

Applying IFRS

Hedge accounting under IFRS 9

February 2014

The EY logo is positioned at the bottom left of the page. It consists of the letters 'EY' in a bold, white, sans-serif font. The 'E' and 'Y' are connected at the top. The background of the entire page is a photograph of a waterfall cascading over mossy rocks, with a bright yellow diagonal stripe cutting across the lower right portion. A series of white vertical lines of varying heights on the left side of the page converge towards the yellow stripe.

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The new hedge accounting model aims to provide a better link between an entity's risk management strategy, the rationale for hedging and the impact of hedging on the financial statements.

1. Introduction

On 19 November 2013 the International Accounting Standards Board (IASB) issued a new version of IFRS 9 *Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39) (IFRS 9 (2013)), which primarily introduces the new hedge accounting requirements. IFRS 9 (2013) does not provide any particular solutions specifically tailored to so-called 'macro hedge' accounting, the term used to describe the more complex risk management practices used by entities such as banks. An accounting model specifically for macro hedging is being developed as a separate standard and a discussion paper on this subject is due to be published in the first quarter of 2014.

The high-level aim of the new hedge accounting model is to provide useful information about risk management activities that use financial instruments, with the effect that financial reporting will reflect more accurately how an entity manages its risk and the extent to which hedging mitigates those risks. Specifically, the new model aims to provide a better link between an entity's risk management strategy, the rationale for hedging and the impact of hedging on the financial statements.

Snapshot of the most significant areas of change for hedge accounting:

Requirement	High-level summary of key changes
Hedge effectiveness testing	This is prospective only and can be qualitative, depending on the complexity of the hedge. The 80-125% range is replaced by an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship.
Risk component	This may be designated as the hedged item, not only for financial items, but also for non-financial items, provided the risk component is separately identifiable and reliably measurable.
Costs of hedging	The time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging. This means that, instead of the fair value changes of these elements affecting profit or loss like a trading instrument, these amounts get allocated to profit or loss similar to transaction costs (which can include basis adjustments), while fair value changes are temporarily recognised in other comprehensive income (OCI).
Groups of items	More designations of groups of items as the hedged item are possible, including layer designations and some net positions.
Disclosures	These are more extensive and require the provision of more meaningful information and insights.

Applying IFRS 9 (2013), before it is superseded by a consolidated version, would enable hedge accounting to be applied whilst deferring the application of the impairment requirements until the mandatory effective date.

The addition of the new hedge accounting requirements mean that, for the first time, the application of IFRS 9 will be a serious consideration for non-financial entities. For many of them, hedge accounting will be the most significant effect of the reform of the accounting for financial instruments. In particular, non-financial entities will have an incentive to apply IFRS 9 (2013) before the IASB completes its phase on impairment because the IASB then intends to create a consolidated version of IFRS 9 that will reduce the early application choices for different parts of the standard. Applying IFRS 9 (2013), before it is superseded by a consolidated version, would enable hedge accounting to be applied whilst deferring the application of the impairment requirements until the mandatory effective date.¹ Based on previous IASB discussions, once the new consolidated version of IFRS 9 has replaced IFRS 9 (2013), entities may be left with no choice but to early apply the hedge accounting and impairment requirements (and the revised classification and measurement requirements) all at the same time.

To gauge the benefits of the new requirements, non-financial entities will need to consider their hedging activities and existing hedge accounting, or why hedge accounting has not been achieved in the past. This assessment encompasses operational aspects (such as the hedge effectiveness test) as well as the eligibility of items (such as risk components of non-financial items) that can be designated in hedging relationships.

For financial entities, the situation is more complex: the ongoing development of the limited amendments to the classification and measurement of financial instruments, as well as the projects on accounting for macro hedging and insurance contracts, create more uncertainty about the eventual picture and how the different projects will interact.

In this publication, we have taken a closer look at the new requirements, consider some of the potential benefits for reporting entities and also explore some of the challenges posed by them. We expect the insights in this publication to be particularly relevant for accountants, treasurers and all who are involved in hedging activities in both financial and non-financial services entities.

1.2 The main changes in the IFRS 9 hedge accounting requirements

Hedge accounting under IAS 39 *Financial Instruments: Recognition and Measurement* is often criticised as being complex and rules-based, thus, ultimately not reflecting an entity's risk management activities. Consequently, the objective of IFRS 9 is to reflect the effect of an entity's risk management activities in the financial statements. This includes replacing some of the arbitrary rules by more principle-based requirements and allowing more hedging instruments and hedged items to qualify for hedge accounting. Overall, this should result in more risk management strategies qualifying for hedge accounting.

Some of the basics of hedge accounting do not change as a result of IFRS 9. There are still three types of hedging relationships:

- ▶ Fair value hedges
- ▶ Cash flow hedges
- ▶ Hedges of net investments in foreign operations

¹ In February 2014, the IASB tentatively decided that the mandatory effective date for IFRS 9 will be for annual periods beginning on or after 1 January 2018.

Hedge accounting remains optional and can only be applied to hedging relationships that meet the qualifying criteria.

Hedge accounting remains optional and can only be applied to hedging relationships that meet the qualifying criteria (see sections 3, 4 and 5).

IFRS 9 does not revisit the mechanics for hedges of net investments in foreign operations. Such hedges must still be accounted for similar to cash flow hedges. IFRS 9 did have some consequential amendments to IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*.

Rather than providing a comprehensive summary of hedge accounting, this publication focuses on the differences between hedge accounting under IAS 39 and the hedge accounting requirements in IFRS 9.

2. Risk management

2.1 Objective of hedge accounting

Every entity is exposed to business risks from its daily operations. Many of those risks have an impact on the cash flows or the value of assets and liabilities, and therefore, ultimately affect profit or loss. In order to manage these risk exposures, companies often enter into derivative contracts (or, less commonly, other financial instruments) to hedge them. Hedging can, therefore, be seen as a risk management activity in order to change an entity's risk profile.

Applying the normal IFRS accounting requirements to those risk management activities can then result in accounting mismatches, when the gains or losses on a hedging instrument are not recognised in the same period(s) and/or in the same place in the financial statements as gains or losses on the hedged exposure. The idea of hedge accounting is to reduce this mismatch by changing either the measurement or (in the case of certain firm commitments) recognition of the hedged exposure, or the accounting for the hedging instrument.

Although the hedge accounting requirements in IAS 39 resolve many of the above-mentioned accounting mismatches, they do not accommodate some risk management activities that are commonly applied in practice. Furthermore, some of the requirements in IAS 39 are arguably arbitrary, such as the 80%-125% effectiveness requirement, and may lead to economic risk management activities not or no longer qualifying for hedge accounting.

As a result, the financial statements of many entities do not necessarily reflect what is done for risk management purposes, which is unhelpful for preparers and users alike. The IASB took this as the cornerstone of its project for a new hedge accounting model. Consequently, the objective of the hedge accounting requirements brought by IFRS 9 is to 'represent, in the financial statements, the effect of an entity's risk management activities.' This is a rather broad objective that focuses on an entity's risk management activities and reflects what the Board wanted to achieve with the new accounting requirements. However, this broad objective does not override any of the hedge accounting requirements, which is why the Board noted that hedge accounting is only permitted if all the new qualifying criteria are met (see section 5 below).

2.2 Risk management strategy versus risk management objective

Linking hedge accounting with an entity's risk management activities requires an understanding of what those risk management activities are. IFRS 9 distinguishes between the *risk management strategy* and the *risk management objective*:

Understanding the difference between the risk management strategy and the risk management objective is critical for assessing whether to continue applying hedge accounting for a particular hedging relationship.

- ▶ The *risk management strategy* is established at the highest level of an entity and identifies the risks to which the entity is exposed and whether and how the risk management activities should address those risks. For example, a risk management strategy could identify changes in interest rates of loans as a risk and define a specific target range for the fixed to floating rate ratio for those loans. The strategy is typically maintained for a relatively long period of time. However, it may include some flexibility to react to changes in circumstances.

IFRS 9 refers to the risk management strategy as normally being set out in 'a general document that is cascaded down through an entity through policies containing more specific guidelines.'

The Board added specific disclosure requirements to IFRS 7 *Financial Instruments: Disclosures* that should allow users of the financial statements to understand the risk management activities of an entity and how they affect the financial statements (see section 9.1):

- ▶ The *risk management objective*, on the contrary, is set at the level of an individual hedging relationship and defines how a particular hedging instrument is designated to hedge a particular hedged item. For example, this would define how a specific interest rate swap is used to 'convert' a specific fixed rate liability into a floating rate liability. Hence, a risk management strategy would usually be supported by many risk management objectives.

How we see it

Small and medium-sized entities with limited risk management activities that use financial instruments, may not have a formal written document outlining their overall risk management strategy in place. Those entities do not have the benefit of being able to incorporate the risk management strategy in their hedge documentation by reference to a formal policy document but instead have to include a description of their risk management strategy directly in their hedge documentation. Also, there are disclosure requirements for the risk management strategy that apply irrespectively of whether an entity uses a formal written policy document as part of its risk management activities.

Two examples of a risk management strategy with a related risk management objective are illustrated below:

Example 1 – Risk management strategies with related risk management objectives

Risk management strategy	Risk management objective
Maintain 40% of financial debt at floating interest rate	Designate an interest rate swap as a fair value hedge of a GBP100m fixed rate liability
Hedge foreign currency risk of up to 70% of forecast sales in USD up to 12 months	Designate a foreign exchange forward contract to hedge the foreign exchange risk of the first USD100m sales in March 2013

Understanding the difference between the risk management strategy and the risk management objective is critical, as a change in a risk management objective, or a specific action without a corresponding change in the risk

management objective, may affect the ability to continue applying hedge accounting. This is illustrated in section 6.3 below.

3. Hedged items

3.1 General requirements

The general requirements of what qualifies as an eligible hedged item are unchanged compared to IAS 39. A hedged item can be:

- ▶ A recognised asset or liability
- ▶ An unrecognised firm commitment
- ▶ A highly probable forecast transaction

Or

- ▶ A net investment in a foreign operation

All of above can either be a single item or a group of items, provided the specific requirements for a group of items are met (see section 3.6 below).

Only assets, liabilities, firm commitments and forecast transactions with an external party qualify for hedge accounting. As an exception, a hedge of the foreign currency risk of an intragroup monetary item qualifies for hedge accounting if that foreign currency risk affects consolidated profit or loss. In addition, the foreign currency risk of a highly probable forecast intragroup transaction would also qualify as a hedged item if that transaction affects consolidated profit or loss. These requirements are unchanged from IAS 39.

As with IAS 39, the item being hedged must still be reliably measurable. Also unchanged from IAS 39, a forecast transaction must be highly probable. However, what has changed in IFRS 9, compared to IAS 39, is how hedged items are designated in a hedging relationship. In particular, the designation of risk and nominal components and the designation of aggregated exposures and groups of items have changed. These changes, which should ultimately lead to more risk management activities qualifying for hedge accounting, all stem from the broader goal of the hedge accounting project, to better align an entity's risk management approach with the accounting outcome.

In the remainder of this section, we focus on changes in the designation of hedged items compared to IAS 39.

3.2 Hedges of exposures affecting other comprehensive income

Only hedges of exposures that could affect profit or loss qualify for hedge accounting. The sole exception to this rule is when an entity is hedging an investment in equity instruments for which it has elected to present changes in fair value in OCI, as permitted by IFRS 9. Using that election, gains or losses on the equity investments will never be recognised in profit or loss.

For such a hedge, the fair value change of the hedging instrument is recognised in OCI. Ineffectiveness is also recognised in OCI. On sale of the investment, gains or losses accumulated in OCI are not reclassified to profit or loss. Consequently, the same also applies for any accumulated fair value changes on the hedging instrument, including any ineffectiveness.

An aggregated exposure is a combination of an exposure that could qualify as a hedged item and a derivative.

3.3 Aggregated exposures

Entities often purchase or sell items (in particular, commodities) that expose them to more than one type of risk. When hedging those risk exposures, entities do not always hedge each risk for the same time period. This is best explained with an example:

Example 2 – Aggregated exposure - copper purchase in a foreign currency

An entity manufacturing electrical wires is expecting to purchase copper in 12 months. The copper price is fluctuating and is denominated in US dollars (USD), which is a foreign currency for the entity. The entity is exposed to two main risks, the copper price risk and the foreign exchange risk.

The entity first decides to hedge the copper price fluctuation risk using a copper futures contract. By doing so, the entity now has a fixed-price copper purchase denominated in a foreign currency and is therefore still exposed to foreign exchange risk.²

Three months later, the entity decides to hedge the foreign exchange risk by entering into a foreign exchange forward contract to buy a fixed amount of USD in nine months. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure to variability of the copper price and the copper futures contract.

IAS 39 precludes derivatives from being designated as part of a hedged item for accounting purposes. Applying IAS 39 to the scenario in Example 2 above, an entity would have two choices:

- ▶ Discontinue the first hedging relationship (i.e., the copper price risk hedge) and re-designate a new relationship with joint designation of the copper futures contract and the foreign exchange forward contract as the hedging instrument. This is likely to lead to some 'accounting' hedge ineffectiveness as the copper futures contract will now have a non-zero fair value on designation of the new relationship.

Or

- ▶ Maintain the copper price risk hedge and designate the foreign exchange forward contract in a second relationship as a hedge of the variable USD copper price. Even if the other IAS 39 requirements could be met, this means that the volume of hedged item is constantly changing as the variable copper price is hedged for foreign exchange risk, which will likely have an impact on the effectiveness of the hedging relationship.

IFRS 9 expands the range of eligible hedged items by including aggregated exposures that are a combination of an exposure that could qualify as a hedged item and a derivative.

Consequently, in the scenario described in Example 2 above, the entity could designate the foreign exchange forward contract in a cash flow hedge of the combination of the original exposure and the copper futures contract (i.e., the aggregated exposure) without affecting the first hedging relationship. In other words, it would no longer be necessary to discontinue and re-designate the first hedging relationship.

² In this example, we assume there is no 'basis risk' between the copper price exposures in the expected purchase and the futures contract, such as the effect of quality and the location of delivery.

IFRS 9 expands the range of eligible hedged items by including aggregated exposures. This expansion, however, comes with some necessary complexity in the accounting for that type of hedge designation.

The individual items in the aggregated exposure are accounted for separately, applying the normal requirements of hedge accounting (i.e., there is no change in the unit of accounting; the aggregated exposure is not treated as a 'synthetic' single item). For example, when hedging a combination of a variable rate loan and a pay fixed/receive variable interest rate swap (IRS), the loan would still be accounted for at amortised cost with the IRS presented separately in the statement of financial position. An entity would not be allowed to present the IRS and the loan (i.e., the aggregated exposure) together in one line item (i.e., as if it were one single fixed rate loan).

However, when assessing the effectiveness and measuring the ineffectiveness of a hedge of an aggregated exposure, the combined effect of the items in the aggregated exposure has to be taken into consideration. This is of particular relevance if the terms of the hedged item and the hedging instrument in the first hedging relationship do not perfectly match, e.g., if there is basis risk. Any ineffectiveness in the first level relationship would automatically also lead to ineffectiveness in the second level relationship.

Basis risk, in the context of hedge accounting, refers to any difference in the underlyings of the hedging instrument and the hedged item. Basis risk usually results in a degree of hedge ineffectiveness. For example, hedging a cotton purchase in India with NYMEX cotton futures contracts is likely to result in some ineffectiveness, as the hedged item and the hedging instrument do not share exactly the same underlying price.

The following examples, partly derived from illustrative examples in the implementation guidance of IFRS 9, help to further explain the concept of a hedge of an aggregated exposure:

Example 3 – Fixed rate loan in a foreign currency - cash flow hedge of an aggregated exposure

An entity has a fixed rate borrowing denominated in a foreign currency and is therefore exposed to foreign exchange risk and fair value risk due to changes in interest rates. The entity decides to swap the borrowing into a functional currency floating rate borrowing using a cross currency interest rate swap (CCIRS). The CCIRS is designated as hedging instrument in a fair value hedge (first-level relationship). By doing so, the entity has eliminated both the foreign exchange risk and the fair value risk due to changes in interest rates. However, it is now exposed to variable functional currency interest payments.

Later, the entity decides to fix the amount of functional currency interest payments by entering into an IRS to pay fix and receive floating interest in its functional currency. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure and the CCIRS. The IRS is designated as a hedging instrument in a cash flow hedge (second-level relationship).

Example 4 – Floating rate loan in a foreign currency - fair value hedge of an aggregated exposure

An entity has a floating rate borrowing denominated in a foreign currency and is therefore exposed to foreign exchange risk and cash flow risk due to changes in interest rates. The entity decides to swap the borrowing into a functional currency fixed rate borrowing using a CCIRS. The CCIRS is designated as hedging instrument in a cash flow hedge (first-level relationship). By doing so, the entity has eliminated both the foreign exchange risk and the cash flow risk due to changes in interest rates. However, it is now exposed to a fair value risk resulting from changes in the functional currency interest rate curve.

Later, the entity decides to hedge this fair value risk and enters into an IRS that receives fixed rate and pays floating rate interest in its functional currency. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure and the CCIRS. The IRS is designated as a hedging instrument in a fair value hedge (second-level relationship).

The concept of hedging aggregated exposures as such is straightforward. However, the accounting for such relationships includes some (necessary) complexity. The accounting mechanics are explained in detail in the illustrative examples in paragraphs IE7-IE39 of the implementation guidance of IFRS 9. In Example 4 above, where an entity has a cash flow hedge in the first-level relationship that is then designated as the hedged item in a fair value hedge, the cross-currency interest rate swap is both a hedging instrument and part of a hedged item at the same time but in different hedging relationships. Its fair value changes are recognised in OCI, but at the same time, should also offset the fair value changes in profit or loss of the interest rate swap in the second-level relationship. This requires a reclassification of the amounts recognised in OCI to profit or loss (to the extent they relate to the second-level relationship) to achieve the offset in the fair value hedging relationship.

As explained in the illustrative examples in the implementation guidance, the application of hedge accounting to an aggregated exposure gets even more complicated when basis risk is involved in one of the hedging relationships, in particular if basis risk is present in the first-level relationship.

The definition of an aggregated exposure includes a forecast transaction of an aggregated exposure. An example, where this might be helpful is when pre-hedging the interest rate risk in a forecast foreign currency debt issue:

Example 5 – Aggregated exposure - interest rate pre-hedge of forecast foreign currency debt issue

Assume it is highly probable that an entity will issue fixed rate foreign currency debt in six month's time. It is also highly probable that on issuance the entity will transact a CCIRS, converting the debt to functional currency variable rate. The combination of the forecast foreign currency fixed rate debt issuance and the forecast conclusion of the CCIRS is a forecast functional currency variable rate debt issuance.

The entity wishes to hedge itself against increases in the variable functional currency interest rate between today and the issue of the debt in six months as well as over the term of the debt. Therefore, the entity enters into a forward starting pay fixed/receive variable IRS. The entity designates the IRS as a hedging instrument in a cash flow hedge of the forecast aggregated exposure.

