IE11 The following table sets out the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness:⁶

⁴ This example assumes that all qualifying criteria for hedge accounting are met (see IFRS 9.6.4.1). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with IFRS 9.6.4.1(b)).

⁵ In this example, the current basis spread at the time of designation is coincidentally the same as Entity A's long-term view of the basis spread (-5 per cent) that determines the volume of coffee purchases that it actually hedges. Also, this example assumes that Entity A designates the hedging instrument in its entirety and designates as much of its highly probable forecast purchases as it regards as hedged. That results in a hedge ratio of 1/(100%-5%). Other entities might follow different approaches when determining what volume of their exposure they actually hedge, which can result in a different hedge ratio and also designating less than a hedging instrument in its entirety (see IFRS 9.B6.4.10).

⁶ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities, equity and profit or loss) are in the format of positive (plus) and negative (minus) numbers (eg a profit or loss amount that is a negative number is a loss).

Example 1—Calculations	Period	1	2	3	4	5	
Commodity price risk hedging relationship (first level relationship)							
<i>Forward purchase contract for coffee</i>							
Volume (lbs)	112,500						
Forward price [FC/lb]	1.25	Price (fwd) [FC/lb]	1.25	1.01	1.43	1.22	2.15
		Fair value [FC]	0	-26,943	20,219	-3,373	101,250
		Fair value [LC]	0	-20,258	14,339	-2,310	70,804
		Change in fair value [LC]		-20,258	34,598	-16,650	73,114
<i>Hedged forecast coffee purchase</i>							
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
Hedged volume	118,421	Price (fwd) [FC/lb]	1.19	0.95	1.34	1.18	2.00
Implied forward price	1.1875	Present value [FC]	0	27,540	-18,528	1,063	-96,158
		Present value [LC]	0	20,707	-13,140	728	-67,243
		Change in present value [LC]		20,707	-33,847	13,868	-67,971
<i>Accounting</i>							
			LC	LC	LC	LC	LC
Derivative			0	-20,258	14,339	-2,310	70,804
Cash flow hedge reserve			0	-20,258	13,140	-728	67,243
Change in cash flow hedge reserve				-20,258	33,399	-13,868	67,971
Profit or loss				0	1,199	-2,781	5,143
Retained earnings			0	0	1,199	-1,582	3,561
FX risk hedging relationship (second level relationship)							
FX rate [FC/LC]		Spot	1.3800	1.3300	1.4100	1.4600	1.4300
		Forward	1.3683	1.3220	1.4058	1.4571	1.4300
<i>FX forward contract (buy FC/sell LC)</i>							
Volume [FC]	140,625						
Forward rate (in P ₂)	1.3220	Fair value [LC]		0	-6,313	-9,840	-8,035
		Change in fair value [LC]			-6,313	-3,528	1,805
<i>Hedged FX risk</i>							
Aggregated FX exposure		Hedged volume [FC]		140,027	138,932	142,937	135,533
		Present value [LC]		0	6,237	10,002	7,744
		Change in present value [LC]			6,237	3,765	-2,258
<i>Accounting</i>							
			LC	LC	LC	LC	LC
Derivative			0	-6,313	-9,840	-8,035	
Cash flow hedge reserve			0	-6,237	-9,840	-7,744	
Change in cash flow hedge reserve					-6,237	-3,604	2,096
Profit or loss					-76	76	-291
Retained earnings				0	-76	0	-291

IE12 The commodity price risk hedging relationship is a cash flow hedge of a highly probable forecast transaction that starts at the end of Period 1 and remains in place when the FX risk hedging relationship starts at the end of Period 2, ie the first level relationship continues as a separate hedging relationship.

IE13 The volume of the aggregated FX exposure (in FC), which is the hedged volume of the FX risk hedging relationship, is the total of:⁷

⁷ For example, at the end of Period 3 the aggregated FX exposure is determined as: 118,421 lbs × 1.34 FC/lb = FC159,182 for the expected price of the actual coffee purchase and 112,500 lbs × (1.25 [FC/lb] - 1.43 [FC/lb]) = FC-20,250 for the expected price differential under the commodity forward contract, which gives a total of FC138,932—the volume of the aggregated FX exposure and the end of Period 3.

- (a) the hedged coffee purchase volume multiplied by the current forward price (this represents the expected spot price of the actual coffee purchase); and
- (b) the volume of the hedging instrument (designated nominal amount) multiplied by the difference between the contractual forward rate and the current forward rate (this represents the expected price differential from benchmark coffee price movements in FC that Entity A will receive or pay under the commodity forward contract).

- IE14 The present value (in LC) of the hedged item of the FX risk hedging relationship (ie the aggregated exposure) is calculated as the hedged volume (in FC) multiplied by the difference between the forward FX rate at the measurement date and the forward FX rate at the designation date of the hedging relationship (ie the end of Period 2).⁸
- IE15 Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 6.5.11 of IFRS 9).
- IE16 The following table shows the effect on Entity A's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency the line items⁹ are disaggregated on the face of the statements by the two hedging relationships, ie for the commodity price risk hedging relationship and the FX risk hedging relationship):

⁸ For example, at the end of Period 3 the present value of the hedged item is determined as the volume of the aggregated exposure at the end of Period 3 (FC138,932) multiplied by the difference between the forward FX rate at the end of Period 3 (1/1.4058) and the forward FX rate and the time of designation (ie the end of Period 2: 1/1.3220) and then discounted using the interest rate (in LC) at the end of Period 3 with a term of 2 periods (ie until the end of Period 5—0.46 per cent). The calculation is: $FC138,932 \times (1/(1.4058[FC/LC]) - 1/(1.3220 [FC/LC]))/(1 + 0.46\%) = LC6,237$.

⁹ The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 *Financial Instruments: Disclosures* sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

Example 1—Overview of effect on statements of financial performance and financial position					
<i>[All amounts in LC]</i>					
Period	1	2	3	4	5
Statement of profit or loss and other comprehensive income					
Hedge ineffectiveness					
Commodity hedge		0	(1,199)	2,781	(5,143)
FX hedge		0	76	(76)	291
Profit or loss	0	0	(1,123)	2,705	(4,852)
Other comprehensive income (OCI)					
Commodity hedge		20,258	(33,399)	13,868	(67,971)
FX hedge		0	6,237	3,604	(2,096)
Total other comprehensive income	0	20,258	(27,162)	17,472	(70,067)
Comprehensive income	0	20,258	(28,285)	20,177	(74,920)
Statement of financial position					
Commodity forward	0	(20,258)	14,339	(2,310)	70,804
FX forward		0	(6,313)	(9,840)	(8,035)
Total net assets	0	(20,258)	8,027	(12,150)	62,769
Equity					
Accumulated OCI					
Commodity hedge	0	20,258	(13,140)	728	(67,243)
FX hedge		0	6,237	9,840	7,744
	0	20,258	(6,904)	10,568	(59,499)
Retained earnings					
Commodity hedge	0	0	(1,199)	1,582	(3,561)
FX hedge		0	76	0	291
	0	0	(1,123)	1,582	(3,270)
Total equity	0	20,258	(8,027)	12,150	(62,769)

IE17 The total cost of inventory after hedging are as follows:¹⁰

<i>Cost of inventory [all amounts in LC]</i>	
Cash price (at spot for commodity price risk and FX risk)	165,582
Gain/loss from CFHR for commodity price risk	-67,243
Gain/loss from CFHR for FX risk	7,744
Cost of inventory	106,083

IE18 The total overall cash flow from all transactions (the actual coffee purchase at the spot price and the settlement of the two derivatives) is LC102,813. It differs from the hedge adjusted cost of inventory by LC3,270, which is the net amount of cumulative hedge ineffectiveness from the two hedging relationships. This hedge ineffectiveness has a cash flow effect but is excluded from the measurement of the inventory.

Example 2—combined interest rate risk and foreign currency risk hedge (fair value hedge/cash flow hedge combination)

Fact pattern

IE19 Entity B wants to hedge a fixed rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of

¹⁰ 'CFHR' is the cash flow hedge reserve, ie the amount accumulated in other comprehensive income for a cash flow hedge.

Period 4. Entity B's functional currency is its Local Currency (LC). Entity B has the following risk exposures:

- (a) fair value interest rate risk and FX risk: the changes in fair value of the fixed rate liability attributable to interest rate changes, measured in LC.
- (b) cash flow interest rate risk: the exposure that arises as a result of swapping the combined fair value interest rate risk and FX risk exposure associated with the fixed rate liability (see (a) above) into a variable rate exposure in LC in accordance with Entity B's risk management strategy for FC denominated fixed rate liabilities (see paragraph IE20(a) below).