As an aggregated exposure is a combination of an exposure and a derivative, the aggregated exposure is often a hedging relationship itself (the first-level relationship). IFRS 9 only requires the first-level relationship to be one that *could* qualify for hedge accounting. The application of hedge accounting for the first-level relationship is not required in order to qualify for hedge accounting for the aggregated exposure. However, applying hedge accounting to the aggregated exposure is more complex when hedge accounting is not applied to the first-level relationship.

3.4 Risk components

3.4.1 General requirements

Instead of hedging the total changes in fair values or cash flows, risk managers often enter into derivatives to only hedge specific risk components. Managing a specific risk component reflects that hedging all risks is often not economical and hence not desirable, or not possible (because of a lack of suitable hedging instruments).

However, under IAS 39, a non-financial item can only be designated as the hedged item for its foreign currency risk or all its risks in their entirety. There is no such restriction for financial items, therefore creating an inconsistency in hedge accounting for risks of financial and non-financial items. This results in many risk management activities, in particular those of non-financial services entities, not qualifying for hedge accounting under IAS 39, or else hedge ineffectiveness being artificially overstated.

The hedge accounting requirements in IFRS 9 now permit an entity to designate a risk component of a non-financial item as the hedged item in a hedging relationship, provided the risk component is separately identifiable and reliably measurable. This is likely to enable many more common risk management strategies to qualify for hedge accounting and will result in less ineffectiveness in profit or loss.

A risk component may be contractually specified or it may be implicit in the fair value or the cash flows of the item to which the component belongs. However, the mere fact that a physical component is part of the make-up of the whole item does not mean that the component necessarily qualifies as risk component for hedge accounting purposes. A physical component is neither required nor by itself sufficient to meet the criteria for risk components that are eligible as a hedged item. However, depending on the market structure, a physical component can help meet those criteria (see section 3.4.3 below). For example, just because rubber is a physical component of car tyres that does not mean that an entity can automatically designate rubber as a risk component in a hedge of forecast tyre purchases or sales, since the price of tyres, may be related only indirectly to the price of rubber. Further analysis of the pricing structure of the whole car tyre would be required.

3.4.2 Contractually specified risk components

Purchase or sales agreements sometimes contain clauses that link the contract price via a specified formula to a benchmark price of a commodity. Examples of contractually specified risk components are each of the price links and indexations in the contracts below:

- ▶ Price of natural gas contractually linked in part to a gas oil benchmark price and in part to a fuel oil benchmark price
- ▶ Price of electricity contractually linked in part to a coal benchmark price and in part to transmission charges that include an inflation indexation

IFRS 9 now permits an entity to designate a risk component of a non-financial item as the hedged item in a hedging relationship, provided the risk component is separately identifiable and reliably measurable.

- ▶ Price of wires contractually linked in part to a copper benchmark price and in part to a variable tolling charge reflecting energy costs
- ▶ Price of coffee contractually linked in part to a benchmark price of Arabica coffee and in part to transportation charges that include a diesel price indexation

In each case, it is assumed that the pricing component would not require separation as an embedded derivative. When contractually specified, a risk component would usually be considered *separately identifiable*. Further, the risk component element of a price formula would usually be referenced to observable data, such as a published price index. Therefore, the risk component would usually also be considered *reliably measurable*. However, entities would still have to consider what has become termed the 'sub-LIBOR issue' (see section 3.4.5 below).

Example 6 – Hedge of a contractually specified risk component – coal supply contract linked to the coal benchmark price and the Baltic Dry Index

An entity purchases coal from its coal supplier under a contract that sets out a variable price for coal linked to the coal benchmark price, represented by futures contracts for coal loaded at the Newcastle Coal Terminal in Australia, plus a logistics charge that is indexed to the Baltic Dry Index, reflecting that the delivery is at an overseas location. The contract sets out minimum purchase quantities for each month covered by its term.

The entity wishes to hedge itself against price changes related to the benchmark coal price but does not want to hedge the price variability resulting from the logistics costs represented by the indexation of the coal price to the Baltic Dry Index. Therefore, the entity enters into Newcastle coal futures contracts whereby it purchases coal for the relevant delivery months. For each relevant delivery month the entity designates the futures contracts as a hedging instrument in a cash flow hedge of the benchmark coal price risk component of the future coal purchases under its supply contract.

In this case, the risk component is contractually specified by the pricing formula in the supply contract. This means it is separately identifiable, because the entity knows exactly which part of the change in the future purchase price of coal under its particular supply contract results from changes in the benchmark price for coal and what part of the price change results from changes in the Baltic Dry Index. The risk component can also be reliably measured using the price in the futures market for the relevant delivery months as inputs for calculating the present value of the cumulative change in the hedged cash flows. An entity could also decide to only hedge its exposure to variability in the coal price that is related to transportation costs. For example, the entity could enter into forward freight agreements and designate them as hedging instruments, with the hedged item being only the variability in the coal price under its supply contract that results from the indexation to the Baltic Dry Index.

3.4.3 Non-contractually specified risk components

Not all contracts define the various pricing elements and, therefore, specify risk components. In fact, we expect most risk components of financial and non-financial items not to be contractually specified. While it is certainly easier to determine that a risk component is separately identifiable and reliably measurable if it is specified in the contract, IFRS 9 is clear that there is no need for a component to be contractually specified in order to be eligible for hedge accounting. The assessment of whether a risk component qualifies for hedge

accounting (i.e., whether it is separately identifiable and reliably measurable) has to be made 'within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place'.

How we see it

We understand the relevance of the market structure to be that the risk component must have a distinguishable effect on changes in the value or the cash flows that an entity is exposed to. Depending on the situation, the market structure can reflect a 'market convention' that establishes, for example, a benchmark interest rate that has a pervasive effect on the value and cash flows for debt instruments. In other situations, the market structure reflects the particular purchasing or selling market of an entity.

For example, this is the case when an entity buys goods from its particular supplier based on a benchmark price plus other charges, as in the examples listed in section 3.4.2 above. Even if the pricing under such a supply arrangement is not a wider market convention, its pricing formula represents the exposure of the particular entity to variability in cash flows from its purchases. The assessment is normally straightforward for contractually specified risk components, which can also be a relevant factor in the assessment of the market structure of non-contractually specified risk components such as risk components of forecast transactions.

The following example from the application guidance of IFRS 9 illustrates the 'separately identifiable and reliably measurable' assessment.

The assessment of whether a risk component is separately identifiable and reliably measurable has to be made 'within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place.'

Example 7 – Hedge of a non-contractually specified risk component – coffee purchases with a benchmark price risk component

An entity purchases a particular quality of coffee of a particular origin from its supplier under a contract that sets out a variable price linked to the benchmark price for coffee. The price is represented by the coffee futures price plus a fixed spread, reflecting the different quality of the coffee purchased compared to the benchmark plus a variable logistics services charge reflecting that the delivery is at a specific manufacturing site of the entity. The fixed spread is set for the current harvest period. For the deliveries that fall into the next harvest period this type of supply contract is not available.

The entity analyses the market structure for its coffee supplies, taking into account how the eventual deliveries of coffee that it receives are priced. The entity can enter into similar supply contracts for each harvest period once the crop relevant for its particular purchases is known and the spread can be set. In that sense, the knowledge about the pricing under the supply contracts also informs the entity's analysis of the market structure more widely, including forecast purchases which are not yet contractually specified. This allows the entity to conclude that its exposure to variability of cash flows resulting from changes in the benchmark coffee price is a risk component that is separately identifiable and reliably measurable for coffee purchases under the variable price supply contract for the current harvest period as well as for forecast purchases that fall into the next harvest period.

In this case, the entity may enter into coffee futures contracts to hedge its exposure to the variability in cash flows from the benchmark coffee price and designate that risk component as the hedged item. This means that changes in the coffee price from the variable logistics services charge as well as future changes in the spread reflecting the different coffee qualities would be excluded from the hedging relationship.

The assessment of whether a risk component qualifies for hedge accounting is mainly driven by an analysis of whether there are different pricing factors that have a distinguishable effect on the item as a whole (in terms of its value or its cash flows). This evaluation would always have to be based on relevant facts and circumstances.

The standard uses the refinement of crude oil to jet fuel as an example to demonstrate how the assessment of the market structure could be made to conclude that crude oil in a particular situation is an eligible risk component of jet fuel. Crude oil is a physical input of the most common production process for jet fuel and there is a well established price relationship between the two.

Extending this example, crude oil is also a major input in the production process for plastic. However, the manufacturing process is complex and involves a number of steps. The process starts with crude oil being distilled into its separate 'fractions', of which only one (naphtha) is used for making plastic. Naphtha then undergoes a number of further processes before the various types of plastic are finally produced.

Generally, the further downstream in the production process an item is, the more difficult it is to find a distinguishable effect of any single pricing factor. The mere fact that a commodity is a major physical input in a production process does not automatically translate into a separately identifiable effect on the price of the item as a whole. For example, crude oil price changes are unlikely to have a distinguishable effect on the retail price of plastic toys even though, in the longer term, changes in the crude oil price might influence the price of such toys to some degree. Similarly, the price for pasta at food retailers in the medium to long term also responds to changes in the price for wheat, but there is no distinguishable direct effect of wheat prices changes on the retail price for pasta, which remains unchanged for longer periods even though the wheat price changes. If retail prices are periodically adjusted in a way that also directionally reflects the effect of wheat price changes, that is not sufficient to constitute a separately identifiable risk component.

How we see it

Allowing non-contractually specified risk components as eligible hedged items opens up a new area of judgement. The assessment of the market structure will normally require the involvement of personnel with a good understanding of the drivers of market prices (e.g., members of the sales or procurement departments responsible for the underlying transactions).

3.4.4 Inflation as a risk component

Under IAS 39, inflation cannot be designated as a hedged risk component for financial instruments, unless the inflation risk component is contractually specified. For non-financial instruments, inflation risk cannot be designated under IAS 39 as a risk component at all.

For financial instruments, IFRS 9 introduces a rebuttable presumption that, unless contractually specified, inflation is not separately identifiable and reliably measureable. This means that there are limited cases under which it is possible to identify a risk component for inflation and designate that inflation component in a hedging relationship. Similar to other non-contractually specified risk components, the analysis would have to be based on the particular circumstances in the respective market, which is, in this case, the debt market.

For financial instruments, IFRS 9 opens the door for designating a non-contractually specified inflation component as a hedged risk component - but only in limited circumstances. For non-financial instruments, the inflation component will be eligible for designation as the hedged item in a hedging relationship provided that it is separately identifiable and reliably measureable.

The example below, derived from the application guidance of IFRS 9, explains a situation in which the presumption that inflation does not qualify as a risk component of a financial instrument can be rebutted.

Example 8 – Inflation risk as eligible risk component of a debt instrument

An entity wishes to hedge the inflation risk component of a debt instrument. The debt instrument is issued in a currency and country in which inflation-linked bonds are actively traded in a significant volume. The volume, liquidity and term structure of these inflation-linked bonds allow the computation of a real interest yield curve. This situation supports that inflation is a factor that is separately considered in the debt market in a way that it is a separately identifiable and reliably measureable risk component.

There are not many currencies with a liquid market for inflation-linked debt instruments, therefore, limiting the availability of designating non-contractually specified inflation risk of financial instruments.

IFRS 9 does not specify whether the analysis of inflation as eligible risk component has to be made by currency or by country, or both. This is particularly relevant for countries forming a monetary union together with other countries, but having different inflation rates (e.g., within the Eurozone). The relevant 'market structure' for inflation will usually be given by the currency.

While IFRS 9 defines in what circumstances inflation can be a risk component for a financial instrument, inflation can, in future, be treated as a risk component for non-financial items in the same manner as any other risk component (as described in sections 3.4.2 and 3.4.3 above, i.e., the rebuttable presumption described in this section applies only to financial instruments). For example, a contractually specified inflation risk component would normally qualify as a hedged item (e.g., a sales contract with a price formula linked to the consumer price index) under IFRS 9, whereas it would not under IAS 39.

3.4.5 The 'sub-LIBOR issue'

Some financial institutions are able to raise funding at interest rates that are below a benchmark interest rate (e.g., LIBOR minus 15 basis points (bps)). In such a scenario, the entity may wish to remove the variability in future cash flows caused by movements in LIBOR benchmark interest rates. However, IFRS 9, like IAS 39, does not allow the designation of a 'full' LIBOR risk component (i.e., LIBOR flat), as a component cannot be more than the total cash flows of the entire item. This is often referred to as the 'sub-LIBOR issue'.

The reason for this restriction is that a contractual interest rate cannot normally be less than zero. Hence, for a borrowing at, say, LIBOR minus 15bps, if benchmark interest rates fall below 15bps, any further reduction in the benchmark would not cause any cash flow variability for the hedged item. Consequently, any designated component has to be less than or equal to the cash flows of the entire item.

In the above scenario, where the interest rate is at LIBOR minus 15bps, the entity could instead designate, as the hedged item, the variability in cash flows of the entire liability (or a proportion of it) that is attributable to LIBOR changes. This would result in some ineffectiveness for financial instruments that have an interest rate 'floor' of zero in situations in which the forward curve for a part of the remaining hedged term is below 15bps because the hedged item will have less variability in cash flows as a result of interest rate changes than a swap without such a floor.

The sub-LIBOR issue is also applicable to non-financial items where the contract price is linked to a benchmark price minus a differential. This is best demonstrated using an example derived from the application guidance of IFRS 9.

Example 9 – Sub-LIBOR issue - Selling crude oil at below benchmark price

Assume an entity has a long-term sales contract to sell crude oil of a specific quality to a specified location. The contract includes a clause that sets the price per barrel at West Texas Intermediate (WTI) minus USD10 with a minimum price of USD30. The entity wishes to hedge the WTI benchmark price risk by entering into a WTI future. As outlined above, the entity cannot designate a full WTI component, i.e., a WTI component that ignores the price differential and the minimum price.

However, the entity could designate the WTI future as a hedge of the entire cash flow variability under the sales contract that is attributable to the change in the benchmark price. When doing so, the hedged item would have the same cash flow variability as a sale of crude oil at the WTI price (or above), as long as the forward price for the remaining hedged term does not fall below USD40.

3.5 Components of a nominal amount

3.5.1 Definition

A component of a nominal amount is a specified part of the amount of an item. This could be a proportion of an entire item (such as, 60% of a fixed rate loan of EUR100 million) or a layer component (for example, the bottom EUR60 million of a EUR100 million fixed rate loan).

Nominal components are frequently used in risk management activities in practice. Examples include:

- ▶ Part of a monetary transaction volume, e.g., the first USD1 million cash flows from sales to customers in a given period
- ▶ Part of a physical volume, e.g., the 50 tonnes bottom layer of coal inventory in a particular location
- ▶ A part of a physical or other transaction volume, e.g., the sale of the first 15,000 units of widgets during January 2015
- ▶ A layer from the nominal amount of the hedged item, e.g., the top layer of a CHF100 million fixed rate debt that can be prepaid at fair value

3.5.2 Hedge accounting requirements in IAS 39

IAS 39 allows the designation of nominal components for a group of forecast cash flows, such as the sale of the first 15,000 units of widgets used as an example above. Such a designation accommodates the fact that there may be a level of uncertainty as to the quantity of the hedged item and that this uncertainty does not form part of the hedging relationship.

However, IAS 39 does not allow the designation of layer components for fair value hedges. Consequently, an entity that wishes to hedge part of a group of items within a fair value hedge must identify specific items within the group (and designate those items only) or designate a percentage of the total as the hedged item. The premise of the IAS 39 model is to replicate, on a portfolio basis, the hedge accounting result that would arise on an individual hedged item basis.

Financial institutions often apply economic layer hedging strategies. However, as illustrated in the example below, they cannot be correctly reflected in the financial statements by using hedge accounting in accordance with IAS 39.

Example 10 – Hedging a bottom layer of a loan portfolio (IAS 39)

A bank holds a portfolio of fixed rate loans with a total nominal amount of CU100m. The borrowers can, at any time during the tenor, prepay 20% of their (original) loan amount at par.

For risk management purposes, the loans are considered together with variable rate borrowings of CU100m. As a result, the bank is exposed to an interest margin risk resulting from the fixed-to-floating rate mismatch. The bank expects CU20m of loans to be prepaid.

As part of the risk management strategy, the bank decides to hedge the interest margin by entering into a pay fixed/receive variable IRS. The objective is to hedge the amount of loans that is not prepayable using an IRS with a notional amount of CU80m. The IRS is designated as a fair value hedge of 80% of the CU100m loan portfolio.

After two years loans of CU10m are prepaid, which is less than 20% and therefore does not affect the economic hedge in place. However, because of the proportionate designation, this is considered a reduction in the hedged amount for hedge accounting purposes. As a result, the entity now has an IRS of CU80m designated as a hedge of loans of CU72m $([CU100m - CU10m] \times 80\%)$, which will inevitably lead to some ineffectiveness.

IFRS 9 now allows, for fair value hedges, the designation of layer components from a defined nominal amount or a defined, but open, population.

3.5.3 Hedge accounting requirements in IFRS 9

IFRS 9 now allows, for fair value hedges, the designation of layer components from a defined nominal amount or a defined, but open, population. IFRS 9 still includes some restrictions, in particular that a layer component that includes a prepayment option does not qualify as a hedged item in a fair value hedge if the fair value of the prepayment option is affected by changes in the hedged risk.

When an entity has an option to prepay a loan, at fair value, the fair value of the option is not affected by changes in the hedged risk. Consequently, an entity would be able to designate a hedge as described in Example 11 below:

Example 11 – Hedging a top layer of a loan

An entity borrows money by issuing a CU10m five-year fixed rate loan. The entity has a prepayment option to pay back CU5m at fair value. The entity wants to be able to make use of the prepayment option without the amount repayable on early redemption being affected by interest rate changes.

Consequently, the entity would like to hedge the fair value interest rate risk of the prepayable part of the loan. To achieve this, the entity enters into a five-year receive fixed/pay variable IRS with a notional amount of CU5m. The entity designates the IRS in a fair value hedge of the interest rate risk of the CU5m top layer of the loan attributable to the benchmark interest rate. As a result, the top layer is adjusted for changes in the fair value attributable to changes in the hedged risk. The bottom layer, which cannot be prepaid, remains at amortised cost.

The gain or loss on the IRS will offset the change in fair value on the top layer attributable to the hedged risk. On prepayment, the fair value hedge adjustment of the top layer is part of the gain or loss on the early repayment of the loan.

Example 11 above, of a hedge of a top layer of a loan, would not often be found in practice as most prepayment options in loan agreements allow, in our experience, for prepayment at the nominal amount (instead of at fair value). Should prepayment be at the nominal amount, the fair value of the prepayment option would be affected by changes in the hedged interest rate risk. Therefore, the top layer would not normally qualify for hedge accounting. However, such a layer will still qualify for hedge accounting if the effect of the related prepayment option is included when measuring the fair value change of the hedged item.

So, bottom layer hedging strategies can be applied if the hedged layer is not affected by the prepayment risk. This is best demonstrated based on the scenario already used in Example 10 above, but this time making use of the new IFRS 9 designation for nominal components.