IE20 Entity B hedges its risk exposures using the following risk management strategy:

- (a) Entity B uses cross-currency interest rate swaps to swap its FC denominated fixed rate liabilities into a variable rate exposure in LC. Entity B hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, Entity B enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap Entity B receives fixed interest in FC (used to pay the interest on the liability) and pays variable interest in LC.
- (b) Entity B considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated variable rate exposure in LC. From time to time, in accordance with its risk management strategy for variable rate interest rate risk (in LC), Entity B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC. Entity B seeks to obtain as a fixed rate exposure a single blended fixed coupon rate (ie the uniform forward coupon rate for the hedged term that exists at the start of the hedging relationship).¹¹ Consequently, Entity B uses interest rate swaps (denominated entirely in LC) under which it receives variable interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays fixed interest.

IE21 The following table sets out the parameters used for Example 2:

¹¹ An entity may have a different risk management strategy whereby it seeks to obtain a fixed rate exposure that is not a single blended rate but a series of forward rates that are each fixed for the respective individual interest period. For such a strategy the hedge effectiveness is measured based on the difference between the forward rates that existed at the start of the hedging relationship and the forward rates that exist at the effectiveness measurement date for the individual interest periods. For such a strategy a series of forward contracts corresponding with the individual interest periods would be more effective than an interest rate swap (that has a fixed payment leg with a single blended fixed rate).

Example 2—Parameters					
	t₀	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2000	1.0500	1.4200	1.5100	1.3700
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	5.02%	6.18%	0.34%	[N/A]
	2.75%	5.19%	6.26%	0.49%	
	2.91%	5.47%	6.37%	0.94%	
	3.02%	5.52%	6.56%	1.36%	
	2.98%	5.81%	6.74%		
	3.05%	5.85%	6.93%		
	3.11%	5.91%	7.19%		
	3.15%	6.06%	7.53%		
	3.11%	6.20%			
	3.14%	6.31%			
	3.27%	6.36%			
	3.21%	6.40%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting mechanics

IE22 Entity B designates the following hedging relationships:¹²

- (a) As a fair value hedge, a hedging relationship for fair value interest rate risk and FX risk between the FC denominated fixed rate liability (fixed rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (ie t₀) with a term to the end of Period 4.

¹² This example assumes that all qualifying criteria for hedge accounting are met (see IFRS 9.6.4.1). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with IFRS 9.6.4.1(b)).

- (b) As a cash flow hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when Entity B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the variability in cash flows that is the effect of changes in the combined cash flows of the two items designated in the fair value hedge of the fair value interest rate risk and FX risk—see (a) above), compared to the interest rates at the end of Period 1 (ie the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

IE23 The following table¹³ sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve and hedge ineffectiveness.¹⁴ In this example, hedge ineffectiveness arises on both hedging relationships.¹⁵

Example 2—Calculations	t₀	Period 1	Period 2	Period 3	Period 4
Fixed rate FX liability					
Fair value [FC]	-1,000,000	-995,522	-1,031,008	-1,030,193	-1,000,000
Fair value [LC]	-1,200,000	-1,045,298	-1,464,031	-1,555,591	-1,370,000
Change in fair value [LC]		154,702	-418,733	-91,560	185,591
CCIRS (receive fixed FC/pay variable LC)					
Fair value [LC]	0	-154,673	264,116	355,553	170,000
Change in fair value [LC]		-154,673	418,788	91,437	-185,553
IRS (receive variable/pay fixed)					
Fair value [LC]		0	18,896	-58,767	0
Change in fair value [LC]			18,896	-77,663	58,767
CF variability of the aggregated exposure					
Present value [LC]		0	-18,824	58,753	0
Change in present value [LC]			-18,824	77,577	-58,753
CFHR					
Balance (end of period) [LC]		0	18,824	-58,753	0
Change [LC]			18,824	-77,577	58,753

IE24 The hedging relationship between the fixed rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (ie t₀) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, ie the first level relationship continues as a separate hedging relationship.

¹³ Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

¹⁴ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (eg an amount in the cash flow hedge reserve that is a negative number is a loss).

¹⁵ For a situation like in this example, hedge ineffectiveness can result from various factors, for example credit risk, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis') or differences in the day count method.

IE25 The cash flow variability of the aggregated exposure is calculated as follows:

- (a) At the point in time from which the cash flow variability of the aggregated exposure is hedged (ie the start of the second level relationship at the end of Period 1), all cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the hedged term (ie until the end of Period 4) are mapped out and equated to a single blended fixed coupon rate so that the total present value (in LC) is nil. This calculation establishes the single blended fixed coupon rate (reference rate) that is used at subsequent dates as the reference point to measure the cash flow variability of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

Example 2—Cash flow variability of the aggregated exposure (calibration)								
Variability in cash flows of the aggregated exposure								
FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV	
CFs	PV	CFs	PV	CFs	PV	1,200,000	Nominal	
						5.6963%	Rate	
						4	Frequency	
	[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
Time								
t_0								
Period 1								
t_1								
t_2								
t_3								
t_4								
Period 2								
t_5	0	0	0	0	-14,771	-14,591	17,089	16,881
t_6	-20,426	-19,977	20,246	19,801	-15,271	-14,896	17,089	16,669
t_7	0	0	0	0	-16,076	-15,473	17,089	16,449
t_8	-20,426	-19,543	20,582	19,692	-16,241	-15,424	17,089	16,229
Period 3								
t_9	0	0	0	0	-17,060	-15,974	17,089	16,002
t_{10}	-20,426	-19,148	20,358	19,084	-17,182	-15,862	17,089	15,776
t_{11}	0	0	0	0	-17,359	-15,797	17,089	15,551
t_{12}	-20,426	-18,769	20,582	18,912	-17,778	-15,942	17,089	15,324
Period 4								
t_{13}	0	0	0	0	-18,188	-16,066	17,089	15,095
t_{14}	-20,426	-18,391	20,246	18,229	-18,502	-16,095	17,089	14,866
t_{15}	0	0	0	0	-18,646	-15,972	17,089	14,638
t_{16}	-1,020,426	-899,695	1,020,582	899,832	-1,218,767	-1,027,908	1,217,089	1,026,493
Totals		-995,522		995,550		-1,200,000		1,199,971
Totals in LC		-1,045,298		1,045,327		-1,200,000		1,199,971
PV of all CFs [LC]		0				Σ		

The nominal amount that is used for the calibration of the reference rate is the same as the nominal amount of aggregated exposure that creates the variable cash flows in LC (LC1,200,000), which coincides with the nominal amount of the cross-currency interest rate swap for the variable rate leg in LC. This results in a reference rate of 5.6963 per cent (determined by iteration so that the present value of all cash flows in total is nil).

- (b) At subsequent dates, the cash flow variability of the aggregated exposure is determined by comparison to the reference point established at the end of Period 1. For that purpose, all remaining cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (ie from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. Also, the reference

rate of 5.6963 per cent is applied to the nominal amount that was used for the calibration of that rate at the end of Period 1 (LC1,200,000) in order to generate a set of cash flows over the remainder of the hedged term that is then also discounted. The total of all those present values represents the cash flow variability of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

Example 2—Cash flow variability of the aggregated exposure (at the end of Period 2)									
Variability in cash flows of the aggregated exposure									
FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV		
CFs	PV	CFs	PV	CFs	PV	1,200,000 Nominal	5.6963% Rate		
[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	4 Frequency	[LC]	[LC]	
Time									
t_0									
Period 1	t_1								
	t_2								
	t_3								
	t_4								
	t_5	0	0	0	0	0	0	0	
Period 2	t_6	0	0	0	0	0	0	0	
	t_7	0	0	0	0	0	0	0	
	t_8	0	0	0	0	0	0	0	
	t_9	0	0	0	0	-18,120	-17,850	17,089	16,835
Period 3	t_{10}	-20,426	-20,173	20,358	20,106	-18,360	-17,814	17,089	16,581
	t_{11}	0	0	0	0	-18,683	-17,850	17,089	16,327
	t_{12}	-20,426	-19,965	20,582	20,117	-19,203	-18,058	17,089	16,070
	t_{13}	0	0	0	0	-19,718	-18,243	17,089	15,810
Period 4	t_{14}	-20,426	-19,726	20,246	19,553	-20,279	-18,449	17,089	15,547
	t_{15}	0	0	0	0	-21,014	-18,789	17,089	15,280
	t_{16}	-1,020,426	-971,144	1,020,582	971,292	-1,221,991	-1,072,947	1,217,089	1,068,643
	Totals		-1,031,008		1,031,067		-1,200,000		1,181,092
Totals in LC		-1,464,031		1,464,116		-1,200,000		1,181,092	
PV of all CFs [LC]	-18,824	←————— Σ							

The changes in interest rates and the exchange rate result in a change of the cash flow variability of the aggregated exposure between the end of Period 1 and the end of Period 2 that has a present value of LC-18,824.¹⁶

IE26 Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 6.5.11 of IFRS 9).

IE27 The following table shows the effect on Entity B's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency some line items¹⁷ are disaggregated on the face of the statements by

¹⁶ This is the amount that is included in the table with the overview of the calculations (see paragraph IE23) as the present value of the cash flow variability of the aggregated exposure at the end of Period 2.

¹⁷ The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 *Financial Instruments: Disclosures* sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

the two hedging relationships, ie for the fair value hedge of the fixed rate FX liability and the cash flow hedge of the aggregated exposure):¹⁸

	t ₀	Period 1	Period 2	Period 3	Period 4
Example 2—Overview of effect on statements of financial performance and financial position					
<i>[All amounts in LC]</i>					
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,958	50,452	59,848	58,827
FVH adjustment		(12,757)	11,941	14,385	(49,439)
		33,202	62,393	74,233	9,388
Reclassifications (CFH)			5,990	(5,863)	58,982
Total interest expense		33,202	68,383	68,370	68,370
Other gains/losses					
Change in fair value of the CCIRS		154,673	(418,788)	(91,437)	185,553
FVH adjustment (FX liability)		(154,702)	418,733	91,560	(185,591)
Hedge ineffectiveness		25	(72)	(54)	(19)
Total other gains/losses		(4)	(127)	68	(57)
Profit or loss		33,198	68,255	68,438	68,313
Other comprehensive income (OCI)					
Effective CFH gain/loss			(12,834)	71,713	229
Reclassifications			(5,990)	5,863	(58,982)
Total other comprehensive income			(18,824)	77,577	(58,753)
Comprehensive income		33,198	49,432	146,015	9,560
Statement of financial position					
FX liability	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,397,984)
CCIRS	0	(154,673)	264,116	355,553	194,141
IRS		0	18,896	(58,767)	(13,004)
Cash	1,200,000	1,166,773	1,098,390	1,030,160	978,641
Total net assets	0	(33,198)	(82,630)	(228,645)	(238,205)
Equity					
Accumulated OCI		0	(18,824)	58,753	0
Retained earnings	0	33,198	101,454	169,892	238,205
Total equity	0	33,198	82,630	228,645	238,205

IE28 The total interest expense in profit or loss reflects Entity B's interest expense that results from its risk management strategy:

- (a) In Period 1 the risk management strategy results in interest expense reflecting variable interest rates in LC after taking into account the effect of the cross-currency interest rate swap. There is also some hedge ineffectiveness that results from a difference in the changes in value for the fixed rate FX liability (as represented by the fair value hedge adjustment) and the cross-currency interest

¹⁸ For Period 4 the values in the table with the overview of the calculations (see paragraph IE23) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (ie including interest accruals) equal the 'clean' values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, ie the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and retained earnings would be nil).

rate swap as well as from differences between the cash flows on the two instruments that were settled during Period 1.

- (b) For Periods 2 to 4 the risk management strategy results in interest expense that reflects, after taking into account the effect of the interest rate swap entered into at the end of Period 1, fixed interest rates in LC (ie locking in a single blended fixed coupon rate for a three-period term based on the interest rate environment at the end of Period 1). However, Entity B's interest expense is affected by the hedge ineffectiveness that arises on its hedging relationships. In Period 2 the interest expense is slightly higher than the fixed rate payments locked in with the interest rate swap because the variable payments received under the interest rate swap are less than the total of the cash flows resulting from the aggregated exposure.¹⁹ In Periods 3 and 4 the interest expense is equal to the locked in rate because the variable payments received under the swap are more than the total of the cash flows resulting from the aggregated exposure.²⁰

Example 3—combined interest rate risk and foreign currency risk hedge (cash flow hedge/fair value hedge combination)

Fact pattern

- IE29 Entity C wants to hedge a variable rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. Entity C's functional currency is its Local Currency (LC). Entity C has the following risk exposures:
- (a) cash flow interest rate risk and FX risk: the changes in cash flows of the variable rate liability attributable to interest rate changes, measured in LC.
- (b) fair value interest rate risk: the exposure that arises as a result of swapping the combined cash flow interest rate risk and FX risk exposure associated with the variable rate liability (see (a) above) into a fixed rate exposure in LC in accordance with Entity C's risk management strategy for FC denominated variable rate liabilities (see paragraph IE30(a) below).
- IE30 Entity C hedges its risk exposures using the following risk management strategy:
- (a) Entity C uses cross-currency interest rate swaps to swap its FC denominated variable rate liabilities into a fixed rate exposure in LC. Entity C hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, Entity C enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap Entity C receives variable interest in FC (used to pay the interest on the liability) and pays fixed interest in LC.
- (b) Entity C considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated fixed rate exposure in LC. From time to time, in accordance with its risk management strategy for fixed rate

¹⁹ In other words, the cash flow variability of the interest rate swap was lower than, and consequently did not fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'underhedge' situation). In those situations the cash flow hedge does not contribute to the hedge ineffectiveness that is recognised in profit or loss because the hedge ineffectiveness is not recognised (see IFRS 9.6.5.11). The hedge ineffectiveness arising on the fair value hedge affects profit or loss in all periods.

²⁰ In other words, the cash flow variability of the interest rate swap was higher than, and consequently more than fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'overhedge' situation). In those situations the cash flow hedge contributes to the hedge ineffectiveness that is recognised in profit or loss (see IFRS 9.6.5.11). The hedge ineffectiveness arising on the fair value hedge affects profit or loss in all periods.

interest rate risk (in LC), Entity C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC. Consequently, Entity C uses interest rate swaps (denominated entirely in LC) under which it receives fixed interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays variable interest.

IE31 The following table sets out the parameters used for Example 3:

Example 3—Parameter overview					
	t₀	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2	1.05	1.42	1.51	1.37
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	1.00%	3.88%	0.34%	[N/A]
	2.75%	1.21%	4.12%	0.49%	
	2.91%	1.39%	4.22%	0.94%	
	3.02%	1.58%	5.11%	1.36%	
	2.98%	1.77%	5.39%		
	3.05%	1.93%	5.43%		
	3.11%	2.09%	5.50%		
	3.15%	2.16%	5.64%		
	3.11%	2.22%			
	3.14%	2.28%			
	3.27%	2.30%			
	3.21%	2.31%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting mechanics

IE32 Entity C designates the following hedging relationships:²¹

- (a) As a cash flow hedge, a hedging relationship for cash flow interest rate risk and FX risk between the FC denominated variable rate liability (variable rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (ie t_0) with a term to the end of Period 4.
- (b) As a fair value hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when Entity C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the change in value that is the effect of changes in the value of the combined cash flows of the two items designated in the cash flow hedge of the cash flow interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (ie the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

IE33 The following table²² sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve.²³ In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made.²⁴

²¹ This example assumes that all qualifying criteria for hedge accounting are met (see IFRS 9.6.4.1). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with IFRS 9.6.4.1(b)).

²² Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

²³ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (eg an amount in the cash flow hedge reserve that is a negative number is a loss).

²⁴ Those assumptions have been made for didactical reasons, in order to better focus on illustrating the accounting mechanics in a cash flow hedge/fair value hedge combination. The measurement and recognition of hedge ineffectiveness has already been demonstrated in Example 1 and Example 2. However, in reality such hedges are typically not perfectly effective because hedge ineffectiveness can result from various factors, for example credit risk, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis') or differences in the day count method.

Example 3—Calculations	t₀	Period 1	Period 2	Period 3	Period 4
Variable rate FX liability					
Fair value [FC]	-1,000,000	-1,000,000	-1,000,000	-1,000,000	-1,000,000
Fair value [LC]	-1,200,000	-1,050,000	-1,420,000	-1,510,000	-1,370,000
Change in fair value [LC]		150,000	-370,000	-90,000	140,000
PV of change in variable CFs [LC]	0	192,310	-260,346	-282,979	-170,000
Change in PV [LC]		192,310	-452,656	-22,633	112,979
CCIRS (receive variable FC/pay fixed LC)					
Fair value [LC]	0	-192,310	260,346	282,979	170,000
Change in fair value [LC]		-192,310	452,656	22,633	-112,979
CFHR					
Opening balance	0	0	-42,310	-28,207	-14,103
Reclassification FX risk		153,008	-378,220	-91,030	140,731
Reclassification (current period CF)		-8,656	-18,410	2,939	21,431
Effective CFH gain/loss		-186,662	479,286	20,724	-135,141
Reclassification for interest rate risk		0	-82,656	67,367	-27,021
Amortisation of CFHR		0	14,103	14,103	14,103
Ending balance		-42,310	-28,207	-14,103	0
IRS (receive fixed/pay variable)					
Fair value [LC]		0	-82,656	-15,289	-42,310
Change in fair value			-82,656	67,367	-27,021
Change in present value of the aggregated exposure					
Present value [LC]		-1,242,310	-1,159,654	-1,227,021	-1,200,000
Change in present value [LC]			82,656	-67,367	27,021

IE34 The hedging relationship between the variable rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (ie t₀) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, ie the first level relationship continues as a separate hedging relationship. However, the hedge accounting for the first level relationship is affected by the start of hedge accounting for the second level relationship at the end of Period 1. The fair value hedge for the second level relationship affects the timing of the reclassification to profit or loss of amounts from the cash flow hedge reserve for the first level relationship:

- (a) The fair value interest rate risk that is hedged by the fair value hedge is included in the amount that is recognised in other comprehensive income as a result of the cash flow hedge for the first level hedging relationship (ie the gain or loss on the cross-currency interest rate swap that is determined to be an effective hedge).²⁵ This means that from the end of Period 1 the part of the effective cash flow hedging gain or loss that represents the fair value interest rate risk (in LC), and is recognised in other comprehensive income in a first step, is in a second step immediately (ie in the same period) transferred from the cash flow hedge reserve to profit or loss. That reclassification adjustment offsets the gain or loss on the interest rate swap that is recognised in profit or

²⁵ As a consequence of hedging its exposure to cash flow interest rate risk by entering into the cross-currency interest rate swap that changed the cash flow interest rate risk of the variable rate FX liability into a fixed rate exposure (in LC), Entity C in effect assumed an exposure to fair value interest rate risk (see paragraph IE30).

loss.²⁶ In the context of accounting for the aggregated exposure as the hedged item, that reclassification adjustment is the equivalent of a fair value hedge adjustment because in contrast to a hedged item that is a fixed rate debt instrument (in LC) at amortised cost, the aggregated exposure is already remeasured for changes regarding the hedged risk but the resulting gain or loss is recognised in other comprehensive income because of applying cash flow hedge accounting for the first level relationship. Consequently, applying fair value hedge accounting with the aggregated exposure as the hedged item does not result in changing the hedged item's measurement but instead affects where the hedging gains and losses are recognised (ie reclassification from the cash flow hedge reserve to profit or loss).

- (b) The amount in the cash flow hedge reserve at the end of Period 1 (LC42,780.44) is amortised over the remaining life of the cash flow hedge for the first level relationship (ie over Periods 2 to 4).²⁷

IE35 The change in value of the aggregated exposure is calculated as follows:

- (a) At the point in time from which the change in value of the aggregated exposure is hedged (ie the start of the second level relationship at the end of Period 1), all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term (ie until the end of Period 4) are mapped out and their combined present value, in LC, is calculated. This calculation establishes the present value that is used at subsequent dates as the reference point to measure the change in present value of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

²⁶ In the table with the overview of the calculations (see paragraph IE33) this reclassification adjustment is the line item "Reclassification for interest rate risk" in the reconciliation of the cash flow hedge reserve (eg at the end of Period 2 a reclassification of a gain of LC82,656 from the cash flow hedge reserve to profit or loss—see paragraph IE35 for how that amount is calculated).

²⁷ In the table with the overview of the calculations (see paragraph IE33) this amortisation results in a periodic reclassification adjustment of LC14,103 that is included in the line item "Amortisation of CFHR" in the reconciliation of the cash flow hedge reserve.

Example 3—Present value of the aggregated exposure (starting point)							
Present value of the aggregated exposure							
		FX liability		CCIRS FC leg		CCIRS LC leg	
		CFs	PV	CFs	PV	CFs	PV
		[FC]	[FC]	[FC]	[FC]	[LC]	[LC]
Period 1	t ₀						
	t ₁						
	t ₂						
	t ₃						
	t ₄						
Period 2	t ₅	-11,039	-10,918	11,039	10,918	-9,117	-9,094
	t ₆	-11,331	-11,082	11,331	11,082	-9,117	-9,067
	t ₇	-11,375	-11,000	11,375	11,000	-9,117	-9,035
	t ₈	-10,689	-10,227	10,689	10,227	-9,117	-9,000
Period 3	t ₉	-10,375	-9,824	10,375	9,824	-9,117	-8,961
	t ₁₀	-10,164	-9,528	10,164	9,528	-9,117	-8,918
	t ₁₁	-10,028	-9,307	10,028	9,307	-9,117	-8,872
	t ₁₂	-10,072	-9,255	10,072	9,255	-9,117	-8,825
Period 4	t ₁₃	-10,256	-9,328	10,256	9,328	-9,117	-8,776
	t ₁₄	-10,159	-9,147	10,159	9,147	-9,117	-8,727
	t ₁₅	-10,426	-9,290	10,426	9,290	-9,117	-8,678
	t ₁₆	-1,010,670	-891,093	1,010,670	891,093	-1,209,117	-1,144,358
Totals			<u>-1,000,000</u>		<u>1,000,000</u>		<u>-1,242,310</u>
Totals in LC			<u>-1,050,000</u>		<u>1,050,000</u>		<u>-1,242,310</u>
PV of aggregated exposure [LC]			-1,242,310		← Σ		

The present value of all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term at the end of Period 1 is LC-1,242,310.²⁸

- (b) At subsequent dates, the present value of the aggregated exposure is determined in the same way as at the end of Period 1 but for the remainder of the hedged term. For that purpose, all remaining cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (ie from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. The total of those present values represents the present value of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

²⁸ In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made (see paragraph IE33). Consequently, the absolute values of the variable rate FX liability and the FC denominated leg of the cross-currency interest rate are equal (but with opposite signs). In situations in which hedge ineffectiveness arises, those absolute values would not be equal so that the remaining net amount would affect the present value of the aggregated exposure.

Example 3—Present value of the aggregated exposure (at the end of Period 2)						
Present value of the aggregated exposure						
FX liability		CCIRS FC leg		CCIRS LC leg		
CFs	PV	CFs	PV	CFs	PV	
[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	
Period 1	t ₀					
	t ₁					
	t ₂					
	t ₃					
	t ₄					
Period 2	t ₅	0	0	0	0	0
	t ₆	0	0	0	0	0
	t ₇	0	0	0	0	0
	t ₈	0	0	0	0	0
Period 3	t ₉	-6,969	-6,921	6,969	6,921	-9,117
	t ₁₀	-5,544	-5,475	5,544	5,475	-9,117
	t ₁₁	-4,971	-4,885	4,971	4,885	-9,117
	t ₁₂	-5,401	-5,280	5,401	5,280	-9,117
Period 4	t ₁₃	-5,796	-5,632	5,796	5,632	-9,117
	t ₁₄	-6,277	-6,062	6,277	6,062	-9,117
	t ₁₅	-6,975	-6,689	6,975	6,689	-9,117
	t ₁₆	-1,007,725	-959,056	1,007,725	959,056	-1,209,117
Totals		<u>-1,000,000</u>		<u>1,000,000</u>		<u>-1,159,654</u>
Totals in LC		-1,420,000		1,420,000		-1,159,654
PV of aggregated exposure [LC]		-1,159,654		← Σ		

The changes in interest rates and the exchange rate result in a present value of the aggregated exposure at the end of Period 2 of LC-1,159,654. Consequently, the change in the present value of the aggregated exposure between the end of Period 1 and the end of Period 2 is a gain of LC82,656.²⁹

IE36 Using the change in present value of the hedged item (ie the aggregated exposure) and the fair value of the hedging instrument (ie the interest rate swap), the related reclassifications from the cash flow hedge reserve to profit or loss (reclassification adjustments) are then determined.

IE37 The following table shows the effect on Entity C's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency some line items³⁰ are disaggregated on the face of the statements by

²⁹ This is the amount that is included in the table with the overview of the calculations (see paragraph IE33) as the change in present value of the aggregated exposure at the end of Period 2.

³⁰ The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 *Financial Instruments: Disclosures* sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

the two hedging relationships, ie for the cash flow hedge of the variable rate FX liability and the fair value hedge of the aggregated exposure):³¹

	<i>t</i> ₀	Period 1	Period 2	Period 3	Period 4
Example 3—Overview of effect on statements of financial performance and financial position					
<i>[All amounts in LC]</i>					
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,122	54,876	33,527	15,035
FVH adjustment		0	(20,478)	16,517	(26,781)
		45,122	34,398	50,045	(11,746)
Reclassifications (CFH)		(8,656)	(18,410)	2,939	21,431
		36,466	15,989	52,983	9,685
Amortisation of CFHR		0	14,103	14,103	14,103
Total interest expense		36,466	30,092	67,087	23,788
Other gains/losses					
IRS		0	82,656	(67,367)	27,021
FX gain/loss (liability)		(150,000)	370,000	90,000	(140,000)
FX gain/loss (interest)		(3,008)	8,220	1,030	(731)
Reclassification for FX risk		153,008	(378,220)	(91,030)	140,731
Reclassification for interest rate risk		0	(82,656)	67,367	(27,021)
Total other gains/losses		0	0	(0)	(0)
Profit or loss		36,466	30,092	67,087	23,788
Other comprehensive income (OCI)					
Effective gain/loss		186,662	(479,286)	(20,724)	135,141
Reclassification (current period CF)		8,656	18,410	(2,939)	(21,431)
Reclassification for FX risk		(153,008)	378,220	91,030	(140,731)
Reclassification for interest rate risk		0	82,656	(67,367)	27,021
Amortisation of CFHR		0	(14,103)	(14,103)	(14,103)
Total other comprehensive income		42,310	(14,103)	(14,103)	(14,103)
Comprehensive income		78,776	15,989	52,983	9,685
Statement of financial position					
FX liability	(1,200,000)	(1,050,000)	(1,420,000)	(1,510,000)	(1,375,306)
CCIRS	0	(192,310)	260,346	282,979	166,190
IRS		0	(82,656)	(15,289)	(37,392)
Cash	1,200,000	1,163,534	1,147,545	1,094,562	1,089,076
Total net assets	0	(78,776)	(94,765)	(147,748)	(157,433)
Accumulated OCI	0	42,310	28,207	14,103	0
Retained earnings	0	36,466	66,558	133,645	157,433
Total equity	0	78,776	94,765	147,748	157,433

IE38 The total interest expense in profit or loss reflects Entity C's interest expense that results from its risk management strategy:

³¹ For Period 4 the values in the table with the overview of the calculations (see paragraph IE33) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (ie including interest accruals) equal the 'clean' values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, ie the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and retained earnings would be nil).