IFRS 9 does not preclude hedge accounting for layers that include a prepayment option. However, changes in fair value of the prepayment option as a result of changes in the hedged risk have to be included when measuring the change in fair value of the hedged item.

Example 12 – Hedging a bottom layer of a loan portfolio (IFRS 9)

A bank holds a portfolio of fixed rate loans with a total nominal amount of CU100m. The borrowers can, at any time during the tenor, prepay 20% of their (original) loan amount at par.

For risk management purposes, the loans are considered together with variable rate borrowings of CU100m. As a result, the bank is exposed to an interest margin risk resulting from the fixed-to-floating rate mismatch. The bank expects CU20m of loans to be prepaid.

As part of the risk management strategy, the bank decides to hedge a part of the interest margin by entering into a pay fixed/receive variable IRS. The objective is to hedge 95% of the amount of loans that is not prepayable using an IRS with a notional amount of CU76m. The hedged layer does not include a prepayment option. Therefore, the IRS is designated in a fair value hedge of the interest rate risk of the CU76m bottom layer of the CU100m loan portfolio.

As a result, the bottom layer is adjusted for changes in the fair value attributable to changes in the hedged risk (i.e., benchmark interest rate risk). The extent to which the borrowers exercise their prepayment option does not affect the hedging relationship. Also, if the bank were to derecognise any of the loans for any other reason, the first CU4m of non-prepayable amount of derecognised loans would not be part of the hedged item (i.e., the CU76m bottom layer).

As mentioned above, IFRS 9 does not preclude hedge accounting for layers including a prepayment option. However, changes in fair value of the prepayment option as a result of changes in the hedged risk have to be included when measuring the change in fair value of the hedged item. Example 13 illustrates what this means in practice:

Example 13 – Hedging a bottom layer including prepayment risk

A bank originates a CU10m five-year fixed rate loan with a prepayment option to pay back CU5m at any time at par.

For risk management purposes, the loan is considered together with variable rate borrowings of CU10m. As a result, the bank is exposed to an interest margin risk resulting from the fixed-to-floating rate mismatch. The bank expects the borrower to prepay CU2m and, therefore, wishes to hedge CU8m only. The bank enters into a five-year pay fixed/receive variable IRS with a notional amount of CU8m and designates CU5m of the IRS in a fair value hedge of the benchmark interest rate risk of the CU5m layer of the non-prepayable loan amount. In addition, the bank enters into a swaption with a notional amount of CU3m that is jointly designated with CU3m of the IRS to hedge the benchmark interest rate risk of the last remaining CU3m of the CU5m prepayable amount of the loan (a bottom layer).

As a result, the non-prepayable loan amount is adjusted for changes in the fair value attributable to changes in the hedged risk (the fixed rate benchmark interest rate risk of a fixed term instrument). However, the CU3m bottom layer of the prepayable amount also needs to be adjusted for the effect of the prepayment option on the changes in the fair value attributable to changes in the interest rate risk. The CU2m top layer remains at amortised cost.

Therefore, the first CU2m of prepayments would have a gain or loss on derecognition determined as the difference between the amortised cost of the prepaid amount and par. For any further prepayments exceeding CU2m, the gain or loss on derecognition would be determined as the difference between the amortised cost including the fair value hedge adjustment and par.

3.6 Groups of items

Hedge accounting under IAS 39 was primarily designed from a single instrument view point. A hedging relationship would typically include a single hedging instrument (e.g., an interest rate swap) hedging a single item (e.g., a loan). However, for operational reasons entities often economically hedge several items together on a group basis. IAS 39 allows several items to be hedged together as a group, but there are restrictions such that there are relatively few types of groups that are eligible as hedged items.

In an effort to address the issues raised by these restrictions, the IASB has broadened the eligibility criteria for groups of items in IFRS 9.

3.6.1 General requirements

Under IAS 39, a group of items is eligible as a designated hedged item for accounting purposes only if:

- ▶ The individual items within the group share the same designated risk exposure.
- ▶ The change in the fair value attributable to the hedged risk for each individual item in the group is 'approximately proportional' to the overall change in the fair value attributable to the hedged risk of the group.

Many hedges will fail to fulfil the second criterion. For example, when hedging a portfolio of shares that replicates a market index, the individual shares would usually not move in tandem with the entire portfolio.

In contrast, under IFRS 9, hedge accounting may be applied to a group of items if:

- ▶ The group consists of items or components of items that would individually qualify for hedge accounting.
- ▶ For risk management purposes, the items in the group are managed together on a group basis.

Example 14 – Hedging a portfolio of shares

An entity holds a portfolio of shares of Swiss companies that replicates the Swiss Market Index (SMI). The entity elected to account for the shares at fair value through other comprehensive income (FVTOCI), as allowed by IFRS 9. The entity decides to lock in the current value of the portfolio by entering into corresponding SMI futures contracts.

The individual shares would be eligible hedged items if hedged individually. As the objective of the portfolio is to replicate the SMI, the entity can also demonstrate that the shares are managed together on a group basis. The entity also assesses the effectiveness criteria for hedge accounting (see section 5 below). Consequently, the entity designates the SMI futures contracts as the hedging instrument in a hedge of the fair value of the portfolio. As a result, the gains or losses on the SMI futures are accounted for in OCI as well, thus eliminating the accounting mismatch.

How we see it

Whether the items in the group are managed together on a group basis is a matter of fact, i.e., it depends on an entity's behaviour and cannot be achieved by mere documentation.

3.6.2 Hedging a component of a group

A group designation can also consist of a component of a group of items, such as a layer component of a group. A component could also be a proportion of a group of items, such as 50% of a fixed rate bond series with a total volume of CU100m. Whether an entity designates a layer component or a proportionate component depends on the entity's risk management objective.

The benefits of identifying a layer component, discussed at section 3.5.3 above, may be even more relevant when applied to a group of items. The bottom layer hedging strategy discussed in Example 12 above is, in fact, a designation of a component of a group.

Another example is a bond issue of CU50m that is made up of 50,000 fixed rate bonds with a face value of CU1,000 each. If the issuer expects that it might repurchase up to CU10m of the issue volume before maturity it could hedge the benchmark component of the fair value interest rate risk with a receive fixed/pay variable interest rate swap that has a notional amount of CU10m. From an economic perspective, that hedge would allow repurchases of up to CU10m total face value for which the gain or loss from changes in the benchmark interest rate would be compensated by the gain or loss on the swap. However, this can only be reflected in the accounting if the entity can designate a CU10m top layer (i.e., for the first CU10m of face value that are repurchased, the entity would include a fair value hedge gain or loss on the full face value

when determining the gain or loss on derecognition of the bonds). If it was not permitted to designate a layer of a group of items, entities would in such cases either have to identify individual items within the group and designate them on a standalone basis or prorate the fair value hedge gain or loss to the entire bond issue volume. The IASB believes this would result in arbitrary accounting results and decided to allow layer component designations for group of items.

A layer component of a group of items only qualifies for hedge accounting if:

- ▶ The layer is separately identifiable and reliably measurable.
- ▶ The risk management objective is to hedge a layer component.
- ▶ The items in the group from which the layer is identified all share the same risk.
- ▶ For a hedge of existing items, the items in the group can be identified and tracked.
- ▶ Any items in the group containing prepayment options meet the requirements for components of a nominal amount (see section 3.5.3 above).

3.6.3 Cash flow hedge of a net position

Many entities are exposed to foreign exchange risk arising from purchases and sales of goods or services denominated in foreign currencies. Cash inflows and outflows occurring on forecast transactions in the same foreign currency are often economically hedged on a net basis. For example, consider an entity that has forecast foreign currency sales of FC100 and purchases of FC80, both in 6 months. It hedges the net exposure using a single foreign exchange forward contract to sell FC20 in 6 months.

Hedging of such a net position does not qualify for hedge accounting under IAS 39. However, hedge accounting could still be achieved by designating the foreign exchange forward contract as hedging FC20 of the FC100 forecast sales. By doing so, hedge accounting would result in FC20 of the total forecast sales of FC100 being recorded at the hedged rate, while the remaining sales and the purchases will be measured at the then prevailing spot rate.

When managing the foreign exchange risk on forecast transactions, treasury departments typically determine the net positions by adding the expected cash inflows and cash outflows for a given date or time period (e.g., week or month). The resulting net exposure is then hedged using a financial instrument. Under IAS 39, if the individual cash flows forming the net position affect profit or loss in different reporting periods they will not offset each other in the income statement, i.e., there will be no 'natural hedge' for accounting purposes.

Example 15 – Accounting mismatch for a 'natural hedge' of foreign currency cash flows (IAS 39)

An entity anticipates foreign currency sales of FC100 in 12 months and also intends to purchase fixed assets of FC80 in 12 months (both denominated in the same foreign currency). The cash inflows of the forecast sales are hedged on a net basis together with the cash outflows from the forecast purchase of the fixed assets. The forecast sales will have an immediate effect upon profit or loss when they occur, while the forecast asset purchases will only affect profit or loss as the assets are depreciated over their useful lives.

IFRS 9 allows net positions as eligible hedged items in cash flow hedges - but only for hedges of foreign exchange risk.

The IASB decided to allow net positions as eligible hedged items in cash flow hedges, including groups where the offsetting risk positions affect profit or loss in different periods. This is, however, limited to hedges of foreign exchange risk.

The standard mechanics of cash flow hedge accounting cannot be applied to a hedged net position whose cash flows affect profit or loss in different periods. Applying standard cash flow hedge accounting to Example 15 above, the gain or loss accumulated in OCI on the FC20 of hedging instrument would be reclassified to profit or loss when the revenue transaction occurs. However, this will only set off the gain or loss on FC20 of the FC100 hedged revenue while the remaining revenue of FC80 and the fixed asset purchase of FC80 (i.e., the economic hedge) would still be measured at the spot rate. This would result in the bottom line profit for the period(s) not reflecting the economic hedge.

IFRS 9 changes the cash flow hedge accounting for such a net position in that the foreign exchange gain or loss on the FC80 revenue cash flows that affect profit or loss in the earlier period must be carried forward to offset the foreign exchange gain or loss on the fixed asset purchase cash flows that will affect profit or loss in later periods. This is achieved by deferring the gain or loss on the natural hedge in OCI, with a reclassification to profit or loss once the offsetting cash flows affect profit or loss (see Example 16 below).

However, the transactions that make up the net position would each need to be recognised when they arise and be measured at the spot foreign currency rate ruling at that time. Hence, they are not adjusted to reflect the result of the hedge. The whole impact of hedge accounting has to be presented in a separate line item in profit or loss. This separate line item includes:

- ▶ The reclassification adjustment of gains or losses on the hedge of the net position
- ▶ The gain or loss on the natural hedge, with the counter-entry being recognised in OCI
- ▶ The later reclassification adjustment of the gain or loss on the natural hedge from OCI to profit or loss

The rather complicated accounting described above is best illustrated using an example:

Example 16 – Cash flow hedge of a foreign currency net position

An entity having the CAD as functional currency anticipates sales of GBP100m in 12 months and also plans a major capital expenditure (fixed assets) of GBP80m in 12 months. The anticipated sales and capital expenditure (i.e., the group) are designated as hedged items and the resulting net position is hedged with a forward contract to sell GBP20m in 12 months. The fixed assets will be depreciated on a straight-line basis over eight years. For simplicity, assume the spot rate equals the forward rate.

The GBP/CAD spot rates are:

At inception of the hedge (beginning of year 1)	1.50
After 12 months (end of year 1)	1.60

The entity would record the following journal entries:

Year 1

(Amounts in millions)

Other comprehensive income	CAD2	
Hedging derivative		CAD2

To account for the fair value change in the hedging instrument (GBP20m × [1.50 - 1.60]).

Cash	CAD160	
Sales		CAD160

To account for the sales of GBP100m at the current spot rate of 1.60 (GBP100m × 1.60).

Property, plant & equipment	CAD128	
Cash		CAD128

To account for the purchase of GBP80m fixed assets at the current spot rate of 1.60 (GBP80m × 1.60).

Hedging derivative	CAD2	
Cash		CAD2

To account for the settlement of the forward contract.

Net position hedging gains/losses	CAD2	
Other comprehensive income		CAD2

To reclassify the cash flow hedge reserve from OCI to profit or loss.

Net position hedging gains/losses	CAD8	
Other comprehensive income		CAD8

To defer the natural hedge gain from profit or loss to OCI (GBP80m × [1.60 - 1.50]).

Example 16 – Cash flow hedge of a foreign currency net position continued

The net profit for the period is CAD150m, which represents the sale of GBP100m at the hedged rate of 1.50 (albeit presented in two different line items).

Years 2 to 9

(amounts in millions)

Depreciation	CAD16	
Property, plant & equipment		CAD16

To account for the straight line depreciation of the fixed assets (CAD128 × 12.5%).

Other comprehensive income	CAD1	
Net position hedging gains/losses		CAD1

To reclassify part of the deferred gain from OCI to profit or loss (CAD8m × 12.5%).

The net loss for each period is CAD15m, which represents depreciation (at 12.5%) of a fixed asset of GBP80m purchased at the hedged rate of 1.50.

Overview

Income statement (CAD millions)

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Total
Sales	160									160
Depreciation		(16)	(16)	(16)	(16)	(16)	(16)	(16)	(16)	(128)
Net position hedging gains/losses	(10)	1	1	1	1	1	1	1	1	(2)
Profit for the period	150	(15)	(15)	(15)	(15)	(15)	(15)	(15)	(15)	30

Statement of financial position (CAD millions)

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9
Cash	30								
Property, plant & equipment	128	112	96	80	64	48	32	16	0
Hedging reserve (OCI)	(8)	(7)	(6)	(5)	(4)	(3)	(2)	(1)	0

The transactions within a net position still have to be measured at their spot rates, with the effect of the hedge presented in a separate line item. In other words, although hedged from a bottom line perspective, there is still volatility in the amounts reported for the individual hedged transactions.

For a net position to qualify for cash flow hedge accounting, the hedge documentation has to include, for each individual item within the net position, its amount and nature as well as the reporting period in which it is expected to affect profit or loss.

3.6.4 Nil net positions

As part of its introduction of the concept of net positions as hedged items, IFRS 9 also addresses hedges of nil net positions. Sometimes entities are hedging a group of items where the hedged items among themselves fully offset the risk that is managed. An entity is allowed to designate such a nil net position in a hedging relationship, provided that:

- ▶ The hedge is part of a rolling net risk hedging strategy.
- ▶ Hedging instruments are used to hedge the net risk when the hedged net position changes in size over the life of the rolling hedging strategy and is not a nil net position.
- ▶ The entity would normally apply hedge accounting to such net positions when the net position is not nil.
- ▶ Not applying hedge accounting to the nil net position would result in inconsistent accounting outcomes over time (because in a period in which the net position is nil, hedge accounting would not be available for what is otherwise the same type of exposure).

3.6.5 Accounting for macro hedging

Financial institutions, particularly retail banks, have as a core business, the collection of funds by depositors that are subsequently invested as loans to customers. This typically includes instruments such as current and savings accounts, deposits and borrowings, loans and mortgages that are usually accounted for at amortised cost. The difference between interest received and interest paid on these instruments (i.e., the net interest margin) is a main source of profitability.

A bank's net interest margin is exposed to changes in interest rates, a risk most banks (economically) hedge by entering into derivatives (mainly interest rate swaps). Applying the hedge accounting requirements (as defined in IAS 39 or IFRS 9) to such hedging strategies on an individual item-by-item basis can be difficult as a result of the characteristics of the underlying financial assets and liabilities:

- ▶ Prepayment options are common features of many fixed rate loans to customers. Customers exercise these options for many reasons, such as when they move house, and so not necessarily in response to interest rate movements. Their behaviour can be predicted much better on a portfolio basis rather than an item-by-item basis.
- ▶ As a result of the sheer number of financial instruments involved, banks typically apply their hedging strategies on a macro (or portfolio) basis, with the number of individual instruments in the hedged portfolio constantly churning.

Although IAS 39 can be applied to macro hedging situations, and guidance exists for portfolio fair value and cash flow hedge accounting for interest rate risk, entities do not always use hedge accounting in those situations. This is because not all sources of interest rate risk qualify for hedge accounting, use of IAS 39 can be operationally complex and cash flow hedge solutions result in volatility of other comprehensive income. Some European banks have, instead, made use of the European Union's carve out of certain sections of the IAS 39 hedge accounting rules.

The IASB is seeking to create a separate accounting model for macro hedging situations that would be based on the risk management activities of a reporting entity. Although mainly focused on financial institutions, the accounting model for macro hedging might also be beneficial for some corporate entities applying macro-type hedging strategies.

Instead of developing particular hedge accounting requirements in IFRS 9 that are specifically tailored to macro hedging strategies, the IASB is seeking to create a separate accounting model for macro hedging situations that would be based on an entity's risk management activities. The accounting for macro hedging was originally part of the IASB's project to replace IAS 39 with IFRS 9. However, the IASB realised that developing the new accounting model would take time and probably be a different concept from hedge accounting. In May 2012, the Board therefore decided to decouple the part of the project that is related to accounting for macro hedging from IFRS 9, allowing more time to develop an accounting model without affecting the timeline for the completion of the other elements of IFRS 9.

Although mainly focused on financial institutions, the accounting model for macro hedging might also be beneficial for some corporate entities applying macro-type hedging strategies. At the time of writing this publication, the IASB aims to issue a discussion paper on accounting for macro hedging in the first quarter of 2014.

3.6.6 Applying hedge accounting for macro hedging strategies under IFRS 9

Because of its pending project on an accounting model specifically tailored to macro hedging situations (see section 3.6.5), the IASB created a scope exception from the IFRS 9 hedging accounting requirements that allows entities to use the specific fair value hedge accounting for portfolio hedges of interest rate risk, as defined in IAS 39, until the project is finalised and becomes effective. However, the implementation guidance accompanying IAS 39 also contains specific illustrations of the implementation of cash flow hedge accounting when financial institutions manage interest rate risk on a net basis.

The IASB decided not to carry forward implementation guidance on hedge accounting to IFRS 9. As a result, many financial institutions were concerned that they would not be able to continue with their existing macro cash flow hedging strategies under IFRS 9. The IASB clarified that not carrying forward the implementation guidance was without prejudice (i.e., it did not mean that the IASB had rejected that guidance and so had not intended to imply that entities cannot apply macro cash flow hedge accounting under IFRS 9).

Nonetheless, the IASB also decided to give entities an accounting policy choice until the project on accounting for macro hedging is completed. Entities may:

- ▶ Apply the new hedge accounting requirements as set out in IFRS 9, in full
- ▶ Apply the new hedge accounting requirements as set out in IFRS 9 to all hedges except fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities; in that case an entity must also apply the paragraphs that were added to IAS 39 when that particular type of hedge was introduced (IAS 39.81A, 89A and AG114-AG132) i.e., an entity must apply all the hedge accounting requirements of IAS 39 (e.g., the 80%-125% bright line effectiveness test) including the paragraphs that specifically address fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities)

Or

- ▶ Continue to apply hedge accounting as set out in IAS 39, to all hedges

3.7 Credit risk exposures

Many financial institutions hedge the credit risk arising from loans or loan commitments using credit default swaps (CDS). This would often result in an accounting mismatch, as loans and loan commitments are typically not accounted for at fair value through profit or loss. The simplest accounting would be to designate the credit risk as a risk component in a hedging relationship. However, the IASB noted that due to the difficulty in isolating the credit risk as a separate risk it does not meet the eligibility criteria for risk components. As a result, the accounting mismatch creates profit or loss volatility.

The IASB spent a considerable amount of its deliberations for the IFRS 9 hedge accounting project on credit risk hedging. This is reflected by the number of paragraphs used to describe the basis for the Board's conclusion. The Exposure Draft leading up to the final published requirements did not propose any changes in this area, however, the IASB asked its constituents to comment on three alternative approaches. The feedback from the comment letters showed that accounting for credit risk hedging strategies is a major concern for many financial institutions.

In its redeliberations the Board confirmed its view that credit risk does not qualify as a separate risk component. However, the IASB decided that an entity undertaking economic credit risk hedging may, at any time, elect to account for a loan or loan commitment or a financial guarantee contract, to the extent that any of these instruments is managed for changes in its credit risk, at fair value through profit or loss. This election can only be made if the asset referenced by the credit derivative has the same issuer and subordination as the hedged exposure (i.e., both the issuer's name and seniority of the exposure match). The accounting for the credit derivative would not change, i.e., it would continue to be accounted at fair value through profit or loss.

If the election is made, the difference at that time between the carrying value (if any) and the fair value of the financial instrument designated as at fair value through profit or loss is immediately recognised in profit or loss. This measurement adjustment would not only reflect any change in credit risk, but also other changes in fair value such as changes in interest rate risk.

Also different to a fair value hedge, once elected, the financial instruments hedged for credit risk are measured at their full fair value instead of just adjusted for changes in the risk actually hedged. As a result, by hedging the credit risk exposure, the entity also has to revalue the financial instrument for the general effect of interest rate risk, which will result in profit or loss volatility.

An entity has to discontinue the specific accounting for credit risk hedges in line with its actual risk management. This would be the case when the credit risk either no longer exists or if the credit risk is no longer managed using credit derivatives (irrespective of whether the credit derivative still exists or is sold, terminated or settled).

On discontinuation, the fair value of the loan becomes its deemed amortised cost and a new effective interest rate is calculated on that basis. The fair value of a loan commitment or a financial guarantee contract is amortised over the remaining life of the instrument unless IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would require a higher amount than the remaining unamortised balance.

In contrast to the fair value option under IFRS 9, the possibility to elect to measure at fair value through profit or loss those financial instruments whose credit risk is managed using credit derivatives, has the following advantages:

- ▶ The election can be made after initial recognition of the financial instrument
- ▶ The election is available for a proportion of the instrument (instead of only the whole instrument)
- ▶ The fair value through profit or loss accounting can be discontinued

Consequently, even though it is not an equivalent to fair value hedge accounting, the new accounting does address several concerns of entities that use CDSs for hedging credit exposures.

4. Hedging instruments

IAS 39 places several restrictions on the types of instruments that can qualify as hedging instruments for hedge accounting purposes. This is to reflect that hedge accounting was mainly intended to address accounting mismatches that resulted from requiring derivatives to be accounted for at fair value through profit or loss. IFRS 9 takes a different approach that focuses on which instruments are used for hedging. As a result, entities are also now permitted to designate, as hedging instruments, non-derivative financial assets or non-derivative financial liabilities that are accounted for at fair value through profit or loss.³ Consequently:

- ▶ A 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 OCI) does not qualify as a hedging instrument. This is because the entire fair value change is not recognised in profit or loss, which would in effect allow the entity to ignore its own credit risk when assessing and measuring hedge ineffectiveness and thus conflict with the concepts of hedge accounting.
- ▶ An equity instrument for which an entity has elected to present changes in fair value in OCI does not qualify as a hedging instrument in a hedge of foreign currency risk. Again, this reflects that fair value changes are not recognised in profit or loss, which is incompatible with the mechanics of fair value hedges and cash flow hedges.

IFRS 9 permits entities to designate, as hedging instruments, non-derivative financial assets and liabilities that are accounted for at fair value through profit or loss.

³In contrast, IAS 39 only permitted non-derivative financial instruments to be designated as hedging instruments for foreign currency risk.

Example 17 – Hedge of a forecast commodity purchase with an investment in a commodity fund or an exchange traded commodity

An entity is exposed to variability in cash flows from highly probable forecast purchases of crude oil that is indexed to Brent crude oil. The entity wants to hedge its cash flow risk from changes in the price of Brent crude oil. Instead of using derivative contracts, the entity purchases exchange traded investments that replicate the performance of Brent futures contracts such as commodity funds or exchange traded commodities (ETCs). ETCs have the legal form of debentures that are coupled to the price development of a commodity (either directly at the spot price or with a commodity futures contract). They can be traded like exchange traded funds but, because they are legally debt securities, they involve credit risk of the issuer (which is usually mitigated by collateralisation through physically deposited commodities or other suitable collateral).

These investments are financial instruments that (under IFRS 9) would be accounted for at fair value through profit or loss. Consequently, they could qualify as hedging instruments if all other qualifying criteria for hedge accounting are met. In particular, the effectiveness assessment would have to consider that the fair value change of the investments will differ from the present value of the cumulative change in the cash flows for the forecast purchases of crude oil. This is because of aspects such as 'tracking errors' (i.e., that investment does not perfectly replicate the performance of futures contracts) and that the investments are fully funded cash-instruments whereas the cash flows on the forecast transactions will only occur in the future.

How we see it

The ability to designate non-derivative hedging instruments can be helpful if an entity does not have access to derivatives markets (e.g., because of local regulations that prohibit the entity from holding such instruments); does not want to be subject to margin requirements, nor enter into uncollateralised over-the-counter derivatives. Purchasing and selling financial investments in such cases can be operationally easier for entities than transacting derivatives.

IAS 39 contains a restriction that a hedging relationship cannot be designated for only a portion of the time period during which a hedging instrument remains outstanding. In essence, this restriction remains, however, it is now formulated more precisely, in that 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. This clarifies that an entity cannot designate a 'partial-term' component of a financial instrument as the hedging instrument, but only the entire instrument for its remaining life (notwithstanding that an entity may exclude from designation the time value of an option, the forward element of a forward contract or the foreign currency basis spread, see sections 7.1 and 7.2 below).

For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. This means that an entity could, for example, hedge the spot risk of highly probable foreign currency forecast sales in 12 months' time that with a seven-year financial liability denominated in the same foreign currency. However, when measuring ineffectiveness, the foreign currency revaluation of the forecast sales would have to be discounted, whereas the hedging instrument (i.e., the IAS 21-based foreign currency component of the financial liability) would not. This would result in some ineffectiveness (see section 6.4.1 below).

Also unchanged from IAS 39, derivatives measured at fair value through profit or loss still qualify as hedging instruments. The sole exception to this rule continues to be written options, unless the written option is designated to offset a purchased option. This would also include hedges of purchased options embedded in another financial instrument.

Two or more financial instruments can be jointly designated as hedging instruments. This was already permitted under IAS 39. Also unchanged is the requirement that a single instrument combining a written option and a purchased option, such as an interest rate collar, cannot be a hedging instrument if it is a net written option at the date of the designation.

How we see it

In practice, many zero cost collars are transacted as legally separate written and purchased options. On the face of it, therefore, it could be argued that such transactions cannot be treated as a combined hedging instrument. In what we believe to be a clarification, IFRS 9 specifically permits such jointly designated hedging instruments if the combined instrument is not a net written option at the date of designation.

Example 18 – Hedging foreign exchange risk of a forecast transaction using a combined option instrument

An entity is exposed to foreign exchange risk resulting from a highly probably forecast transaction in a foreign currency. In order to hedge that exposure, the entity enters into a collar by combining a long call and a short put option. The premium paid on the long call option equals the premium received on the short put option (i.e., it is what is termed a 'zero cost collar').

The entity designates the combination of the two instruments in a cash flow hedge of its highly probable forecast transaction.

The requirement that the hedging instrument has to be a contract with a party external to the reporting entity remains.

5. Qualifying criteria

5.1 Designation

Unchanged from IAS 39, to qualify for hedge accounting, a hedging relationship has to consist of eligible hedging instruments and eligible hedged items (see sections 3 and 4 above). Also, at inception of the hedging relationship, there still has to be a formal designation and documentation. This would include the entity's risk management objective underlying the hedging relationship and how that fits within the overall risk management strategy. The documentation has to include an 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.

However, compared to IAS 39, the entity's risk management strategy and objective are more important under IFRS 9 because of the effect on discontinuation of hedge accounting and the hedge accounting related disclosures. IFRS 9 also requires documentation of the hedge ratio and potential sources of ineffectiveness (that may have to be updated as part of a continuing hedging relationship).

Like IAS 39, entities can still only designate one of three types of hedging relationships: a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. For hedges of the foreign currency risk of a firm commitment, an entity may designate either a fair value hedge or a cash flow hedge.

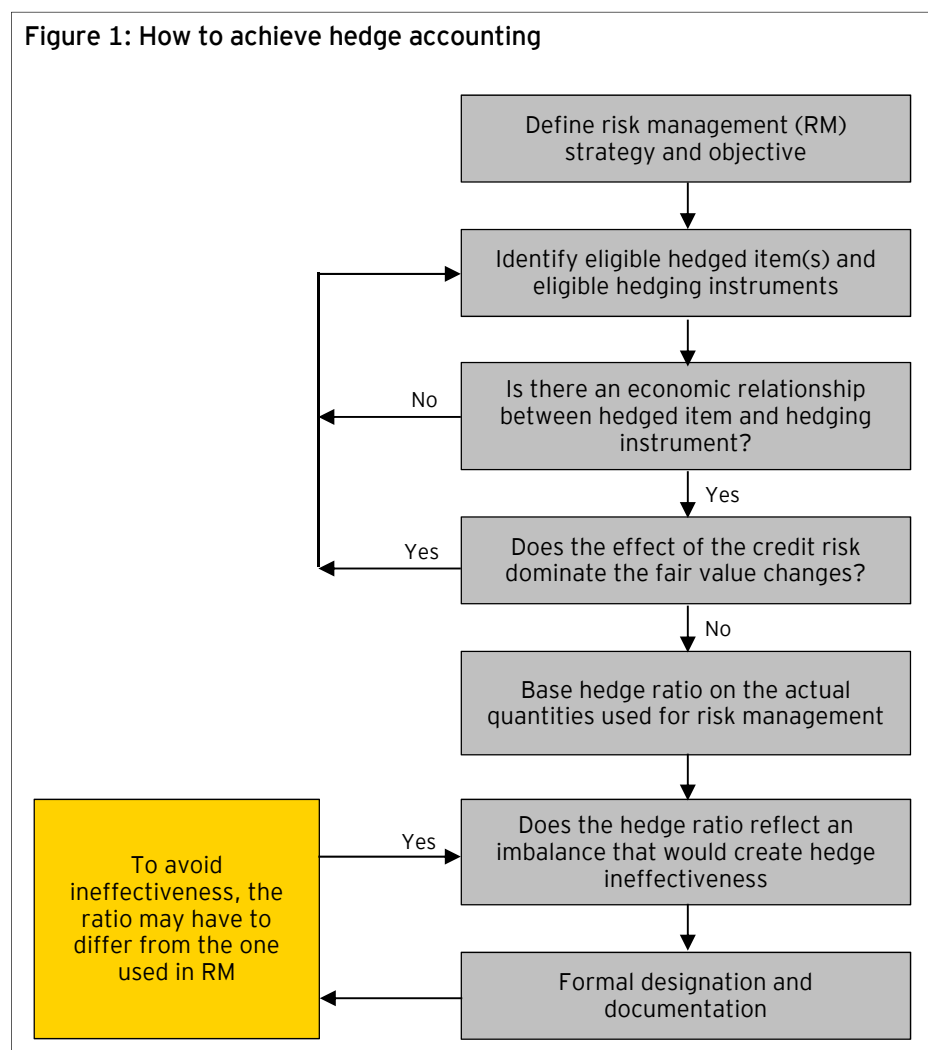
Unlike IAS 39, entities are no longer required to perform an onerous quantitative effectiveness assessment to demonstrate that the hedge in any period was highly effective, using the 80%-125% bright line. Instead, IFRS 9 uses a new approach to the effectiveness assessment that is only prospective, does not involve any bright lines and, depending on the circumstances, may also be qualitative. This approach can also require that the method for assessing effectiveness is changed in response to changes in circumstances, in which case the hedge documentation is updated but without resulting in discontinuation of the hedging relationship.

Under IFRS 9, a hedging relationship qualifies for hedge accounting if it meets *all* of the following effectiveness requirements:

- ▶ There is 'an economic relationship' between the hedged item and the hedging instrument.
- ▶ The effect of credit risk does not 'dominate the value changes' that result from that economic relationship.
- ▶ The hedge ratio of the hedging relationship is the same as that resulting from the quantity of 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.

IFRS 9 uses a new approach to the effectiveness assessment that is only prospective, does not involve any bright lines and, depending on the circumstances, may also be qualitative.

The required steps for designating a hedging relationship can be summarised in a flow chart, as follows:



The individual steps in the new effectiveness assessment are discussed in more detail below.

5.2 Economic relationship

The first requirement means that the hedging instrument and the hedged item must be expected to move in opposite directions as a result of a change in the hedged risk. This should be based on an economic rationale rather than just by chance, as could be the case if the relationship is based only on a statistical correlation. However, a statistical correlation may provide corroboration of an economic rationale.

This requirement will automatically be fulfilled for many hedging relationships, as the underlying of the hedging instrument often matches, or is closely aligned with, the hedged risk. Even when there are differences between the hedged item and the hedging instrument, the economic relationship will often be capable of being demonstrated using a qualitative assessment. However, when the critical terms of the hedging instrument and hedged item are not closely aligned, IFRS 9 suggests that 'it might only be possible for an entity to conclude [that there is an economic relationship] on the basis of a quantitative assessment.'

Statistical correlation by itself is not sufficient to establish that an economic relationship exists. However, regression analysis can be used as corroboration for an economic rationale.

This assessment, whether qualitative or quantitative, would need to consider, amongst other possible sources of mismatch between the designated hedged item and the hedging instrument:

- ▶ Maturity
- ▶ Volume or nominal amount
- ▶ Cash flow dates
- ▶ Interest rate basis, or quality and location basis differences
- ▶ Day count methods
- ▶ Credit risk, including the effect of collateral
- ▶ The extent that the hedging instrument is already 'in the money, or 'out of the money' when designated

IFRS 9 does not specify a method for assessing whether an economic relationship exists. An entity should use a method capturing all the relevant characteristics of the hedging relationship. A possible method is to use statistical analysis, such as regression analysis, to support the assessment of whether an economic relationship exists. This will also help demonstrate a suitable hedge ratio. However, as already mentioned, to quote the IASB, 'the mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists.'

The following example illustrates an approach that uses a qualitative assessment:

Example 19 – Economic relationship between HKD and USD

An entity has foreign currency exposures in both Hong Kong dollars (HKD) and US dollars (USD). The entity aggregates its exposures in the two currencies and only used USD linked hedges to hedge those currency exposures.

Because the HKD is pegged to the USD in a way that allows fluctuations only within a very narrow band (HKD7.75 – HKD7.85 per USD) the entity concludes that an economic relationship exists between its USD linked hedges (with the USD as the underlying) and its HKD denominated foreign currency exposures.

The entity monitors the currency peg for changes and treats the movements of the HKD within the narrow band as a source of some ineffectiveness for all hedges in which the hedged item relates to amounts denominated in HKD.

5.3 Impact of credit risk

IFRS 9 requires that, to achieve hedge accounting, the impact of changes in credit risk should not be of a magnitude such that it dominates the value changes, even if there is an economic relationship between the hedged item and hedging instrument. Credit risk can arise on both the hedging instrument and the hedged item in the form of counterparty's credit risk or the entity's own credit risk.

Judgement has to be used in determining when the impact of credit risk is 'dominating' the value changes. But clearly, to 'dominate' would mean that there would have to be a very significant effect on the fair value of the hedged item or the hedging instrument. The standard provides guidance that small effects should be ignored even when, in a particular period, they affect the fair values more than changes in the hedged risk. In other words, it is not only a relative but also an absolute assessment.

The credit risk assessment involves the hedging instrument and the hedged item.

5.3.1 Credit risk on the hedging instrument

IFRS 13 *Fair Value Measurement* is clear that the effect of credit risk, both the counterparty's credit risk and the entity's own credit risk, has to be reflected in the measurement of fair value. The effect of credit risk on the measurement of the hedging instrument would obviously result in some hedge ineffectiveness. The expected effect of that ineffectiveness should not be of a magnitude that it neutralises the offsetting impact of a significant change in the values of the hedging instrument and the hedged item (see section 5.2).

How we see it

We expect the assessment of the effect of credit risk to be a qualitative assessment in most cases. For example, entities typically have counterparty risk limits defined as part of their risk management policy. The credit standing of the counterparties is monitored on a regular basis. The risk management policy may include measures to be taken once a significant deterioration in the credit risk is identified. Such measures could include settling the derivative and possibly novating it to another party (in which case, the hedging relationship would have to be discontinued), or negotiating collateral or other credit enhancements (which would significantly improve the hedging relationship). However, a quantitative assessment of the impact of credit risk on the value changes of the hedging relationship might be required in some instances, e.g., to find out what factors contribute to a low offset between the changes in the value of the hedging instrument and the hedged item and the magnitude of their influence.

Nowadays, most over-the-counter derivative contracts between financial institutions are cash collateralised. Furthermore, current initiatives in several jurisdictions, such as, the European Market Infrastructure Regulation (EMIR) in the European Union or the Dodd-Frank Act in the United States, will result in more derivative contracts being collateralised by cash. Cash collateralisation significantly reduces the credit risk for both parties involved, meaning that credit risk is unlikely to dominate the change in fair value of such hedging instruments.

5.3.2 Credit risk on the hedged item

The analysis of the hedged item is somewhat different, as credit risk does not apply to all types of hedged items. For example, inventory and forecast transactions would not have credit risk. Loan assets typically have counterparty credit risk, while financial liabilities bear the issuing entity's own credit risk.

Credit risk cannot dominate the value change in a hedge of a forecast transaction as the transaction is, by definition, only anticipated but not committed. Credit risk is defined as 'risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. For the same reason, inventory also does not involve credit risk. Consequently, credit risk can only apply if the entity enters into a contract (e.g., if the hedged item is a firm commitment or a financial instrument).