- (a) In Period 1 the risk management strategy results in interest expense reflecting fixed interest rates in LC after taking into account the effect of the cross-currency interest rate swap.
- (b) For Periods 2 to 4, after taking into account the effect of the interest rate swap entered into at the end of Period 1, the risk management strategy results in interest expense that changes with variable interest rates in LC (ie the variable interest rate prevailing in each period). However, the amount of the total interest expense is not equal to the amount of the variable rate interest because of the amortisation of the amount that was in the cash flow hedge reserve for the first level relationship at the end of Period 1.³²

³² See paragraph IE34(b). That amortisation becomes an expense that has an effect like a spread on the variable interest rate.

Appendix

Amendments to guidance on other IFRSs

The following amendments to guidance on IFRSs are necessary in order to ensure consistency with IFRS 9 Financial Instruments and the related amendments to other IFRSs.

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

IGA1 The heading above paragraph IG52 and paragraphs IG52–IG58A, IG59 and IG60B are amended to read as follows:

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*

IG52 An entity recognises and measures all financial assets and financial liabilities in its opening IFRS statement of financial position in accordance with IFRS 9, except as specified in paragraphs B2–B6 of the IFRS, which address derecognition and hedge accounting.

Recognition

IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with IFRS 9 and have not yet qualified for derecognition in accordance with IFRS 9, except non-derivative financial assets and non-derivative financial liabilities derecognised in accordance with previous GAAP before 1 January 2004, to which the entity does not choose to apply paragraph B3 (see paragraphs B2 and B3 of the IFRS). For example, an entity that does not apply paragraph B3 does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred before 1 January 2004 if those transactions qualified for derecognition in accordance with previous GAAP. However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after 1 January 2004, those further transfers qualify for derecognition only if they meet the derecognition criteria of IFRS 9.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition in accordance with IFRS 9, or have already qualified for derecognition in accordance with IFRS 9.

Embedded derivatives

IG55 When IFRS 9 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IFRS 9 reflect circumstances at that date (IFRS 9 paragraph 4.3.3). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it measures the entire combined contract as at fair value through profit or loss (IFRS 9 paragraph 4.3.6).

Measurement

- IG56 In preparing its opening IFRS statement of financial position, an entity applies the criteria in IFRS 9 to identify on the basis of the facts and circumstances that exist at the date of transition to IFRSs those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost. The resulting classifications are applied retrospectively.
- IG57 ... first satisfied the recognition criteria in IFRS 9. However, ...
- IG58 An entity's estimates of impairments of financial assets measured at amortised cost at the date of transition to IFRSs are consistent with estimates made for the same date ...

Transition adjustments

- IG58A An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings at the date of transition to IFRSs only to the extent that it results from adopting IAS 39 and IFRS 9. Because all derivatives, other than those that are financial guarantee contracts, a commitment to provide a loan at a below-market interest rate or are designated and effective hedging instruments, are measured at fair value through profit or loss, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which IAS 39 and IFRS 9 are initially applied (other than for a derivative that is a financial guarantee contract, a commitment to provide a loan at a below-market interest rate or a designated and effective hedging instrument).
- IG59 An entity may, in accordance with its previous GAAP, have measured investments at fair value and recognised the revaluation gain outside profit or loss. If an investment is classified as at fair value through profit or loss, the pre-IFRS 9 revaluation gain that had been recognised outside profit or loss is reclassified into retained earnings on initial application of IFRS 9. If, on initial application of IFRS 9, an investment in an equity instrument is classified as at fair value through other comprehensive income, then the pre-IFRS 9 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on the financial asset in other comprehensive income (except dividends, which are recognised in profit or loss) and accumulates the cumulative gains and losses in that separate component of equity. On subsequent derecognition, the entity may transfer that separate component of equity within equity.

Hedge accounting

- IG60 Paragraphs B4–B6 of the IFRS deal with hedge accounting. The designation and documentation of a hedge relationship must be completed on or before the date of transition to IFRSs if the hedge

relationship is to qualify for hedge accounting from that date. Hedge accounting can be applied prospectively only from the date that the hedge relationship is fully designated and documented.

IG60A An entity may, in accordance with its previous GAAP, have deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, an entity adjusts the carrying amount of the hedged item at the date of transition to IFRSs. The adjustment is the lower of:

- (a) that portion of the cumulative change in the fair value of the hedged item and was not recognised in accordance with previous GAAP; and
- (b) that portion of the cumulative change in the fair value of the hedging instrument and, in accordance with previous GAAP, was either (i) not recognised or (ii) deferred in the statement of financial position as an asset or liability.

IG60B An entity may, in accordance with its previous GAAP, have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of transition to IFRSs, the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in the cash flow hedge reserve within equity. Any net cumulative gain or loss that has been reclassified to the cash flow hedge reserve on initial application of IFRS 9 remains there until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects profit or loss or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss is reclassified from the cash flow hedge reserve to profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge in accordance with IFRS 9, hedge accounting is no longer appropriate starting from the date of transition to IFRSs.

IGA2

IG Example 11, paragraph IG63 is amended to read as follows:

The table 'Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)' is amended to read as follows:

Note		<i>Previous GAAP CU</i>	<i>Effect of transition to IFRSs CU</i>	<i>IFRSs CU</i>
1	Property, plant and equipment	8,299	100	8,399
2	Goodwill	1,220	150	1,370
2	Intangible assets	208	(150)	58

3	Financial assets	3,471	420	3,891
	Total non-current assets	13,198	520	13,718
	Trade and other receivables	3,710	0	3,710
4	Inventories	2,962	400	3,362
5	Other receivables	333	431	764
	Cash and cash equivalents	748	0	748
	Total current assets	7,753	831	8,584
	Total assets	20,951	1,351	22,302
	Interest-bearing loans	9,396	0	9,396
	Trade and other payables	4,124	0	4,124
6	Employee benefits	0	66	66
7	Restructuring provision	250	(250)	0
	Current tax liability	42	0	42
8	Deferred tax liability	579	460	1,039
	Total liabilities	14,391	276	14,667
	Total assets less total liabilities	6,560	1,075	7,635
	Issued capital	1,500	0	1,500
5	Cash flow hedge reserve	0	302	302
9	Retained earnings	5,060	773	5,833
	Total equity	6,560	1,075	7,635

Note 3 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

3 Financial assets are all classified at fair value through profit or loss in accordance with IFRSs and are carried at their fair value of CU3,891. They were carried at cost of CU3,471 in accordance with previous GAAP. The resulting gains of CU294 (CU420, less related deferred tax of CU126) are included in retained earnings.

Note 5 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

5 Unrealised gains of CU431 on unmatured forward foreign exchange contracts are recognised in accordance with IFRSs, but were not recognised in accordance with previous GAAP. The resulting gains of CU302 (CU431, less related deferred tax of CU129) are included in the cash flow hedge reserve because the contracts hedge forecast sales.

Note 8 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

8 The above changes increased the deferred tax liability as follows:

	CU
Cash flow hedge reserve (note 5)	129
Retained earnings	331
Increase in deferred tax liability	<u>460</u>

Because the tax base at 1 January 20X4 of the items reclassified from intangible assets to goodwill (note 2) equalled their carrying amount at that date, the reclassification did not affect deferred tax liabilities.