This should be contrasted with the assessment of whether a forecast transaction is highly probable. Even though such a transaction does not involve credit risk, depending on the possible counterparties for the anticipated transaction, the credit risk that affects them can indirectly affect the assessment of whether the forecast transaction is highly probable. For example, assume an entity sells a product to only one particular customer abroad for which the sales are denominated in a foreign currency and the entity does not have alternative customers to sell the product to in that currency (or

other sales in that currency). In that case, the credit risk of that particular customer would indirectly affect the likelihood of the entity's forecast sales in that currency occurring. Conversely, if the entity has a wider customer base for sales of its product that are denominated in the foreign currency then the potential loss of a particular customer would not significantly (or even not at all) affect the likelihood of the entity's forecast sales in that currency occurring.

For regulatory and accounting purposes, banks usually have systems in place to determine the credit risk on their loan portfolios. Therefore, banks should be able to identify loans with a significant deterioration in the credit standing that would require a qualitative assessment of whether credit risk is dominating the value changes in the hedging relationship.

The systems to assess the credit risk of loans would also permit banks to determine the appropriate economic hedge when hedging the interest rate risk of such loans, as illustrated by Example 20 below:

The assessment of credit risk for hedge effectiveness purposes, which in many cases may be carried out on a qualitative basis, should not be confused with the requirement to actually measure and recognise the impact of credit risk on the hedging instrument and the hedged item.

Example 20 – Designating interest rate hedges of loan assets when credit risk is expected

Assume a bank wishes to hedge the interest rate risk of a portfolio of loans that have similar credit risk characteristics. Economically, the bank should hedge only the cash flows it expects to collect. When expecting to collect 95% of all cash flows in a loan portfolio, the bank should designate the first 95% of cash flows only. A designation of more than 95% would result in an economic over-hedge and would also increase the risk of credit risk dominating the value changes of the hedging relationship.

As a significant change compared to IAS 39, the designation of such a nominal component (often referred to as a bottom layer) is now possible under IFRS 9 (see section 3.5.3 above). This type of designation would require that all items included in the layer are exposed to the same hedged risk so that the measurement of the hedged layer is not significantly affected by items that make up the 95% layer from the overall 100% of the portfolio. Therefore, the entity has to designate the same kind of benchmark interest rate risk component of each loan to make up the bottom layer. If there is a deterioration in the credit risk of a particular loan that results in credit risk dominating the economic relationship with the benchmark interest rate, such that its benchmark interest rate risk component will no longer qualify to be designated as a hedged item, it would not be part of the bottom layer unless and until loans with such a deterioration in the credit risk would exceed 5% of the portfolio.

The example should not be taken to imply that for an individual loan with an expected loss of 5% an entity could not hedge the interest rate risk using an interest rate swap that has a notional amount equal to the loan's face value. In such a situation the credit risk of the loan would not dominate the interest rate related changes unless and until the credit risk changes. However, if the loan deteriorated in its credit quality to an extent where the credit risk related changes start dominating the interest rate risk related changes, the hedging relationship would have to be discontinued.

The assessment of the effect of credit risk on value changes for hedge effectiveness purposes, which, in many cases, may be carried out on a qualitative basis, should not be confused with the requirement to measure and recognise the impact of credit risk on the hedging instrument and the designated hedged item, which will normally give rise to hedge ineffectiveness recognised in profit or loss.

5.4 Setting the hedge ratio

The hedge ratio is the ratio between the amount of hedged item and the amount of hedging instrument. For many hedging relationships, the hedge ratio would be 1:1 as the underlying of the hedging instrument perfectly matches the designated hedged risk.

For a hedging relationship with a correlation between the hedged item and the hedging instrument that is not a simple 1:1 relationship, risk managers will generally set the hedge ratio so as to adjust for the type of relation in order to improve the effectiveness (i.e., the hedged ratio may be different to 1:1). Accordingly, the third effectiveness requirement is that the hedge ratio used for accounting should be the same as that used for risk management purposes. This does not mean that an entity must designate hedging relationships to the same extent as it hedges for risk management purposes.

For example, if an entity uses a hedge ratio of a quantity of hedging instrument to a quantity of hedged item of 1.1:1 and for risk management purposes hedges a notional amount of hedged items of 100 using a notional amount of hedging instruments of 110, it could decide to designate only a notional amount of 80 of hedged items and designate a notional amount of 88 of its hedges as hedging instruments for accounting purposes.

Example 21 – Setting the hedge ratio

An entity purchases a raw material whose price is at a discount to the commodity benchmark price, reflecting that the raw material is not yet processed to the same extent as the benchmark commodity, as well as quality differences. The entity runs a rolling 12-month regression analysis at each month end to ascertain that the price of the commodity in the futures market and the price of the raw material remain highly correlated. The slopes of the regression analyses (commodity benchmark price to raw material price) over recent months varied between 1.237 and 1.276.

The entity considers that the pattern of its regression analyses is consistent with its longer term view that the raw material trades at an approximately 20% discount to the commodity benchmark price and does not indicate a change in trend but fluctuations around that discount. Therefore, the entity uses a notional amount of 1 tonne of a forward contract for the benchmark commodity to hedge highly probable forecast purchases of 1.25 tonnes of the raw material. Note that this is not exactly the same as the particular slope of the most recent monthly regression, which is not required because the standard requires only that the entity uses the hedge ratio that it actually uses for risk management purposes, and not that it is required to minimise ineffectiveness. The example also illustrates what the standard acknowledges: there is no 'right' answer, as different entities would run different regression analyses (e.g., in terms of frequency and data inputs used, which means there is no one hedge ratio that could be required). The fluctuation of the actual discount around the particular hedge ratio chosen for designating the hedging relationship will give rise to some ineffectiveness.

However, the standard requires the hedge ratio for accounting purposes to be different from the hedge ratio used for risk management if the hedge ratio reflects an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. This complex language was introduced because the IASB is specifically concerned with deliberate under-hedging, either to minimise recognition of ineffectiveness in cash flow hedges or the creation of additional fair value adjustments to the hedged item in fair value hedges.

Example 22 – Deliberate under-hedging in a cash flow hedge to minimise ineffectiveness

Consistent with the equivalent requirements of IAS 39, paragraph 6.5.11(a) of IFRS 9 requires the cash flow hedge reserve to be adjusted for the lower of (a) the cumulative gain or loss on the hedging instrument or (b) the cumulative change in fair value of the hedged item. If (a) exceeds (b), the difference is recognised in profit or loss as ineffectiveness. On the other hand, no ineffectiveness is recognised if (b) exceeds (a).

An entity has highly probable forecast purchases of a raw material used in its manufacturing process. The average volume of raw material purchases is expected to be Russian Ruble (RUB)200m per month. The entity wishes to hedge the commodity price risk on those forecast purchases. The only derivative available does not have an underlying risk exactly matching the one from the actual raw material hedged. The slope of a linear regression analysis is 0.93, indicating the ideal hedge ratio.

To seek to avoid recognition of accounting ineffectiveness, the entity ensures (b) will exceed (a), applying the accounting requirement discussed above. It enters into derivatives with a notional amount of only RUB150m per month and designates the RUB150m of forward contracts as hedging instruments in cash flow hedges of highly probable forecast purchases of RUB200m (thereby setting the hedge ratio at 0.75:1).

In this scenario, the hedge ratio would be considered unbalanced and only entered into to avoid recognition of accounting ineffectiveness. For hedge accounting purposes, the hedge ratio would have to be based on the expected sensitivity between the hedged item and the hedging instrument (in this example possibly around the 0.93:1 based on the linear regression analysis). As a result, if the relative change in the fair value of the hedging instrument is greater than that on the hedged item because the relationship between the underlyings changes, some ineffectiveness will have to be recognised.

Example 23 – Deliberate under-hedging in a fair value hedge to create fair value accounting

An entity acquires a CU50m portfolio of debt instruments. The debt instruments fail the 'cash flow characteristics test' in paragraphs 4.1.2(b) and 4.1.3 of IFRS 9 (i.e., the contractual cash flows do not solely represent payments of principal and interest on the principal amount outstanding) and are therefore accounted for at fair value through profit or loss.

The treasurer dislikes the profit or loss volatility resulting from the fair value accounting. He realises that one of the entity's fixed rate bank borrowings has a similar term structure and that fair value changes on the liability would more or less offset the fair value changes on the asset portfolio. However, at the time of entering into the bank borrowing, the entity did not apply the fair value option to this liability.

The treasurer enters into a CU1m receive fixed/pay variable IRS and designates the IRS in a fair value hedge of CU50m of fixed rate liability (thereby setting the hedge ratio at 0.02:1). As a result, the entire CU50m of liability would be adjusted for changes in the hedged interest rate risk.

In this scenario, the hedge ratio is unbalanced as the real purpose of the hedging relationship is to achieve fair value accounting (related to changes in interest rate risk) for CU49m of the liability. The hedge ratio used for hedge accounting purposes would have to be different (likely close to 1:1).

The above examples are of course extreme scenarios and instances of unbalanced hedge designations are likely to be rare; IFRS 9 does not require an entity to designate a 'perfect hedge'. For instance, if the hedging instrument is only available in multiples of 25 metric tonnes as the standard contract size, an imbalance due to using, say, 400 metric tonnes nominal value of hedging instrument to hedge 409 metric tonnes of forecast purchases, would not be regarded as resulting in an outcome 'that would be inconsistent with the purpose of hedge accounting' and so would meet the qualifying criteria.

5.5 Designating proxy hedges

The objective of the standard is to represent, in the financial statements, the effect of an entity's risk management activities. However, this does not mean that an entity can only designate hedging relationships that exactly mirror its risk management activities. In fact, in many cases entities will designate so called proxy hedges (i.e., designations that do not exactly represent the actual risk management). During the redeliberations leading to the final standard, the Board decided that proxy hedging is permitted, provided the designation is 'directionally consistent' with the actual risk management activities. The examples below are common proxy hedging designations.

IFRS 9 permits 'proxy hedging' provided the designation is 'directionally consistent' with the actual risk management activities.

Example 24 – Common proxy hedging designations

Net position cash flow hedging

IFRS 9.6.6.1(c) limits the designation of net positions in cash flow hedges to hedges of foreign exchange risk (discussed in section 3.6.3 above). However, in practice, entities often hedge other types of risk on a net cash flow basis. Such entities could still designate the net position as a gross designation.

Example:

An entity holds Australian Dollar (AUD)2m of variable rate loan assets and AUD10m of variable rate borrowings. The treasurer is hedging the cash flow risk exposure on the net position of AUD8m, by entering into a pay fixed/receive variable IRS with a nominal amount of AUD8m. The entity designates the IRS in a hedge of variable rate interest payments on a portion of AUD8m of its AUD10m borrowing.

Macro hedging strategies

Permitting proxy hedging is of particular relevance for banks wishing to apply macro cash flow hedging strategies. Typically, banks manage the interest margin risk resulting from fixed-floating mismatches of financial assets and financial liabilities held at amortised cost on their banking books. Assume the assets are floating and the liabilities are fixed. The fixed-floating mismatches are closed by entering into receive fixed/pay variable interest rate swaps. There is no hedge accounting model that perfectly accommodates such hedges of the interest margin. Consequently, banks in such a scenario are forced to use either fair value hedge accounting for the liabilities or cash flow hedge accounting for the assets, although the actual risk management activity is neither to hedge fair values nor cash flows, but to hedge the interest margin. Both, cash flow hedge accounting and fair value hedge accounting would be directionally consistent with the risk management activity.

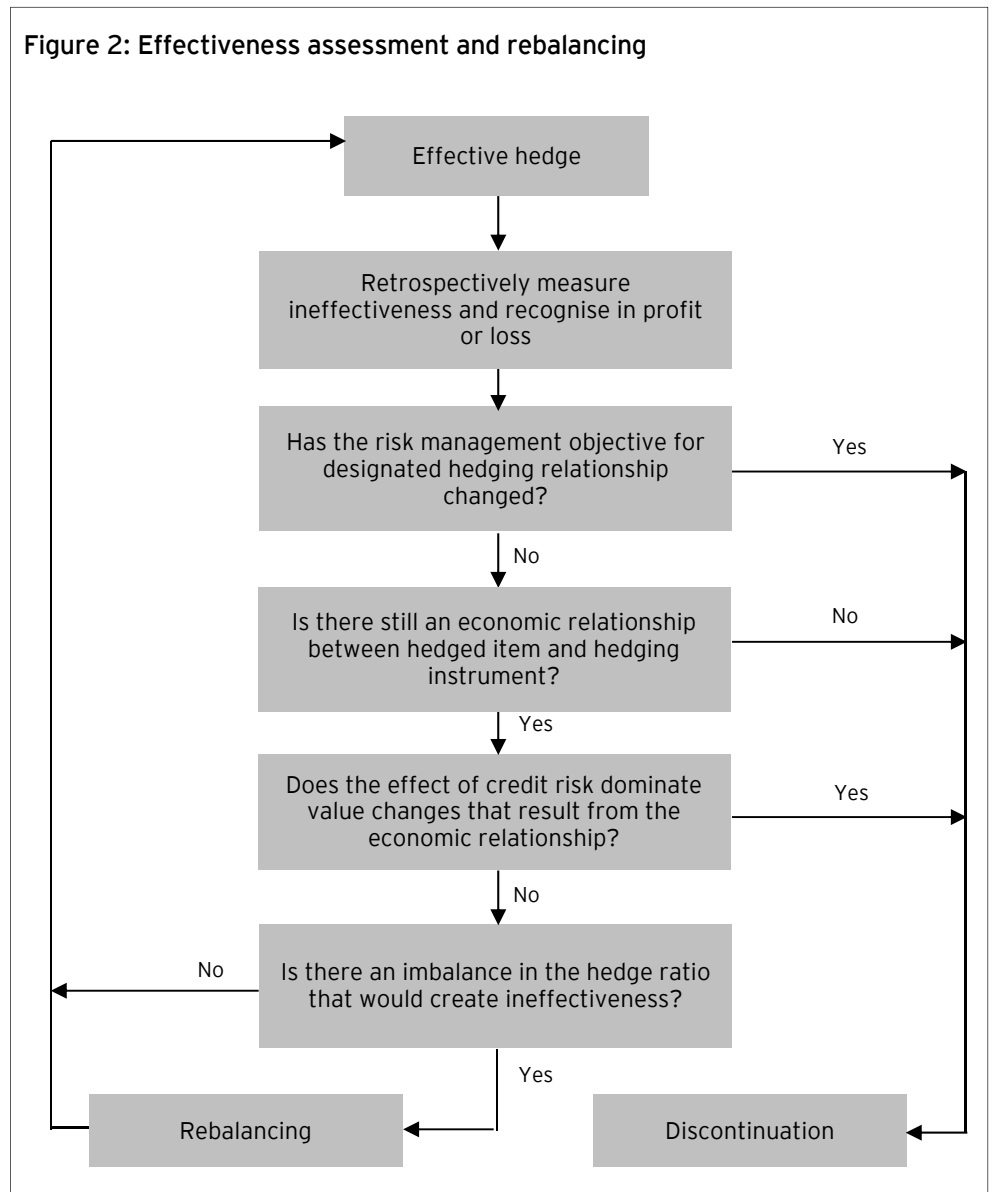
A prospective effectiveness assessment is required on an ongoing basis, as a minimum at each reporting date.

6. Subsequent assessment of effectiveness, rebalancing and discontinuation

6.1 Assessment of effectiveness

Entities no longer need to perform a retrospective quantitative effectiveness assessment using the 80%-125% bright lines. However, this does not mean that hedge accounting continues irrespective of how effective the hedge is. A prospective effectiveness assessment is still required, in a similar manner as at the inception of the hedging relationship (see section 5.1 above) and on an ongoing basis, as a minimum at each reporting date.

Figure 2: Effectiveness assessment and rebalancing



Rebalancing under IFRS 9 allows entities to refine their hedge ratio without discontinuing the hedging relationship.

An entity first has to assess whether the risk management objective for the hedging relationship has changed. A change in risk management objective is a matter of fact that triggers discontinuation. Discontinuation of hedging relationships is discussed in section 6.3 below.

An entity would also have to discontinue hedge accounting if it turns out that there is no longer an economic relationship. This makes sense as whether there is an economic relationship is a matter of fact that cannot be altered by adjusting the hedge ratio. The same is true for the impact of credit risk; if credit risk is now dominating the hedging relationship, then the entity has to discontinue hedge accounting.

But the hedge ratio may need to be adjusted if it turns out that the hedged item and hedging instrument do not move in relation to each other as expected. The entity has to assess whether it expects this to continue to be the case going forward. If so, the entity is likely to rebalance the hedge ratio to reflect the change in the relationship between the underlyings.

Currently, under IAS 39, when a hedge ratio is revised, entities have to discontinue the hedging relationship in its entirety and restart a new hedging relationship. For a cash flow hedge this is likely to lead to a degree of recognised ineffectiveness, as the hedging instrument will likely now have changed in fair value since it was originally designated (colloquially known as the 'late hedge' issue).

Rebalancing under IFRS 9 allows entities to refine their hedge ratio without discontinuation and so reducing this source of recorded ineffectiveness.

6.2 Rebalancing

6.2.1 Definition

The newly introduced concept of rebalancing only comprises changes to the hedge ratio to reflect expected changes in the relationship between the hedged item and the hedging instrument. Any other changes made to the quantities of the hedged item or hedging instrument would not be rebalancing (with the consequence that it would most likely need to be treated as a partial discontinuation if the entity reduces the extent to which it hedges, and a new designation of a hedging relationship if the entity increases it).

Therefore, rebalancing is only relevant if there is basis risk between the hedged item and the hedging instrument. It only affects the expected relative sensitivity between the hedged item and the hedging instrument going forward, as ineffectiveness from past changes in the sensitivity will have already been recognised in profit or loss.

6.2.2 Requirement to rebalance

Whether an entity has to rebalance a hedging relationship is first and foremost a matter of fact, which is, whether the hedge ratio has changed for risk management purposes. An entity has to rebalance a hedging relationship if that relationship still has an unchanged risk management objective but no longer meets the hedge effectiveness requirements regarding the hedge ratio. This will, in effect, be if the hedge ratio is no longer that actually used for risk management (see section 5.4 above).

However, as on initial designation, the hedge ratio for hedge accounting purposes would have to differ from the hedge ratio used for risk management if the latter would result in ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

IFRS 9 clarifies that 'not every change in the extent of offset between the ... hedging instrument and the hedged item ... constitutes a change in the relationship' that requires rebalancing. For example, hedge ineffectiveness arising from a fluctuation around an otherwise valid hedge ratio cannot be reduced by adjusting the hedge ratio. A trend in the amount of ineffectiveness on the other hand might suggest that retaining the hedge ratio would result in increased ineffectiveness going forward. IFRS 9 further clarifies that an accounting outcome that would be inconsistent with the purpose of hedge accounting as the result of failing to adjust the hedge ratio for risk management purposes, would not meet the qualifying criteria for hedge accounting. This simply means that the qualifying criteria treat inappropriate hedge ratios in the same way, irrespective of whether they were achieved by acting (inappropriate designation) or failure to act (by not adjusting a designation that has become inappropriate).