Note 9 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

9 The adjustments to retained earnings are as follows:

	CU
Depreciation (note 1)	100
Financial assets (note 3)	420
Production overhead (note 4)	400
Pension liability (note 6)	(66)
Restructuring provision (note 7)	250
Tax effect of the above	<u>(331)</u>
Total adjustment to retained earnings	<u>773</u>

The reconciliation of total comprehensive income for 20X4 is amended to read as follows:

Reconciliation of total comprehensive income for 20X4				
Note	Previous GAAP CU	Effect of transition to IFRSs CU	IFRSs CU	
	Revenue	20,910	0	20,910
1, 2, 3	Cost of sales	<u>(15,283)</u>	<u>(97)</u>	<u>(15,380)</u>
	Gross profit	5,627	(97)	5,530

6	Other income	0	180	180
1	Distribution costs	(1,907)	(30)	(1,937)
1, 4	Administrative expenses	(2,842)	(300)	(3,142)
	Finance income	1,446	0	1,446
	Finance costs	(1,902)	0	(1,902)
	Profit before tax	422	(247)	175
5	Tax expense	(158)	74	(84)
	Profit (loss) for the year	264	(173)	91
7	Cash flow hedges	0	(40)	(40)
8	Tax relating to other comprehensive income	0	(29)	(29)
	Other comprehensive income	0	(69)	(69)
	Total comprehensive income	264	(242)	22

Note 6 to the reconciliation of total comprehensive income for 20X4 is amended to read as follows:

6 Financial assets at fair value through profit or loss increased in value by CU180 during 20X4. They were carried at cost in accordance with previous GAAP. Fair value changes have been included in 'Other income'.

IFRS 3 Business Combinations

IGA2A In the table of comparison of IFRS 3 and SFAS 141(R), in the guidance section on 'Contingent consideration' the first reference to IAS 39 is footnoted as follows:

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

IFRS 4 Insurance Contracts

IGA3 In the table in IG Example 1, the 'Treatment in Phase I' column of contract types 1.7–1.12, 1.15, 1.18, 1.19 and 1.20(a) are amended to read as follows:

1.7	Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Within the scope of IFRS 9 <i>Financial Instruments</i> unless the contract contains a discretionary participation feature. Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all scenarios that have commercial substance).
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1.8	Within the scope of IFRS 9.
1.9	Paragraph 35 of the IFRS sets out requirements for these contracts, which are excluded from the scope of IFRS 9.
1.10	Within the scope of IFRS 9. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph B4.3.8(g) of IFRS 9).
1.11	<p>Insurance contract, but within the scope of IFRS 9, not IFRS 4. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 and IAS 32^(b) or IFRS 4 to such financial guarantee contracts.</p> <p>The legal form of the contract does not affect its recognition and measurement.</p> <p>Accounting by the holder of such a contract is excluded from the scope of IFRS 9 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10–12 of IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> apply. Those paragraphs specify criteria to use in developing an accounting policy if no IFRS applies specifically to an item.</p>
1.12	Not an insurance contract. A derivative within the scope of IFRS 9.
1.15	<p>Insurance contract within the scope of the IFRS (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable).</p> <p>However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and within the scope of IFRS 9.</p> <p>Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 <i>Leases</i>.</p>
1.18	Insurance risk is insignificant. Therefore, the contract is a financial asset within the scope of IFRS 9. Servicing fees are within the scope of IAS 18 (recognise as services are provided, subject to various conditions).
1.19	Financial instrument with embedded derivative within the scope of IFRS 9.
1.20	<p>The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component.</p> <p>(a) If specified conditions are met, paragraph 10 of the IFRS requires the holder to unbundle the deposit component and apply IFRS 9 to it.</p>

	(b) ...
--	---------

IGA4 Paragraph IG3 is amended to read as follows:

IG3 IFRS 9 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the IFRS). Nevertheless, separation and fair value measurement of such an embedded derivative are not prohibited if the insurer's existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the IFRS.

IGA5 In the table in IG Example 2, the 'Treatment if embedded in a host insurance contract' and 'Treatment if embedded in a host investment contract' columns of embedded derivative types 2.4, 2.5, 2.6(b), 2.12 and 2.14–2.17 are amended to read as follows:

Type	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.4	<p>The embedded guarantee is not an insurance contract (unless significant payments are life-contingent^(a)). However, it is closely related to the host contract (paragraph B4.3.8(b) of IFRS 9). Fair value measurement is not required (but not prohibited).</p> <p>If significant payments are life-contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the deposit component (paragraph 10 of the IFRS).</p> <p>If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be</p>	<p>Fair value measurement is not permitted (paragraph B4.3.8(b) of IFRS 9).</p>

	interdependent; if the option to cancel the deposit component cannot be measured separately (ie without considering the other option), both options are regarded as part of the insurance component (paragraph B4.3.8(h) of IFRS 9).	
2.5	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent). Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).
2.6(b)	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an un-leveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an un-leveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).
2.12	Fair value measurement is not required (but not prohibited: paragraph 8 of the IFRS). The surrender value may be viewed as a deposit component, but the IFRS does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph B4.3.5(e) of IFRS 9). Otherwise, the surrender option is measured at fair value.
2.14	The option is not closely related to the host contract (unless the option is life-contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the IFRS and B4.3.5 (c) and (d) of IFRS 9).	Fair value measurement is required (paragraph B4.3.5 (c) and (d) of IFRS 9).
2.15	If the insurer measures that portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender	If the insurer regards the account value as the amortised cost or fair value of that portion of its obligation, no further adjustment is needed for the option (unless

	value differs significantly from account value) (see paragraph B4.3.8(g) of IFRS 9). Otherwise, fair value measurement is required.	the surrender value differs significantly from account value). Otherwise, fair value measurement is required.
2.16	The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph B4.3.5(f) of IFRS 9). Fair value measurement is required.	Fair value measurement is required.
2.17	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the IFRS). Fair value measurement is required.	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph B4.3.5(b) of IFRS 9). If the option or provision is not closely related to the host instrument, fair value measurement is required.

IGA6

IG Example 3 is amended to read as follows:

IG Example 3: Unbundling a deposit component of a reinsurance contract

Application of requirements: case 1—no claims

...

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows. Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying IFRS 9 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component. Assume that an appropriate discount rate is 10 per cent and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of CU10 by the cedant is then made up of a loan advance of CU6.7 and an insurance premium of CU3.3.

...

Incremental cash flows because of the claim in year 1

...

The incremental cash flows have a present value, in year 1, of CU35 (assuming a discount rate of 10 per cent is appropriate). Applying paragraphs 10–12 of the IFRS, the cedant unbundles the contract and

applies IFRS 9 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the CU150 received in year 1 as income, and the incremental payments in years 2–5 as expenses. However, in substance, the reinsurer has paid a claim of CU35 and made a loan of CU115 (CU150 less CU35) that will be repaid in instalments.

...

IGA7

IG7 and IG Example 4 are amended to read as follows:

IG7 Shadow accounting is not the same as fair value hedge accounting under IFRS 9 and will not usually have the same effect.

IG Example 4: Shadow accounting

Background

...

At the inception of a contract, insurer A has DAC of CU20 relating to that contract and the present value, at inception, of EGP is CU100. In other words, DAC is 20 per cent of EGP at inception. Thus, for each CU1 of realised gross profits, insurer A amortises DAC by CU0.20.

For example, if insurer A sells assets and recognises a gain of CU10, insurer A amortises DAC by CU2 (20 per cent of CU10).

Before adopting IFRSs for the first time in 20X5, insurer A measured financial assets on a cost basis. (Therefore, EGP under those national requirements considers only realised gains and losses.) However, under IFRSs, it classifies its financial assets as measured at fair value through profit or loss.

In 20X5, insurer A recognises unrealised gains of CU10 on the assets backing the contract and in 20X6 it sells the assets for an amount equal to their fair value at the end of 20X5.

Application of paragraph 30 of the IFRS

Paragraph 30 of the IFRS permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 20X5 by an additional CU2 (20 per cent of CU10) as a result of the change in the fair value of the assets. Insurer A recognises the additional amortisation of CU2 in profit or loss.

When insurer A sells the assets in 20X6, it makes no further adjustment to DAC.

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain. If insurer A does not adopt shadow accounting, unrealised gains on assets do not affect the amortisation of DAC.

IGA8

Paragraph IG65A is amended to read as follows:

IG65A The issuer of a financial guarantee contract provides disclosures complying with IFRS 7 if it applies IFRS 9 in recognising and measuring the contract. If the issuer elects, when permitted by paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and

measuring the contract, it provides disclosures complying with IFRS 4. The main implications are as follows:

- (a) IFRS 4 requires disclosure about actual claims compared with previous estimates (claims development), but does not require disclosure of the fair value of the contract.
- (b) IFRS 7 requires disclosure of the fair value of the contract, but does not require disclosure of claims development.

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

IGA9 The tables in Example 10 are amended to read as follows:

	Carrying amount at the end of the reporting period before classification as held for sale	Carrying amount as remeasured immediately before classification as held for sale
	CU*	CU
Goodwill	1,500	1,500
Property, plant and equipment (carried at revalued amounts)	4,600	4,000
Property, plant and equipment (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investments in equity instruments	1,800	1,500
Total	16,000	14,900

* In this guidance, monetary amounts are denominated in 'currency units (CU)'.

...

The impairment loss is allocated to non-current assets to which the measurement requirements of the IFRS are applicable. Therefore, no impairment loss is allocated to inventory and investments in equity instruments. The loss is allocated to the other assets in the order of allocation set out in paragraphs 104 and 122 of IAS 36 (as revised in 2004).

...

	Carrying amount as remeasured immediately before classification as held for sale	Allocated impairment loss	Carrying amount after allocation of impairment loss
	CU	CU	CU
Goodwill	1,500	(1,500)	0
Property, plant and equipment (carried at revalued amounts)	4,000	(165)	3,835
Property, plant and equipment (carried at cost)	5,700	(235)	5,465
Inventory	2,200	–	2,200
Investments in equity instruments	1,500	–	1,500

	Financial assets at fair value			Total
	Trading securities	Trading derivatives	Equity investments	
	CU million	CU million	CU million	CU million
Opening balance	6	5	3	14
Total gains or losses				
in profit or loss	(2)	(2)	–	(4)
in other comprehensive income	–	–	1	1
Purchases	1	2	1	4
Issues	–	–	–	–
Settlements	–	(1)	–	(1)
Transfers out of Level 3	–	(2)	–	(2)
Closing balance	<u>5</u>	<u>2</u>	<u>5</u>	<u>12</u>
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	<u>(1)</u>	<u>(1)</u>	<u>–</u>	<u>(2)</u>
Gains or losses included in profit or loss for the period (above) are presented in trading income and in other income as follows:				
			Trading Income	
Total gains or losses included in profit or loss for the period			<u>(4)</u>	
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period			<u>(2)</u>	
(Note: For liabilities, a similar table might be presented.)				

IGA14

Paragraph IG14 and the illustrative disclosure following paragraph IG14 are amended to read as follows:

IG14 The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph B5.4.8 of IFRS 9. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognised in profit or loss in subsequent periods in accordance with IFRS 9 and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph B5.4.9 of IFRS 9).

Paragraph 28 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 28:

...

Accounting policies

The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IFRS 9, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IFRS 9, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

IGA15 Paragraph IG36 is amended to read as follows:

IG36 The following example illustrates the application of the disclosure requirement in paragraph 40(a):

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X). [footnote omitted] ...

IGA15A The heading 'Hedge accounting (paragraphs 24A–24C)' and paragraphs IG13C–IG13E are added as follows:

Hedge accounting (paragraphs 24A-24C)

IG13C Paragraph 24A of IFRS 7 requires that an entity discloses amounts related to items designated as hedging instruments in a tabular format. The following example illustrates how that information might be disclosed.

	Nominal amount of the hedging instrument	Carrying amount of the hedging instrument		Line item in the statement of financial position where the hedging instrument is located	Changes in fair value used for calculating hedge ineffectiveness for 201X
		Assets	Liabilities		
Cash flow hedges					
Commodity price risk - Forward sales contracts	xx	xx	xx	Line item XX	xx
Fair value hedges					
Interest rate risk - Interest rate swaps	xx	xx	xx	Line item XX	xx
Foreign exchange risk - Foreign currency loan	xx	xx	xx	Line item XX	xx

IG13D Paragraph 24B of IFRS 7 requires that an entity discloses amounts related to items designated as hedged items in a tabular format. The following example illustrates how that information might be disclosed.

	Carrying amount of the hedged item		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Line item in the statement of financial position in which the hedged item is included	Change in value used for calculating hedge ineffectiveness for 201X	Cash flow hedge reserve
	Assets	Liabilities	Assets	Liabilities			
Cash flow hedges							
Commodity price risk							
- Forecast sales	n/a	n/a	n/a	n/a	n/a	xx	xx
- Discontinued hedges (forecast sales)	n/a	n/a	n/a	n/a	n/a	n/a	xx
Fair value hedges							
Interest rate risk							
- Loan payable	-	xx	-	xx	Line item XX	xx	n/a
- Discontinued hedges (Loan payable)	-	xx	-	xx	Line item XX	n/a	n/a
Foreign exchange risk							
- Firm commitment	xx	xx	xx	xx	Line item XX	xx	n/a

IG13E Paragraph 24C of IFRS 7 requires that an entity discloses amounts that have affected the statement of comprehensive income as a result of applying hedge accounting 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 ^(b)	Change in the value of the hedging instrument recognised in other comprehensive income	Hedge ineffectiveness recognised 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 Commodity X	n/a	xx	xx	Line item XX	xx	Line item XX
- Discontinued hedge	n/a	n/a	n/a	n/a	xx	Line item XX
<p>(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.</p> <p>(b) This disclosure only applies to cash flow hedges of foreign currency risk.</p>						

Fair value hedges	Ineffectiveness recognised in profit or loss	Line item(s) in profit or loss (that include(s) hedge ineffectiveness)
Interest rate risk	xx	Line item XX
Foreign exchange risk	xx	Line item XX

IAS 1 Presentation of Financial Statements

IGA16 The heading above paragraph IG7 and paragraphs IG7–IG9 are deleted. Paragraph IG2 is amended to read as follows:

IG2 The guidance is in two sections. Paragraphs IG3–IG6 provide examples of the presentation of financial statements. Paragraphs IG7–IG9 have been deleted. Paragraphs IG10 and IG11 provide examples of capital disclosures.

IGA17 In the illustrative financial statements, references to ‘Available-for-sale financial assets’ are replaced by ‘Investments in equity instruments’. In the single statement of comprehensive income the reference to footnote (b) against the deleted line item ‘Available-for-sale financial assets’ is deleted. The heading and table ‘Disclosure of components of other comprehensive income’ are amended to read as follows:

Part I: Illustrative presentation of financial statements			
Disclosure of components of other comprehensive income [footnote omitted]			
Notes			
Year ended 31 December 20X7			
(in thousands of currency units)			
	20X7		20X6
Other comprehensive income:			
Exchange differences on translating foreign operations [footnote omitted]	5,334		10,667
Investments in equity instruments	(24,000)		26,667
Cash flow hedges:			
Gains (losses) arising during the year	(4,667)	(4,000)	
Less: Reclassification adjustments for gains (losses) included in profit or loss	<u>4,000</u>	(667)	<u>–</u> (4,000)
Gains on property revaluation	933		3,367
Actuarial gains (losses) on defined benefit pension plans	(667)		1,333
Share of other comprehensive income of associates	<u>400</u>		<u>(700)</u>
Other comprehensive income	(18,667)		37,334
Income tax relating to components of other comprehensive income [footnote omitted]	4,667		(9,334)

Other comprehensive income for the year	(14,000)	28,000

IGA18 The second paragraph in footnote (k) to the illustrative financial statements is amended to read as follows:

- (k) The amount included in the translation, investments in equity instruments and cash flow hedge reserves represents other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to investments in equity instruments for 20X6 of 16,000 is 26,667, less tax 6,667, less non-controlling interests 4,000.

IGA19 The second paragraph in footnote (l) to the illustrative financial statements is amended to read as follows:

- (l) The amount included in the translation, investments in equity instruments and cash flow hedge reserves represents other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to the translation of foreign operations for 20X7 of 3,200 is 5,334, less tax 1,334, less non-controlling interests 800.

IAS 18 Revenue

IGA20 In the illustrative examples, paragraphs 5 and 14 are amended to read as follows:

5 ...

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, IFRS 9 *Financial Instruments* applies.

14 *Financial service fees*

...

- (a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

...

- (i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IFRS 9 is measured at fair value through profit or loss.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition,

evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs [footnote omitted] (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IFRS 9, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in IAS 39), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

- (iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as at fair value through profit or loss, the origination fees received are included, with the related transaction costs (as defined in IAS 39) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

- (b) *Fees earned as services are provided.*

(i) ...

- (ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IFRS 9, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that

are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

(iii) ...

IAS 27 Consolidated and Separate Financial Statements

- IGA21 Paragraph IG7 is amended to read as follows:
- IG7 IFRS 9 *Financial Instruments* does not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27, IAS 28 and IAS 31 respectively. When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of IFRS 9. In all other cases, instruments containing potential voting rights are accounted for in accordance with IFRS 9.
- IGA22 A footnote is added to 'IAS 39' after the Table of Concordance as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all financial items within the scope of IAS 39. This section refers to matters relevant when IAS 27 was issued.

IAS 32 Financial Instruments: Presentation

- IGA23 Paragraph IE1 is amended to read as follows:
- IE1 The following examples [footnote omitted] illustrate the application of paragraphs 15–27 and IFRS 9 to the accounting for contracts on an entity's own equity instruments (other than the financial instruments specified in paragraphs 16A and 16B or paragraphs 16C and 16D).
- IGA24 In the example in paragraph IE5, the caption below the first journal entry is amended to read as follows:
- To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IFRS 9, paragraph B5.1.1).*

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

- IGA25 Example 9 is amended to read as follows:
- On 31 December 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1, the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.
- This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*, but is within the scope of IFRS 9 *Financial Instruments*,

because it also meets the definition of a financial guarantee contract in IFRS 9. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 4 or IFRS 9 to such financial guarantee contracts. IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits and that also complies with the requirements in IFRS 9 for financial guarantee contracts within the scope of IFRS 9.