6.2.3 Mechanics of rebalancing

Rebalancing can be achieved by:

- ▶ Increasing the volume of the hedged item
- ▶ Increasing the volume of the hedging instrument
- ▶ Decreasing the volume of the hedged item

Or

- ▶ Decreasing the volume of the hedging instrument

Decreasing the volume of the hedging instrument or hedged item does not mean that the respective transactions or items no longer exist or are no longer expected to occur. As demonstrated in Example 25 below, rebalancing only changes what is designated in the particular hedging relationship.

Example 25 – Rebalancing the hedge ratio by decreasing the volume of the hedging instrument

At 1 January 20x1 an entity expects to purchase 1m barrels of West Texas Intermediate (WTI) crude oil in 12 months. The entity designates a futures contract of 1.05m barrels of Brent crude oil in a cash flow hedge to hedge the highly probable forecast purchase of 1m barrels of WTI crude oil (hedge ratio of 1.05:1).

At 30 June 20x1, the cumulative changes in fair value of hedged item is CU200, while the cumulative change in fair value of hedging instrument is CU229.

The entity would account for the hedging relationship, as follows:

Hedging gain/loss - other comprehensive income	CU200	
Hedge ineffectiveness -profit or loss	CU29	
Derivatives - hedging instruments		CU229

To account for the fair value change in the hedging instrument.

Under the requirements of IAS 39, the hedging relationship would still be considered effective (87.3%/114.5% effectiveness). However, the treasurer of the entity is very sensitive to ineffectiveness and therefore considers rebalancing the hedging relationship.

The analysis of the treasurer shows that the sensitivity of Brent crude oil to WTI crude oil prices was not as expected. Going forward, the treasurer expects a different relationship between the two benchmark prices and decides to reset the hedge ratio to 0.98:1.

To rebalance at 30 June 20x1, the treasurer can either designate more WTI exposure or de-designate part of the hedging instrument. The entity decides to do the latter, that is, discontinue hedge accounting for 0.07m barrels of Brent crude oil derivatives.

Of the total of 1.05m barrels of Brent derivative 0.07m barrels are no longer part of the hedging relationship. Therefore, the entity needs to reclassify 7/105 (or 6.7%) of the hedging instrument in the statement of financial position to a held for trading derivative, measured at fair value through profit or loss. The hedge documentation is updated accordingly.

The entity accounts for the rebalancing, as follows:

Derivatives - hedging instruments	CU15	
Derivatives - trading		CU15

To reflect that a part of the derivative is no longer part of a hedging relationship.

In Example 25 above, the entity no longer needs to hold this portion of the derivative any longer for hedging purposes and could, therefore, close it out. As mentioned, the entity could have also rebalanced by designating more WTI exposure (assuming that the higher level of exposure is highly probable of occurring). In that case, there would not be any immediate accounting entries; the entity would simply designate more WTI exposure. The same would be true when rebalancing by increasing the volume of hedging instrument, in which case the entity would simply designate additional volume of hedging instrument (provided, of course, it is available).

Example 26 – Rebalancing the hedge ratio by decreasing the volume of hedged item

At 1 April 20x1, an entity has highly probable forecast purchases of diesel over the next 12 months. The entity expects to get monthly deliveries of 10,000 metric tonnes at the local market price. The entity designates futures contract referenced to the Platts Diesel D2 price with a nominal amount of 9,500 metric tonnes in a cash flow hedge, to hedge 10,000 metric tonnes of highly probable diesel purchases in September (giving a hedge ratio of 1:0.95).

At 30 June 20x1, the cumulative change in fair value of hedged item is CU820, while the cumulative change in fair value of hedging instrument is CU650. The entity would account for the hedging relationship, as follows:

Hedging reserve - other comprehensive income	CU650	
Derivatives - hedging instruments		CU650

To account for the fair value change in the hedging instrument.

Despite the hedge only being 79% effective, no hedging ineffectiveness is recorded as a result of the 'lower of test' in paragraph 6.5.11 of IFRS 9. As per that paragraph, the amount accumulated in other comprehensive income has to be the lower of:

- i) The cumulative gain or loss on the hedging instrument
- ii) The cumulative change in fair value of the hedged item, with any remaining gain or loss on the hedging instrument being recorded in profit or loss

Based on an analysis, the entity now believes that the appropriate hedge ratio going forward is 1:1.05. Consequently, the entity can either increase the volume of hedging instrument or decrease the volume of hedged item. Based on a cost-benefit analysis the entity decides to reduce the volume of hedging instrument by 952 metric tonnes.

At 30 June 20x1, rebalancing a hedge ratio by decreasing the volume of hedged item is considered a partial discontinuation of the hedging relationship. The entity is discontinuing 952 ($10,000 - (9,500/1.05) = 952$) metric tonnes of diesel purchases while 9,048 metric tonnes of forecast purchases remain in the hedging relationship. The hedge documentation is updated accordingly. No accounting entry is required.

How we see it

Even though the standard allows for adjustments to either the quantity of hedging instrument or the quantity of the hedged item, when rebalancing, entities should consider that adjusting the hedged item will be operationally more complex than adjusting the hedging instrument because of the need to track the history of different quantities that were designated during the term of the hedging relationship.

For example, if a quantity of 10 tonnes of a hedged item were added to increase the quantity of hedged item and later deducted to decrease it, those 10 tonnes would have been part of the hedged item for only a part of the life of the hedging relationship. However, any cash flow hedge adjustment would still, in part, relate to that quantity. This can get more complex in situations in which the hedging relationship needs frequent rebalancing, if not all hedged transactions occur at the same time, or in conjunction with the cost formulae used for the measurement of the cost of inventory.

In addition, adjusting the hedged item might suggest the entity is using an accounting driven approach to hedge accounting, because risk management would normally adjust the quantity of the designated hedging instruments when rebalancing since the hedged exposure is the 'given' and drives what hedges are needed.

IFRS 9 now introduces 'partial discontinuation' of hedge accounting, which means that hedge accounting continues for the remaining part of the hedging relationship.

6.3 Discontinuation

An entity would have to discontinue hedge accounting if the qualification criteria are no longer met. As also mentioned at section 6.1 above, this includes if the risk management objective for the hedging relationship has changed.

In an important change to IAS 39, IFRS 9 now introduces 'partial discontinuation' of hedge accounting, which means that hedge accounting continues for the remaining part of the hedging relationship.

The table below summarises the main scenarios resulting in either full or partial discontinuation:

Scenario	Discontinuation
The risk management objective has changed	Full or partial
There is no longer an economic relationship between the hedged item and the hedging instrument	Full
The effect of credit risk dominates the value changes of the hedging relationship	Full
As part of rebalancing, the volume of the hedged item or the hedging instrument is reduced	Partial
The hedging instrument expires	Full
The hedging instrument is (in full or in part) sold, terminated or exercised	Full or partial
The hedged item (or part of it) no longer exists or is no longer expected to occur	Full or partial

The application guidance in IFRS 9 provides three examples elaborating on what constitutes a change in risk management objective. We believe that a change in risk management objective has to be a matter of fact that can be observed in the entity's actual risk management. The examples below, the first of which is derived from the application guidance to IFRS 9, demonstrate how this could be assessed in practice.

Example 27 – Partial discontinuation as a result of a change in risk management objective

ABC Ltd is currently fully financed with variable rate borrowings (the tables show nominal amounts):

Non-current financial liabilities	1 January 20x1	
	Variable rate	Fixed rate
Borrowings	CU100 100%	CU0 0%

Risk management strategy

To maintain between 20% and 40% of borrowings at a fixed rate.

Risk management activity

The treasurer of ABC enters into a pay fixed/receive variable IRS and designates the IRS in a hedging relationship.

Risk management objective

Use a pay fixed/receive floating interest rate swap with a notional amount of CU30 m in a cash flow hedge to hedge the interest payments on CU30m of the variable rate borrowings in order to maintain 30% of the borrowings at fixed rate.

Non-current financial liabilities	1 January 20x1	
	Variable rate	Fixed rate
Borrowings	CU100	CU 0
Pay fixed/receive variable interest rate swap	(30)	30
Total	CU 70 70%	CU30 30%

On 31 March 20x2, the entity needs further funding and takes advantage of lower interest rates by issuing a CU50m fixed rate bond. At the same time, the entity decides to set its fixed rate exposure at 40% of total borrowings, still being within the risk management strategy.

Non-current financial liabilities	31 March 20x2	
	Variable rate	Fixed rate
Borrowings	CU100	CU50
Pay fixed/receive variable interest rate swap	(30)	30
Total	CU 70 47%	CU80 53%

Example 27 – Partial discontinuation as a result of a change in risk management objective *continued*

It becomes evident that ABC is no longer within the target range of its risk management strategy. In order to execute the risk management strategy, ABC no longer needs part of its interest rate swap. In other words, the risk management objective for the hedging relationship has changed. Consequently, ABC discontinues CU20m of the hedging relationship (a partial discontinuation).

Going forward, ABC's debt financing and risk profile will be, as follows:

Non-current financial liabilities	31 March 20x2	
	Variable rate	Fixed rate
Borrowings	CU100	CU50
Pay fixed/receive floating interest rate swap	(10)	10
Total	<u>CU 90</u>	<u>CU60</u>
	60%	40%

The above example only illustrates the outcome of one particular course of action. The entity could also have adjusted its interest rate exposure in a different way in order to remain in the target range for its fixed rate funding, for instance by swapping CU20m of the new fixed rate bond into variable rate funding. In that case, instead of discontinuing a part of the already existing cash flow hedge the entity would have designated a new fair value hedge.

How we see it

The example in the application guidance of the standard is obviously a simplified one. In practice, entities tend to have staggered maturities for different parts of their financing. In such situations, it would often be obvious from the maturity of the new interest rate swaps if they are a fair value hedge of the debt or a reduction of the already existing cash flow hedge volume. For example, if the new CU50m fixed rate bond is for a longer period than the existing debt and the new interest rate swap is for the same longer period, it would suggest that it is a fair value hedge of the new fixed rate bond instead of a reduction of the cash flow hedge for the already existing debt. Conversely, a reduction of the cash flow hedge volume would be consistent with entering into a new interest rate swap that has the same remaining maturity as the existing interest rate swap and offsets it partially.

Example 28 – Partial discontinuation of an interest margin hedge

XYZ Bank is holding a combination of fixed and variable rate assets and liabilities on its banking book. For risk management purposes, the bank allocates all the assets and liabilities to time buckets based on their contractual maturity. As of 1 January 20x1, the bank holds the following instruments in the 5-year time bucket (the table show nominal amounts in CU millions):

Summary of instruments with a 5-year maturity	Fixed		Variable	
	Assets	Liabilities	Assets	Liabilities
Bonds held	-	-	20	-
Mortgages	30	-	10	-
Retail loans	30	-	10	-
Client term deposits	-	-	-	(60)
Bonds issued	-	(30)	-	(10)
Total	<u>60</u>	<u>(30)</u>	<u>40</u>	<u>(70)</u>
Fixed-variable interest mismatch		<u>30</u>		<u>(30)</u>

The fixed-variable mismatch results in interest margin risk due to changes in interest rates.

Risk management strategy

To eliminate the interest margin risk resulting from fixed-variable interest mismatches.

Risk management activity

In order to achieve the risk management strategy, XYZ Bank enters into a pay fixed/receive variable IRS with a notional amount of CU30m. For accounting purposes, the bank could either designate the IRS in a cash flow hedge of CU30m of specific variable rate liabilities or in a fair value hedge of CU30m of specific fixed rate assets. Under the local regulatory requirements, fair value hedges are more favourable for the bank's regulatory capital.

Risk management objective

Using a CU30m pay fixed/receive variable IRS in a fair value hedge of CU30m of fixed rate retail loans to hedge a fixed-variable interest mismatch on fixed and variable rate assets and liabilities in the 5-year time bucket of XYZ Bank's banking book.

Example 28 – Partial discontinuation of an interest margin hedge continued

At the beginning of year 20x3, XYZ Bank attracts CU10m of client term deposits as a result of a successful marketing campaign. The new term deposits all have a fixed interest rate for a maturity of three years, therefore, matching the (remaining) maturity of the instruments in the above time bucket. The XYZ Bank uses the proceeds from the new term deposits to buy back CU10m of variable rate bonds that it has issued. The new situation in the (now) 3-year time bucket is:

Summary of instruments with a 3-year maturity	Fixed		Variable	
	Assets	Liabilities	Assets	Liabilities
Bonds held	-	-	20	-
Mortgages	30	-	10	-
Retail loans	30	-	10	-
Client term deposits	-	(10)	-	(60)
Bonds issued	-	(30)	-	(0)
Total	60	(40)	40	(60)
Fixed-variable interest mismatch	20		(20)	
Pay fixed/receive variable interest rate swap	(30)		30	

As a result of the change in funding, the risk management objective of the hedging relationship has changed. XYZ Bank is over-hedged and needs to discontinue CU10m of its hedging relationship.

A consequence of linking the discontinuation to the risk management objective is that voluntary discontinuations just for accounting purposes are no longer permitted. This change, introduced in the Exposure Draft leading up to the final published amendments, gave rise to concern among some constituents who argued that, given hedge accounting is optional, voluntary discontinuation should be retained.

Entities have often voluntarily discontinued hedge accounting to adjust, for instance:

- ▶ The hedge ratio for a change in the expected relationship between the hedged item and the hedging instrument
- ▶ The volume of hedged forecast transactions if part of the volume is no longer highly probable

Each of the scenarios mentioned above is addressed in IFRS 9 by introducing a new effectiveness assessment, rebalancing and partial discontinuation. Hence, voluntary discontinuation is no longer needed in such situations.

In its redeliberations, the IASB noted that hedge accounting is an exception to the general accounting principles in IFRS to present in the financial statements a particular risk management objective of a risk management activity. If that risk management objective is unchanged and the qualifying criteria for hedge accounting are still met, a voluntary discontinuation would jeopardise the original reason for applying hedge accounting. The Board believes that hedge accounting, including its discontinuation, should have a meaning and should not be a mere accounting exercise. Based on this, the IASB decided not to allow voluntary discontinuation for hedges with unchanged risk management objectives.

6.4 Measuring ineffectiveness

IFRS 9 adds only two paragraphs in the application guidance on how to measure ineffectiveness, dealing with the time value of money and hypothetical derivatives. Although intended as a clarification, these two paragraphs might have wider implications for some practices currently applied by entities.

6.4.1 The effect of the time value of money

Entities have to consider the time value of money when measuring hedge ineffectiveness. This means that an entity has to determine the value of the hedged item on a present value basis (thereby including the effect of the time value of money).

IFRS 9 does not clarify more than what was already clear under IAS 39. In valuation practice, the effect of the time value of money is also included when measuring the fair value of financial instruments. Consequently, it is more than logical to apply the same principle to the hedged item as well.

Example 29 – Impact of time value of money when measuring ineffectiveness

A manufacturing company in India, having the Indian Rupee as its functional currency, is expecting forecast sales in USD. The company assesses sales of USD1m per month for the next twelve months to be highly probable and wishes to hedge the related foreign currency exposure. The company also holds a borrowing of USD20m. Instead of entering into foreign currency forward contracts, the company designates the US dollar borrowing as a hedging instrument in hedges of the spot risk of the monthly highly probable US dollar sales.

This hedge is a pure accounting hedge as the cash flows of the sales and the borrowing do not match. When measuring hedge ineffectiveness, the foreign currency revaluation of the forecast sales would have to be discounted, whereas the revaluation of the hedging instrument would not.

IFRS 9 also clarifies that a hypothetical derivative may only be used to represent the hedged item but not a 'perfect hedging instrument'. Hence, an entity cannot include features in the hypothetical derivative that only exist in the hedging instrument, but not in the hedged item.

6.4.2 Hypothetical derivatives for measuring ineffectiveness

When measuring ineffectiveness of cash flow hedges under IAS 39, entities often make use of a so-called 'hypothetical derivative'. This involves establishing a notional derivative that has terms that match the critical terms of the hedged exposure (normally an interest rate swap or forward contract with no unusual terms and a zero fair value at inception of the hedging relationship). The fair value of the hypothetical derivative is then used to measure the change in the value of the hedged item against which changes in value of the actual hedging instrument are compared, to assess effectiveness and measure ineffectiveness. However, although commonly used in practice, use of a hypothetical derivative is not specifically addressed in IAS 39.

IFRS 9 clarifies that use of a hypothetical derivative is one possible way of determining the change in the value of the hedged item when measuring ineffectiveness. However, IFRS 9 also clarifies that a hypothetical derivative has to be a replication of the hedged item and that any different method for determining the change in the value of the hedged item would have to have the same outcome. Consequently, an entity cannot include features in the hypothetical derivative that only exist in the hedging instrument, but not in the hedged item.

What appears to be a logical requirement may have wider implications for cash flow hedges than many would have expected. IFRS 9 is clear that the hypothetical derivative is supposed to represent the hedged item and not the 'perfect hedge'. In other words, an entity cannot simply assume no ineffectiveness for a cash flow hedge with matching terms (e.g., where the terms of the hedging instrument exactly match the terms of a hedged forecast transaction).

For example, IFRS 13 requires an entity to reflect both the counterparty's credit risk and the entity's own credit risk in the measurement of a derivative. The counterparty credit risk of a derivative designated in a hedging relationship is likely to be different from the counterparty credit risk in the hedged item (if there is any). The difference in credit risk would result in some ineffectiveness (see section 5.3 above). IFRS 9 is clear that, when using a hypothetical derivative for measuring ineffectiveness in a cash flow hedge, the counterparty credit risk on the hedging instrument could not be deemed to equally be a feature also present in the hedged item. For example, if the hedged item is a forecast transaction it would not involve any credit risk, so that there is no offset for any credit risk affecting the fair value of the hedging instrument, which would give rise to some ineffectiveness. Also, if the hedged item involves credit risk, the effect of that has to be established independently of the hedging instrument.

Another (maybe unexpected) source of ineffectiveness is the discount rate used for measuring the fair value of cash collateralised IRS. Historically, the fair values of interest rate swaps have been calculated using LIBOR-based discount rates. As per its definition, LIBOR is the average rate at which the reference banks can fund unsecured cash in the interbank market for a given currency and maturity.

However, the use of LIBOR as the standard discount rate ignores the fact that many derivative transactions are now collateralised. For cash-collateralised trades, a more relevant discount rate is an overnight rate rather than LIBOR. Overnight index swaps (OIS) are interest rate swaps where the floating leg is linked to an interest rate for overnight unsecured lending to a bank. OIS rates much better reflect the funding cost of cash collateralised IRS.

When measuring the fair value of cash-collateralised LIBOR indexed interest rate swap, an entity would have to use a LIBOR-based forward curve to determine the future floating cash flows, but these are then discounted using an OIS swap curve. This would obviously result in a different fair value compared to a non-collateralised IRS for which both the forward rates and the discount rates are derived from the LIBOR swap curve. The resulting ineffectiveness is sometimes referred to as the 'multi curve issue'.

Historically, the difference between LIBOR and OIS rates has been equal to a few basis points only. However, the basis differential widened significantly during the financial crisis and is not expected to revert in the foreseeable future.