IAS 39 Financial Instruments: Recognition and Measurement

- IGA26 Sections C, D and F are deleted.
- IGA27 The following Questions and Answers (Q&A) are deleted:
- Section B Definitions: B.1–B.23, B.28–B.32
 - Section E Measurement: E.1, E.3, E.4.9, E.4.10
- IGA28 In the answer to Question A.1, ‘IAS 39’ is amended to ‘IFRS 9’.
- IGA29 In the answer to Question A.2, ‘exemption from IAS 39’ is amended to ‘exemption from paragraph 5 of IAS 39’.
- IGA30 Question B.26 is amended to read as follows:
- How is amortised cost calculated for financial assets measured at amortised cost in accordance with IFRS 9?**
- IGA31 In the answer to Question E.2.1, ‘IAS 39.AG72’ is amended to ‘paragraph B5.4.4 of IFRS 9’.
- IGA32 In the answer to Question E.2.2, ‘IAS 39.AG71’ is amended to ‘paragraph B5.4.3 of IFRS 9’.
- IGA33 The answer to Question E.4.2 is amended to read as follows:
- No. Paragraph 5.1.1 of IFRS 9 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, paragraph 5.2.2 of IFRS 9 requires an entity to apply the impairment requirements in IAS 39. IAS 39.58 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with paragraph 5.1.1 of IFRS 9 and IAS 39.58 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.
- IGA34 Question E.4.5 is amended to read as follows:
- A financial institution calculates impairment in the unsecured portion of financial assets measured at amortised cost on the basis of a provision matrix that specifies fixed provision rates for the number of days a financial asset has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90–180 days, 50 per cent if 181–365 days and 100 per cent if more than 365 days). Can the results be considered**

to be appropriate for the purpose of calculating the impairment loss on the financial assets measured at amortised cost under IAS 39.63?

IGA43

Q&A G.1 is amended to read as follows:

IFRS 9 requires remeasurement of financial assets and financial liabilities measured at fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in profit or loss, and fair value changes for financial assets designated at fair value through other comprehensive income are recognised in other comprehensive income. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IFRS 7.20 requires items of income, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognised in profit or loss and changes that are recognised in other comprehensive income. Further breakdown is provided of changes that relate to:

- (a) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are mandatorily measured at fair value in accordance with IFRS 9. For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss;
- (b) financial assets measured at fair value through other comprehensive income; and
- (c) hedging instruments.

In addition, IFRS 7.11A and IFRS 7.11B require an entity to disclose the amount of gain or loss recognised in other comprehensive income for financial assets measured at fair value through other comprehensive income, including any amount transferred within equity.

IFRS 7 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that meet the definition of held for trading in IFRS 9, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IFRS 7.8 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition; (ii) financial assets mandatorily classified as such in accordance with IFRS 9; (iii) financial liabilities that meet the definition of held for trading in IFRS 9; and (iv) disclosures of financial assets measured at fair value through other comprehensive income.

IGA43A In the title of, and the answer to, Question G.2, references to 'IAS 39' are replaced with 'IFRS 9'.

IFRIC 12 Service Concession Arrangements

IGA44 Paragraphs IE7 and IE28 are amended to read as follows:

IE7 IFRS 9 *Financial Instruments* may require the entity to measure the amounts due from the grantor at amortised cost, unless the entity designates those amounts as measured at fair value through profit or loss. If the receivable is measured at amortised cost in accordance with IFRS 9, it is measured initially at fair value and subsequently at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.

IE28 IFRS 9 *Financial Instruments* may require the entity to measure the amount due from or at the direction of the grantor in exchange for the construction services at amortised cost. If the receivable is measured at amortised cost in accordance with IFRS 9, it is measured initially at fair value and subsequently at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments.

IFRIC 16 Hedges of a Net Investment in a Foreign Operation

IGA45 Paragraph IE5 is amended to read as follows:

IE5 When the investment in Subsidiary C is disposed of, IFRS 9 requires the full €24 million gain on the hedging instrument to be reclassified to profit or loss. ...

Tables of Concordance

This table shows how the contents of IAS 39 and IFRS 9 correspond. In transferring the material from IAS 39 to IFRS 9 some minor editorial changes have been necessary.

Paragraph in IAS 39 (as amended by IFRS 9 in 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IAS 39 (as amended by IFRS 9 in 2009)	Paragraphs in IFRS 9 (October 2010)	
1—deleted		103–103G—not moved		
2–8—not moved		103H–103J—deleted		
		103M	7.2.9	
		105–107A—deleted		
9—the following definitions are moved to IFRS 9:	The definitions noted were added to Appendix A	108–108C—not moved		
• derecognition		109–110—not moved		
• derivative		AG1–AG4A—not moved		
• fair value		AG4B–AG4K	B4.1.27–B4.1.36	
• financial guarantee contract		AG5–AG8—not moved		
• financial liability at fair value through profit or loss		AG9–AG12A	BA.1–BA.5	
• held for trading		AG13—not moved		
• regular way purchase or sale		AG14–AG15	BA.6–BA.8	
10		4.3.1	AG27–AG33B	B4.3.1–B4.3.10
11–13		4.3.3–4.3.7	AG34, AG35	B3.1.1, B3.1.2
14	3.1.1	AG36–AG52	B3.2.1–B3.2.17	
15–37	3.2.1–3.2.23	AG53–AG56	B3.1.3–B3.1.6	
38	3.1.2	AG57–AG63	B3.3.1–B3.3.7	
39–42	3.3.1–3.3.4	AG64	B5.1.1	
43, 44	5.1.1, 5.1.2	AG69–AG79	B5.4.1–B5.4.12	
47	4.2.1	AG80, AG81—deleted		
48–49	5.4.1–5.4.3	AG82	B5.4.13	
50, 50A	4.4.2, 4.4.3	AG83	B5.7.2, B5.7.4	
53 and 54—deleted		AG84–AG93—not moved		
55	5.7.1	AG94–AG95—not moved		
56	5.7.2, 5.7.3	AG96—deleted		
57	5.7.4	AG97–AG133—not moved		
58–65—not moved				
71–102—not moved				

This table shows how the contents of IFRS 9 (issued in November 2009) and IFRS 9 (issued in October 2010) correspond.

Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)
1.1	1.1	8.2.4	7.2.4
2.1	2.1	8.2.5	7.2.5
3.1.1	3.1.1	8.2.6	7.2.6
3.1.2	Replaced by amended 3.1.2	8.2.7	7.2.7
4.1	4.1.1	8.2.8	7.2.8
4.2	4.1.2	8.2.9	Replaced by 7.2.9
4.3	4.1.3	8.2.10	7.2.10
4.4	4.1.4	8.2.11	7.2.11
4.5	4.1.5	8.2.12	7.2.14
4.6	4.3.1	8.2.13	7.2.15
4.7	4.3.2	B4.1	B4.1.1
4.8	Replaced by 4.3.3–4.3.7	B4.2	B4.1.2
4.9	4.4.1	B4.3	B4.1.3
5.1.1	5.1.1	B4.4	B4.1.4
5.2.1	5.2.1	B4.5	B4.1.5
5.2.2	5.2.2	B4.6	B4.1.6
5.2.3	5.2.3	B4.7	B4.1.7
5.3.1	5.6.1	B4.8	B4.1.8
5.3.2	5.6.2	B4.9	B4.1.9
5.3.3	5.6.3	B4.10	B4.1.10
5.4.1	Replaced by 5.7.1	B4.11	B4.1.11
5.4.2	5.7.2	B4.12	B4.1.12
5.4.3	Replaced by 5.7.3	B4.13	B4.1.13
5.4.4	5.7.5	B4.14	B4.1.14
5.4.5	5.7.6	B4.15	B4.1.15
8.1.1	Replaced by 7.1.1	B4.16	B4.1.16
8.2.1	7.2.1	B4.17	B4.1.17
8.2.2	7.2.2	B4.18	B4.1.18
8.2.3	7.2.3	B4.19	B4.1.19
Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)
B4.22	B4.1.22	B4.20	B4.1.20
		B4.21	B4.1.21
		Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)
		B5.7	B5.4.16

HEDGE ACCOUNTING

B4.23	B4.1.23
B4.24	B4.1.24
B4.25	B4.1.25
B4.26	B4.1.26
B5.1	B5.1.1
B5.2	B5.1.2
B5.3	B5.2.1
B5.4	B5.2.2
B5.5	B5.4.14
B5.6	B5.4.15

B5.8	B5.4.17
B5.9	B4.4.1
B5.10	B4.4.2
B5.11	B4.4.3
B5.12	B5.7.1
B5.13	B5.7.2
B5.14	B5.7.3
B5.15	B5.7.4
B8.1	B7.2.1