For cash-collateralised derivatives, both parties to the contract would have equal collateral requirements, significantly reducing the credit risk of both parties to the contract. This would improve the economic effectiveness of a hedging relationship while at the same time, may also result in more accounting ineffectiveness.

IFRS 9 introduces a new accounting treatment for changes in the fair value of the time value of an option, if only the intrinsic value is designated in the hedging relationship. The appropriate accounting treatment depends on the nature of the item that is hedged with the option's intrinsic value.

7. Other changes from IAS 39

7.1 Time value of options

The fair value of an option consists of the intrinsic value and the time value. When using an option for hedging activities, only the intrinsic value is used for offsetting the fair value changes attributable to the hedged risk (unless the hedged item is also an option, see section 3 above). Unchanged from IAS 39, an entity can either designate an option as a hedging instrument in its entirety, or it can separate the intrinsic value and the time value and designate only the intrinsic value.

Under IAS 39, when designating the option in its entirety as a hedge of a non-option item, changes in the portion of the fair value attributable to the time value result in ineffectiveness. Depending on the level of ineffectiveness, an entity might even not pass the prospective effectiveness assessment or be forced to discontinue hedge accounting as a result of changes in the time value. Alternatively, when designating the intrinsic value of the option only, the time value has to be accounted for at fair value through profit or loss, thus, also resulting in potentially significant profit or loss volatility. In either case, the change in the time value will be recognised in profit or loss.

From a risk management perspective, entities typically consider the premium paid on an option (which, on inception, is often only time value) as a cost of hedging rather than a trading position. Economically, the time value could be considered as a premium for protection against risk (i.e., an 'insurance premium').

IFRS 9 does not change how an option is designated in a hedging relationship (i.e., whether in its entirety or the intrinsic value only). However, the IASB has acknowledged these concerns and introduced a new accounting treatment for changes in the fair value of the time value if only the intrinsic value is designated in the hedging relationship.

Changes in the fair value of the time value of options are first recognised in OCI. The subsequent treatment depends on the nature of the hedged transaction. The standard differentiates between transaction related hedged items and time-period related hedged items:

- ▶ *Transaction related hedged item*: the time value of an option used to hedge such an item represents part of the cost of the transaction. An example would be a hedge of a forecast commodity purchase. The amount that is accumulated in OCI is removed similar to amounts accumulated in the cash flow hedge reserve (see section 8.1 below), i.e., if the hedged transaction subsequently results in the recognition of a non-financial item the amount becomes a 'basis adjustment' and else the amount is reclassified to profit or loss (reclassification adjustment) in the same period or periods during which the hedged cash flows affect profit or loss.
- ▶ *Time-period related hedged item*: the time value of an option used to hedge such an item has the character of the cost of protection against a risk over a particular period of time. An example would be a hedge of commodity inventory over a six month period. The amount that is accumulated in OCI is amortised on a systematic and rational basis to profit or loss as a reclassification adjustment. The amortisation period is the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or other comprehensive income in case the option hedges an equity instrument accounted for at fair value through other comprehensive income).

The distinction between transaction related hedged items and time-period related hedged items reflects that the accounting for the time value of the option should follow general IFRS principles for how to account for payments that are akin to insurance premiums (the 'insurance premium view' mentioned above). So, in making the distinction, an entity needs to consider how the accounting for the hedged item will eventually affect profit or loss.

If the hedged item later results in a transaction for which the transactions costs are accounted for as part of a one-off event (like a purchase or a sale of an item), the option's time value relates to a transaction related hedged item. Examples are hedges of forecast purchases of inventory or property, plant and equipment, and forecast sales. Similarly, if the purchases or sales result from a firm commitment, the option's time value relates to a transaction related hedged item because the transactions resulting from those firm commitments affect profit or loss at the same time as similar forecast transactions.

If the hedged item later results in protection against risk for a particular period that does not involve a transaction for which the transactions costs are accounted for as part of a one-off event, the option's time value relates to a time-period related hedged item. Examples are hedges of interest expense or income in particular periods, already existing inventory hedged for fair value changes or a hedge of a net investment in a foreign operation. In the case of a forward starting interest rate option, the time value would be amortised over the interest periods that the option covers (i.e. the amortisation period would exclude the initial part of the option's life).

A practical reference point for identifying the correct accounting is to look at how the intrinsic value of the related hedging relationship could affect profit or loss. That dictates the timing of recognising the time value of the option in profit or loss in most cases, with firm commitments as hedged items being the notable exception. For fair value hedges of firm commitments to buy or sell a non-financial item, any intrinsic value of the option would affect profit or loss during the commitment period but the time value of the option would still have to be deferred until the commitment is settled (as noted above for transaction related hedged items).

It is important to note that because this accounting for 'costs of hedging' only applies if the time value of the option is excluded from the designation of the hedging relationship, the amounts deferred in accumulated other comprehensive income are not part of the cash flow hedge reserve but instead a different component of equity. The cash flow hedge reserve only includes amounts that are gains or losses on hedging instruments that are determined to be an effective hedge (i.e., amounts that are included in the designation of a hedging relationship). By default, the time value will be zero at expiry of an option contract. For a transaction related hedged item, recognising the fair value changes of the time value in OCI means that on expiry, the time value that existed at designation will have accumulated in OCI. Once the hedged transaction happens, the accounting for the accumulated time value follows the accounting for any changes in fair value of the intrinsic value of the option (that were also accumulated in OCI). For time-period related hedged items, the standard does not prescribe what 'on a systematic and rational basis' means in the context of amortising the time value from OCI to profit or loss. We believe a straight-line amortisation to be appropriate in most cases.

Example 30 – Hedging the purchase of equipment (transaction related)

In the first quarter of a year, a manufacturing entity plans to purchase a new machine for its manufacturing process. Delivery of the machine is expected in the third quarter and the purchase price will be Swedish Krona (SEK)5m. The entity has the Norwegian Krone (NOK) as its functional currency and, therefore, is exposed to foreign currency risk on this forecast transaction. The entity buys a call option to purchase SEK5m, as it wishes to hedge the downside risk only. The terms of the option match the terms of the forecast transaction. The entity designates only the intrinsic value of the call option in a cash flow hedge of the highly probable forecast purchase of the machine.

At inception, the time value of the option amounts to NOK30,000. After inception, the time value of the option amounts to NOK16,000 at the end of the first quarter and NOK7,000 at the end of the second quarter.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within OCI and the reserve within equity for accumulating amounts in relation to the time value of options associated with transaction related hedged items:

(All amounts in NOK thousands)	Q1	Q2	Q3
Reserve at beginning of quarter	-	(14)	(23)
Change in time value of option	(14)	(9)	(7)
Basis adjustment to machine	-	-	30
Reserve at end of quarter	<u>(14)</u>	<u>(23)</u>	<u>-</u>
Effect on OCI for the period	(14)	(9)	(7)

Example 31 – Hedging interest rate risk of a bond (time period related)

An entity issues a seven-year floating rate bond and wishes to protect itself against increases in the interest expense for the first two years. Therefore, the entity purchases an interest rate cap with a maturity of two years. Only the intrinsic value of the cap is designated as a hedging instrument in a cash flow hedge.

The time value on designation is CU20,000 which is amortised to profit or loss on a straight-line basis over the protection period (i.e., the first two years). After inception, the time value of the option amounts to CU13,000 at the end of the first year.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within OCI and the reserve within equity for accumulating amounts in relation to the time value of options associated with time-period related hedged items:

(All amounts in CU thousands)	Year 1	Year 2
Reserve at beginning of year	-	3
Change in time value of option	(7)	(13)
Amortisation of time value at inception	<u>10</u>	<u>10</u>
Reserve at end of year	<u>3</u>	<u>-</u>
Effect on OCI for the year	3	(3)
Effect on profit or loss for the year	(10)	(10)

The accounting for the time value of options would also apply to combinations of options, for example, when hedging a highly probable forecast transaction with a zero-cost collar. When designating the intrinsic value only, the volatility resulting from changes in the time values of the two options would be recognised in other comprehensive income. However, the amortisation (in the case of time-period related hedged items) or the transaction costs deferred at the end of the life of the hedging relationship (for transaction related hedged items) would be nil when using a zero-cost collar.

Examples 30 and 31 above both assume that the critical terms of the option match the hedged item. However, in practice, this is not always the case. The accounting treatment described above applies only to the extent the time value relates to the hedged item. An additional assessment has to be made if the critical terms of the option do not match the hedged item. For that purpose, the actual time value has to be compared with that of a hypothetical option that perfectly matches the critical terms of the hedged item (in IFRS 9 referred to as the aligned time value).

When the terms of the option are not aligned with the hedged item, the accounting for the time value in situations in which the aligned time value exceeds the actual time value is different to situations in which the actual time value exceeds the aligned time value.

If, at inception, the actual time value exceeds the aligned time value:

- ▶ The aligned time value at inception is amortised on a rational basis from OCI to profit or loss over the period the hedged item affects profit or loss (for a time-period related hedged item).
- ▶ The change in the fair value of the aligned time value is recognised in OCI.
- ▶ The remaining difference in change in fair value between the actual time value and the aligned time value is recognised in profit or loss.

If, at inception, the aligned time value exceeds the actual time value:

- ▶ The actual time value at inception is amortised on a rational basis from OCI to profit or loss over the period the hedged item affects profit or loss (for a time-period related hedged item).
- ▶ Lower of the cumulative change in the fair value of the actual time value and the aligned time value is recognised in OCI.
- ▶ The remaining difference in change in fair value between the actual time value and the aligned time value, if any, is recognised in profit or loss.

For the hedging strategy introduced in Example 31 above, this would change the accounting, as follows:

Example 32 – Hedging interest rate risk of a bond (time period related)

Scenario 1: Actual time value exceeds aligned time value

The actual time value at inception is CU20,000. The aligned time value at inception is CU15,000.

(All amounts in CU thousands)	Year 1	Year 2
Change in actual time value of option	(10)	(10)
Change in aligned time value of option	(6)	(9)
Reserve in equity at beginning of year	-	1.5
Change in time value of option (based on aligned time value)	(6)	(9)
Amortisation of time value at inception (based on aligned time value)	7.5	7.5
Reserve in equity at end of year	<u>1.5</u>	<u>-</u>
Effect on OCI for the year	1.5	(1.5)
Remaining change in (actual) time value recognised in profit or loss	(4)	(1)
Effect on profit or loss for the year	(11.5)	(8.5)

The above accounting treats the difference between the actual and the aligned time value, consistent with its designation, as derivative at fair value through profit or loss.

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

The actual time value at inception is CU20,000. The aligned time value at inception is CU24,000.

(All amounts in CU thousands)	Year 1	Year 2
Change in actual time value of option	(8)	(12)
Change in aligned time value of option	(14)	(10)
Reserve in equity at beginning of year	-	2
Change in time value of option (based on the lower of the cumulative change in aligned time value and actual time value)	(8)	(12)
Amortisation of time value at inception (based on actual time value)	10	10
Reserve in equity at end of year	<u>2</u>	<u>-</u>
Effect on OCI for the year	2	(2)
Remaining change in (actual) time value recognised in profit or loss	-	-
Effect on profit or loss for the year	(10)	(10)

The above 'lower of test' for the accounting of the time value assures that the entity does not recognise more expense in profit or loss than the entity actually incurred (based on the time value at inception).

IFRS 9 does not define the 'aligned time value' in much detail but it is clear that it is part of the concept of 'costs of hedging'. Therefore, regular pricing features, such as dealer margins, are part of the aligned time value of an option, reflecting that they are part of the fair value of the financial instrument whose intrinsic value is designated as the hedging instrument.

This is different from using a hypothetical derivative, which has the purpose of measuring the hedged item. For that purpose, features that are only in the hedging instrument but not the hedged item cannot be taken into account, whereas the same rationale does not apply for the purpose of accounting for the costs of hedging. This becomes clearer from the example of the foreign currency basis spread (see section 7.2.2 below); it cannot be included as part of a hypothetical derivative to measure the hedged item but it is a cost of hedging.

IFRS 9 introduces an optional accounting treatment for the forward element of a forward contract similar to the accounting for the time value of an option. This applies when only the spot element of the forward contract is designated as the hedging instrument. A similar treatment would be available for the foreign currency basis spread of a financial instrument if it is excluded from the designation as the hedging instrument.

7.2 Forward element of forward contracts and foreign currency basis spread of financial instruments

7.2.1 General requirements

Under IAS 39, entities using foreign currency forward contracts in hedging relationships can designate the instrument in its entirety or designate the spot element only. Designating the spot element only results in the forward points (often also called the 'forward element') to be accounted for at fair value through profit or loss.

When designating the entire instrument, IAS 39 allows the hedged item alternatively to be measured at the forward rate instead of the spot rate. For example, when hedging a highly probable forecast transaction, the hedged item, once transacted, would be measured at the forward rate at designation. This is often referred to as the 'forward rate method'. However, IAS 21 requires monetary financial assets and liabilities denominated in a foreign currency to be measured at the spot rate. As a result, the forward rate method does not provide a similar solution for hedges of such monetary items because of how IAS 21 works.

IFRS 9 introduces an optional treatment similar to the accounting for time value of options when the spot element only is designated. This is, however, not an accounting policy choice, but an election for each designation.

When designating the spot element only, the change in fair value of the (actual) forward element is recognised in OCI and accumulated in a separate component of equity. The (aligned) forward element that exists at inception is amortised from the separate component of equity to profit or loss on a rational basis.

As a result of the above accounting, fluctuations in the fair value of the forward element over time will affect other comprehensive income only, while the amount recognised in profit or loss will be stable.

Example 33 – Funding swaps - designating the spot risk only

A bank, having the Singapore Dollar (SGD) as its functional currency, borrows money by entering into a two-year fixed rate loan denominated in Japanese Yen (JPY). The bank transfers the JPY funds into its functional currency and lends the money as a SGD denominated two-year fixed rate loan. To hedge the SGD/JPY exchange risk, the bank enters into a foreign exchange forward contract to buy JPY against SGD in two years time. The fair value of the forward element at inception is SGD20,000 and it is SGD13,000 at the end of the first year.

From an economic standpoint, the bank has now hedged the foreign exchange risk and locked in the interest margin for the entire two-year period.

In economic theory, the forward points represent the difference in interest rates between the two currencies involved. Hence, the forward element that exists at inception is seen as one element of the interest margin (however, see section 7.2.2 below).

Applying the IFRS 9 accounting requirements to the forward element of the forward contract results in the following movement within OCI and the hedging reserve:

(All amounts in SGD thousands)	Year 1	Year 2
Reserve in equity at beginning of year	-	3
Change in fair value of forward element	(7)	(13)
Amortisation of forward element at inception	10	10
Reserve in equity at end of year	3	-
Effect on OCI for the year	3	(3)
Effect on profit or loss for the year	(10)	(10)

The bank would present the amortisation of the forward element in the income statement within the interest margin, together with the interest income from the loan and the interest expense from the borrowing, showing the economically fixed interest margin in SGD of the transaction.

7.2.2 Foreign currency basis spreads

IFRS 9 also introduces a new accounting treatment for currency basis spreads. The currency basis spread, a phenomenon that became very significant during the financial crisis, is a charge embedded in financial instruments that compensates for aspects such as country and liquidity risk. This charge only applies to transactions involving the exchange of foreign currencies at a future point in time (as, for example, in currency forward contracts or CCIRS).

Historically, the difference between the spot and forward prices of currency forward contracts and CCIRS represented the differential between the interest rates of the two currencies involved. However, basis spreads increased significantly during the financial crisis and with the following sovereign debt crisis, and have become a significant and volatile component of the pricing of longer term forward contracts and CCIRS.

The standard cites currency basis spread as an example of an element that is only present in the hedging instrument, but not in a hedged item that is a single currency instrument. Consequently, this would result in some ineffectiveness even when using a hypothetical derivative for measuring ineffectiveness (see section 6.4.2 above).

When using a foreign currency forward contract or a CCIRS in a hedge, the currency basis spread is an unavoidable 'cost' of the hedging instrument. During its redeliberations leading to the published final standard, the Board decided that currency basis spreads are a 'cost of hedging'. The cost of a hedging activity should be recognised in profit or loss at the same time as the hedged transaction. Consequently, the Board decided to expand the requirements regarding the accounting for costs of hedging to also include currency basis spreads in a way similar to the forward element of forward contracts. This means that, when designating a hedging instrument, an entity can exclude the currency basis spread and account for it separately in the same way as the accounting for the forward element of the forward rate, as described in section 7.2.1 above. However, if an entity designates the entire hedging instrument, fair value changes due to changes in the currency basis spread would result in some ineffectiveness.

7.3 Own use contracts

Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell non-financial items that can be settled net in cash, as if they were financial instruments (i.e., they are in substance similar to financial derivatives). Many commodity purchase and sale contracts meet the criteria for net settlement in cash because the commodities are readily convertible to cash. 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.

Own use contracts are accounted for as normal sales or purchase contracts (i.e., executory contracts), with the idea that any fair value change of the contract is not relevant given the contract is used for the entity's own use. However, some participants of certain industries enter into contracts for own use and similar financial derivatives for risk management purposes and manage all these contracts together. In such a situation, own use accounting leads to an accounting mismatch as the fair value change of the derivative positions for risk management purposes cannot be offset against fair value changes of the own use contracts.

To eliminate the accounting mismatch, an entity could apply hedge accounting by designating an own use contract as the hedged item in a fair value hedging relationship. However, hedge accounting in these circumstances is administratively burdensome. Furthermore, entities enter into large volumes of commodity contracts and, within the large volume of contracts, some positions may offset each other. An entity would therefore typically hedge on a net basis.

A consequential amendment to IAS 39 introduces a fair value option for 'own use' contracts. On transition to the new requirement, entities can apply the fair value option on an 'all-or-nothing' basis for similar types of existing 'own use' contracts.

Example 34 – Processing and brokerage of soybeans and sunflowers

An entity is in the business of procuring, transporting, storing, processing and merchandising soybeans and sunflower seeds. The inputs and the outputs are agricultural commodities which are traded in liquid markets. The entity has both a broker business and a processing business, which are operationally distinct. However, the entity analyses and monitors its net commodity risk position, comprising inventories, physically settled forward purchase and sales contracts and exchange traded futures and options. The target is to keep the net fair value risk position close to nil.

Under IAS 39, the physically settled forward contracts from the processing business have to be accounted for as own use contracts, whereas all other contracts are accounted for at fair value through profit or loss. The resulting accounting mismatch does not reflect how the entity is managing the overall fair value risk of those contracts.

By way of a consequential amendment to IAS 39, the IASB introduced a fair value option for own use contracts. At inception of a contract, an entity may make an irrevocable designation to measure an own use contract at fair value through profit or loss (the fair value option). However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch.

On transition to IFRS 9, entities can apply the fair value option on an all-or-nothing basis for similar types of (already existing) own use contracts.

How we see it

Some entities, especially in the power and utilities sector, enter into long-term own use contracts, sometimes for as long as 15 years. The business model of those entities would often be to manage those contracts together with other contracts on a fair value basis. However, there are often no derivatives available with such long maturities, while fair values for longer dated contracts may be difficult to determine. Hence, a fair value based management approach might only be used for the time horizon in which derivatives are available. The fair value option is, however, only available on inception of the own use contract. Consequently, the fair value option will mainly be useful for entities that apply a fair value based risk management strategy for entire contracts, which is more likely to be the case for shorter-term own use contracts.

8. Presentation

8.1 Cash flow hedges

The general mechanics of how ongoing cash flow hedges are presented does not change compared with IAS 39. Entities would continue to accumulate in the hedging reserve (i.e., in equity, now in the standard called 'cash flow hedge reserve') the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item. This is often referred to as the 'lower-of-test' and basically assures that, in line with the IASB's *Conceptual Framework*, an entity is not recognising an asset or liability that does not exist.

IFRS 9 is stricter than IAS 39 as to how the amount accumulated in the hedging reserve is subsequently accounted for, depending on the nature of the underlying hedged transaction:

- ▶ If the hedged transaction subsequently results in the recognition of a non-financial item, the amount accumulated in equity is removed from the separate component of equity and included in the initial cost or other carrying amount of the hedged asset or liability. This accounting entry, sometimes referred to as 'basis adjustment', does not affect OCI of the period.
- ▶ The above accounting treatment would equally apply to situations where the hedged forecast transaction of a non-financial asset or non-financial liability subsequently becomes a firm commitment for which fair value hedge accounting is applied.
- ▶ For any other cash flow hedges, the amount accumulated in equity is reclassified to profit or loss as a reclassification adjustment in the same period or periods during which the hedged cash flows affect profit or loss. This accounting entry does affect OCI of the period.

If cash flow hedge accounting is discontinued, the amount that has been accumulated in OCI shall:

- ▶ Remain in accumulated OCI if the hedged future cash flows are still expected to occur
- ▶ Be immediately reclassified to profit or loss as a reclassification adjustment if the hedged future cash flows are no longer expected to occur

After discontinuation, once the hedged cash flow occurs, any amount remaining in accumulated OCI shall be accounted for depending on the nature of the underlying transaction (as described above).

In contrast, IAS 39 provides an accounting policy choice to entities that hedge a forecast transaction resulting in the recognition of a non-financial item, to account for the amount accumulated in equity either as a basis adjustment or as a reclassification adjustment.

IFRS 9 also mentions 'periods that interest income or interest expense is recognised' as an example of a period over which the amount accumulated in the hedging reserve would have to be reclassified to profit or loss. This clarifies that entities cannot simply account for the net payment on an interest rate swap in profit or loss, but would have to present this as a reclassification adjustment between OCI and profit or loss.

8.2 Fair value hedges

IFRS 9 does not change how fair value hedges are presented. Entities would continue to recognise the gain or loss on the hedging instrument in profit or loss and adjust the carrying amount of the hedged item for the hedging gain or loss with the adjustment being recognised in profit or loss. However, the accounting is different for hedges of equity instruments for which an entity has elected to present fair value changes in other comprehensive income (see section 3.2 above).

8.3 Hedges of groups of items

8.3.1 Cash flow hedges

When designating a group of items in a cash flow hedge, the presentation of the related hedging gains or losses in the statement of profit or loss depends on the nature of the group position.

Nature of position	Line items affected in profit or loss	Presentation in the income statement
Gross position	One line item	The amount reclassified from equity to profit or loss has to be presented in the same line item as the underlying hedged transaction.
	Multiple line items	The amount reclassified from equity to profit or loss has to be allocated to the line items affected by the hedged items on a systematic and rational basis.
Net position	Multiple line items	The amount reclassified from equity to profit or loss has to be presented in a separate line item.

Note that the designation of a net position cash flow hedge is only permitted when hedging foreign currency risk (see section at 3.6.3 above).

The above requirement for net position cash flow hedges might not seem very attractive, as the presentation of the hedged transactions would not reflect the effect of the hedge. However, the Board was concerned that grossing-up the hedging gain or loss would result in non-existing gains or losses being recognised in the statement of profit or loss, which would be in conflict with the IASB's *Conceptual Framework for Financial Reporting*.

8.3.2 Fair value hedges

For fair value hedges of groups of items with offsetting risk positions (i.e., hedges of a net position), entities would have to present the hedging gains or losses in a separate line item in the income statement in order to avoid grossing up the hedging gain or loss on a single instrument into multiple line items.

However, the treatment in the statement of financial position is different, in that the individual items in the group are separately adjusted for the change in fair value due to changes in the hedged risk.

The new disclosures include a requirement for a much more detailed qualitative description of the risk management strategy of the entity, but only where hedge accounting is applied.

9. Disclosures

9.1 Background and general requirements

The disclosure requirements for entities applying hedge accounting are set out in IFRS 7. Those disclosure requirements were amended as a consequence of the new hedge accounting requirements.

Many constituents, users in particular, have asked for improved disclosures that link more clearly an entity's risk management activities and how it applies hedge accounting. Linking the two requires an understanding of an entity's risk management strategy, which is why the IASB introduced a requirement for a much more detailed qualitative description of the risk management strategy of the entity. These disclosures of risk management strategies will, however, only be required where hedge accounting is applied.

The objective of the new hedge accounting disclosures is that entities shall disclose information about:

- ▶ The risk management strategy and how it is applied to manage risks
- ▶ How the risk management activities may affect the amount, timing and uncertainty of future cash flows
- ▶ The effect that hedge accounting has had on the statement of financial position, the statement of comprehensive income and the statement of changes in equity

In applying this objective, an entity has to consider the necessary level of detail, the balance between different disclosure requirements, the appropriate level of disaggregation and whether additional explanations are necessary to meet the objective.

The hedge accounting disclosures should be presented in a single note or a separate section of the financial statements. An entity may include information by cross-referencing to information presented elsewhere, such as a risk report, provided that information is available to users of the financial statements on the same terms as the financial statements and at the same time.

The IASB made it clear that it would require entities to give clear disclosures about their risk management activities. These should be specific to the entity rather than generic or 'boiler plate'.

9.2 Risk management strategy

The risk management strategy has to be described by type of risk, and this description has to include how each risk arises and how, and to what extent, the risk is managed. This description must also include whether the entity hedges only a part of the risk exposure, such as a nominal component or selected contractual cash flows. To satisfy this requirement, an entity must disclose:

- ▶ The hedging instruments and how they are used to hedge the risk exposure
- ▶ Why the entity believes there is an economic relationship between the hedged item and the hedging instrument
- ▶ How the hedge ratio is determined
- ▶ The expected sources of ineffectiveness

When only a component of a risk exposure is hedged, an entity must also disclose how it determined the component and how the component relates to the item in its entirety. In our view, this would include a description of whether the risk component is contractually specified and if not how the entity determined that the non-contractually specified risk component is separately identifiable and reliably measurable.

Example 35 – Illustrative disclosure of risk management strategy for commodity price risk

Coffee price risk

Fluctuations in the coffee price are the main source of market risk for the Alpha Beta Coffee Group (the Group). The Group purchases Arabica coffee from various suppliers in South America. For this purpose, the Group enters into long-term contracts (for between 1 and 3 years) with its suppliers, in which the future coffee price is indexed to the USD Arabica benchmark coffee price, adjusted for transport cost that are indexed to diesel prices plus a quality coefficient that is reset annually for a crop period. In order to secure the volume of coffee needed, supply contracts are always entered into (or renewed) at least one year prior to harvest.

The Group forecasts the monthly volume of expected coffee purchases for a period of 18 months and manages the coffee price risk exposure on a 12-month rolling basis. For this purpose, the Group enters into futures contracts on the Arabica benchmark price and designates the futures contracts in cash flow hedges of the USD Arabica benchmark price risk component of its future coffee purchases. Some of those purchases are committed minimum volumes under the contracts and some purchases are highly probable forecast transactions (i.e., quantities in excess of the minimum purchases volumes and sometime for periods for which no contract has yet been entered into). The underlying risk of the coffee futures contracts is identical to the hedged risk component (i.e., the USD Arabica benchmark price). Therefore, the Group has established a hedge ratio of 1:1 for all its hedging relationships. The USD Arabica benchmark price risk component is contractually specified in its purchase contracts, therefore, the Group considers the risk component to be separately identifiable and reliably measurable based on the price of coffee futures.

The Group does not hedge its exposure to the variability in the purchase price of coffee that results from the annual reset of the quality coefficient, because hedging that risk would require highly bespoke financial instruments that in the Group's view are not economical.

The Group's exposure to the variability in the purchase price of coffee that results from the diesel price indexation of the transport costs is integrated into its general risk management of logistics costs that aggregates exposures resulting from various logistics processes of the Group (Cross reference: see Section 'XYZ' of this report).

Example 35 – Illustrative disclosure of risk management strategy for commodity price risk *continued*

The Group determined the USD Arabica benchmark coffee price risk component that it designates as the hedged item on the basis of the pricing formula in the Group's coffee supply contracts (see the above description). That benchmark component is the largest pricing element. The quality coefficient depends on the particular crop in the region from which the Group sources its coffee, depending mainly on weather conditions that affect size and quality of the crop. Sometimes pest and plant diseases can have similar effects. Over the last 10 crop periods, the quality coefficient ranged between USD0.02 and USD0.27 per pound (lb). For the effect of the diesel price indexation, refer to the section 'Logistics costs management' in the Risk Management Report that is included in this Annual Report.

More information about how the Group manages its risk, including the extent to which the Group hedges, the hedging instruments used and sources of ineffectiveness, is provided in the Risk Management Report (see section 'Commodity Price Risk Management').

The risk management strategy disclosures are an important cornerstone of the new hedge accounting model, as they provide the link between an entity's risk management activities and how they affect the financial statements. The notes should also disclose the key judgements the entity has used in applying the new hedge accounting model (including those used to determine whether an economic relationship exists between the hedged item and the hedging instrument, how the hedge ratio was set and how risk components were identified, just to mention a few).

Disclosures have to be made by type of risk, rather than the type of hedging relationship (e.g., cash flow hedge or fair value hedge). This should enable users to follow the various disclosures by type of risk, resulting in a much better understanding of the hedging activities and their impact on the financial statements.

9.3 The amount, timing and uncertainty of future cash flows

Further to the strategy, entities have to disclose the 'terms and conditions of hedging instruments and how they affect the amount, timing and uncertainty of future cash flows'. More precisely, an entity has to disclose, by category of risk:

- ▶ A profile of the timing of the nominal amount of the hedging instrument
- ▶ If applicable, the average price or rate of the hedging instrument, which could be a strike price or a forward rate

Entities also have to disclose a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This would include an update of new sources of ineffectiveness that emerge in a hedging relationship over the term.

Finally, if an entity has previously designated forecast transactions as hedged items in a cash flow hedging relationship and these are no longer expected to occur, this fact and a description of the forecast transaction have to be disclosed.

Example 36 – Illustrative disclosure of timing, nominal amount and average price of coffee futures contracts

As of 31 December 20x0, Alpha Beta Coffee Group is holding the following coffee futures contracts to hedge the exposure on its coffee purchases over the next twelve months:

	Month of maturity							Total
	Jan	Feb	Mar	Apr	May	...	Dec	
Notional amount (in lbs thousands)	1,275	1,425	1,350	1,312	1,350	...	1,200	16,275
Average hedged rate (in US cents per lb)	122	125	128	133	135	...	139	133

Disclosure of the profile of nominal amounts of hedging instruments and their average prices, as required by paragraph 23B of IFRS 7, would not be very meaningful when an entity applies a dynamic hedging process in which both the amount of hedged item and hedging instrument change frequently. Consequently, an entity using a dynamic hedging process is exempt from providing these disclosures. Instead, such an entity must disclose:

- ▶ A description of what the ultimate risk management strategy is in relation to those dynamic hedging relationships.
- ▶ A description of how it reflects this risk management strategy by using hedge accounting and designating those particular hedging relationships.
- ▶ 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.

If, at the reporting date, the volume of hedging relationships (which is part of the disclosures discussed in section 9.4 below) to which the above exemption applies is not representative of the normal volumes hedged during the period, an entity has to disclose this fact and the reason it believes the volumes are not representative.

9.4 The effects of hedge accounting on the financial position and performance

IFRS 7 sets out a specific requirement to disclose the effect hedge accounting has on the entity's financial position and the performance. All disclosures are required in a tabular format and by type of risk.

Instead of reproducing the specific requirements of IFRS 7 we provide examples below of how those disclosures might look.

Example 37 – Illustrative disclosure of the effects of hedge accounting on the financial position and performance

The impact of hedging instruments designated in hedging relationships as of 31 December 20x0 on the statement of financial position of Alpha Beta Coffee Group (the Group) is, as follows:

Cash flow hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Coffee price risk				
Arabica coffee futures	16,275lbs (thousands)	(4.5)	Short-term derivative financial liabilities	(1.0)
Interest rate risk				
Pay fixed/receive variable interest rate swap	EUR50m	4.0	Long-term derivative financial assets	1.0

Fair value hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate risk				
Receive fixed/pay variable interest rate swap	EUR200m	(10.0)	Long-term derivative financial liabilities	(2.0)

The impact of hedged items designated in hedging relationships as of 31 December 20x0 on the statement of financial position of the Group is, as follows:

Cash flow hedges	Change in value used for measuring ineffectiveness	Cash flow hedge reserve
Coffee price risk		
Coffee purchases	1.0	4.5
Interest rate risk		
Forecast interest payments	(0.9)	(3.9)

Example 37 – Illustrative disclosure of the effects of hedge accounting on the financial position and performance *continued*

Fair value hedges	Carrying amount	Thereof accumulated fair value adjustments	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate risk				
Fixed rate borrowings	211.0	11.0	Long-term borrowings	2.1

The above hedging relationships affected profit or loss and other comprehensive income, as follows:

Cash flow hedges	Hedging gain or loss recognised in OCI	Ineffectiveness recognised in profit or loss	Line item in the statement of profit or loss	Amount reclassified from OCI to profit or loss	Line item in the statement of profit or loss
Coffee price risk					
Hedges of forecast coffee purchases	(1.0)	–	–	–	–
Interest rate risk					
Forecast interest payments	0.9	0.1	Other financial income	0.5	Interest expense

Fair value hedges	Ineffectiveness recognised in profit or loss	Line item in the statement of profit or loss
Interest rate risk		
Hedge of fixed rate borrowings	(0.1)	Other financial expenses

IFRS 7 further requires a reconciliation of the components in equity that arise in connection with hedge accounting (such as the hedging reserve) and an analysis of OCI. That information needs to be disaggregated by risk category, which can be done in the notes.

Hedge accounting in accordance with IFRS 9 applies prospectively, with some limited exceptions.

10. Effective date and transition

10.1 Effective date

In its February 2014 meeting, the IASB tentatively decided that the mandatory effective date for IFRS 9 will be for annual periods beginning on or after 1 January 2018. Early application continues to be permitted.

10.2 Prospective application in general

A hedging relationship can only be designated on a prospective basis, in order to avoid the use of hindsight. The same concern about using hindsight would also apply if the new hedge accounting requirements were to be applied retrospectively. Consequently, the IASB decided that hedge accounting in accordance with IFRS 9 has to be applied prospectively, with some limited exceptions.

Of course, an entity may only apply the new hedge accounting requirements to a hedging relationship if all the IFRS 9 qualifying criteria are met. Many preparers will already be applying hedge accounting under IAS 39 before transitioning to IFRS 9. For such entities, the standard clarifies that hedging relationships under IAS 39 which also qualify for hedge accounting under IFRS 9, are treated as continuing hedges. Hedge accounting under IAS 39 ceases in the very same second as hedge accounting under IFRS 9 starts, therefore resulting in no accounting entries on transition. However, entities might have to rebalance their hedges on transition to fulfil the new effectiveness requirements under IFRS 9 in which case any resulting gain or loss must be recognised in profit or loss.

10.3 Limited retrospective application

The exceptions from prospective application of the new standard are for the new accounting treatment for the time value of options, when only the intrinsic value is designated, for the forward element of forward contracts, when only the spot element is designated, and for the foreign currency basis spread of financial instruments (discussed in section 7 above).

The transition requirements for hedge accounting in IFRS 9 also replicate the retrospective application for the amendments that were made to IAS 39 by Novation of Derivatives and Continuation of Hedge Accounting.

10.3.1 Accounting for the time value of options

Entities have to apply the new accounting treatment for the time value of options retrospectively, however, only to hedging relationships that existed at the beginning of the earliest comparative period and hedging relationships designated thereafter. This means that, for example, foreign entities registered and reporting with the United States Securities and Exchange Commission and required to present two comparative years of income statements, would have a longer period to cover for the retrospective application of the new requirements.

Applying the new accounting requirement retrospectively might have a much wider impact than anticipated. Depending on the type of hedging relationship, many line items in the primary statements and many disclosures in the notes might be affected.

Example 38 – Retrospective application of accounting for time value of option

An entity applies the IFRS hedge accounting requirements as of 1 January 2015. The entity only presents the required comparative information, therefore, 1 January 2014 being the beginning of the earliest comparative period presented.

As of 1 January 2014, the entity had a hedging relationship in place in which the intrinsic value of an option was designated as the hedging instrument of a highly probable forecast purchase of a machine as of 31 March 2014. When preparing the 2015 financial statements, the entity would have to:

- ▶ Determine the time value of that option as of 1 January 2014 and restate accumulated OCI against retained earnings as of that date
- ▶ Determine the time value of that option as of 31 March 2014 and restate accumulated OCI against retained earnings as of that date
- ▶ Restate the initial carrying amount of the machine as of 31 March 2014 (basis adjustment of amount accumulated in OCI)
- ▶ Determine the new depreciation amount for 2014 and restate the carrying amount of the machine as of 31 December 2014 against retained earnings as of that date
- ▶ Reflect the restatement in the statement of profit or loss and other comprehensive income, the statement of changes in equity and the statement of financial position
- ▶ Reflect the restatement in the notes disclosures

10.3.2 Accounting for the forward element of forward contracts and the foreign currency basis spread of financial instruments

Different to the accounting for the time value of options, entities will have an option to apply retrospectively the new accounting for the forward element of forward contracts. However, the option applies on an all or nothing basis (i.e., if an entity elects to apply the accounting retrospectively, it has to be applied to all hedging relationships that qualify for the election). The retrospective application would also only apply to those hedging relationships that existed at the beginning of the earliest comparative period or that were designated thereafter. Consequently, assets and liabilities cannot be adjusted to reflect hedges that had already finished at the start of the comparative period.

A similar transition requirement applies for the accounting for foreign currency basis spreads (see section 7.2.2 above). However, in contrast to the transition requirements for the forward element of forward contracts, for foreign currency basis spreads the requirements that it had been excluded from the designation as the hedging instrument under IAS 39 and that the retrospective application can only be elected on an all or nothing basis do not apply. This is owing to the differences in circumstances (IAS 39 did not have an exception for excluding a foreign currency basis spread from the designation of a financial instrument as a hedging instrument).

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