

# Hedge accounting – summary of redeliberations

## What you need to know

At its September meeting, the International Accounting Standard Board (IASB, the Board) completed redeliberations on the Exposure Draft Hedge Accounting (the ED).

- ▶ The Board made some significant changes to proposals in the ED.
- ▶ The Board's decisions have attempted to resolve some, but not all, of the major concerns raised by constituents in their comment letters on the ED.
- ▶ The IASB plans to publish a staff draft of the standard on its website before the final standard is published.
- ▶ The final standard is due to be issued by the IASB in the next three months.
- ▶ Meanwhile, the Board continues to deliberate on macro hedge accounting as a separate proposal.

## Summary of tentative decisions

The table below summarises the IASB's main tentative decisions. As the final standard has not yet been issued, all tentative decisions are subject to potential change.

Proposal as per the ED	Constituents' concerns	Tentative decisions in redeliberations
<b>Objective of hedge accounting</b>		<b>Change proposed</b>
The objective is to represent in the financial statements the effect of an entity's management of risks that affect profit or loss.	There are concerns that hedge accounting is limited to risks affecting profit or loss and that risks affecting other comprehensive income (OCI) are excluded.  Furthermore, some constituents raised scenarios of certain legitimate risk management strategies where designating hedge accounting was still prohibited under the proposed standard. This includes, e.g., a macro hedging model or the use of basis interest rate swaps for managing interest rate risks.	Hedge accounting is permitted for equity instruments recorded at fair value through OCI in accordance with IFRS 9. Any ineffectiveness will be presented in OCI. This concession is not extended to other items affecting OCI (such as changes in actuarial gains or losses of defined benefit obligations that are recorded in OCI).

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<b>Instruments that qualify for designation as hedging instruments</b>		
<p>Non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss (FVTPL) may be eligible for designation as hedging instruments.</p>	<p>IFRS 9 allows an entity to account for a non-derivative financial instrument at FVTPL applying the fair value option if it eliminates or substantially reduces an accounting mismatch. A few respondents questioned whether those instruments should be eligible for designation as a hedging instrument in a cash flow hedge as it would override the basis for designating the item as at FVTPL in the first place.</p>	<p>Any designation as a hedging instrument must not contradict the entity's election of the fair value option (i.e., re-create an accounting mismatch).</p> <p>A liability for which the fair value option is applied cannot be an eligible hedging instrument, as the part of the change in fair value that is attributable to changes in the credit risk of that liability is recognised in OCI.</p>
<b>Aggregated exposures</b>		
<p>An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item.</p> <p>An example would be a EUR entity that hedges highly probable coffee purchases in USD against the USD price risk using future contracts. The derivative and the highly probable forecast transaction in combination is a highly probable fixed price purchase exposed to USD/EUR foreign exchange risk (i.e., the aggregated exposure).</p>	<p>Respondents have requested more guidance on how to account for the hedge of an aggregated exposure.</p>	<p>The Board has confirmed the proposals in the ED and decided that three illustrative (numerical) examples should accompany the final standard.</p> <p>The Board also clarified that achieving hedge accounting on the first level hedge relationship (i.e., the combination of the exposure and the derivative that constitute the aggregated exposure) is not a precondition for the aggregated exposure being eligible as a hedged item.</p>
<b>Designation of risk components</b>		
<p>Risk components in non-financial items will be permitted as eligible hedged items, if they are separately identifiable and reliably measurable.</p> <p>Inflation risk is not an eligible risk component of a financial instrument unless it is contractually specified.</p>	<p>Many respondents have requested more guidance on the qualification requirements for non-contractually specified risk components.</p> <p>Some constituents did not agree with the proposal that rules out non-contractually specified inflation risk as an eligible hedged item.</p>	<p>The Board clarified that the market structure is key to determining whether an eligible risk component exists. The final standard will include additional guidance and illustrative examples.</p> <p>The final standard will include a rebuttable presumption that non-contractually specified inflation risk will usually not be an eligible hedged item. Examples of two scenarios will be provided, one in which an inflation risk component may be eligible for hedge accounting and another where it may not.</p>

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<b>Designation of layer components of nominal amounts</b>		
<p>A layer component (e.g., the first 100 barrels of the oil purchases in June 201X) is permitted as a hedged item. However, this will not apply to layer components in a fair value hedge that include a prepayment option where the options fair value is impacted by the hedged risk.</p>	<p>Many respondents disagreed with the proposal not to allow the designation of a layer component of a contract that includes a prepayment option.</p>	<p><b>Change proposed</b></p> <p>A pre-payable layer can be a hedged item if the prepayment effect is included in the measurement of the hedged item.</p> <p>For items pre-payable after a period of time, a layer based approach may also be permitted, if the hedged layer is not pre-payable at the time of designation.</p>
<b>Hedge effectiveness requirements to qualify for hedge accounting</b>		
<p>The quantitative prospective and retrospective assessment with the 80-125% threshold is removed.</p> <p>Instead, in order to qualify for hedge accounting, the hedge relationship must (prospectively) produce an unbiased result, minimise hedge ineffectiveness and achieve other than accidental offsetting.</p>	<p>There were concerns on the interpretation of the new terms “unbiased result” and “other than accidental offsetting” and the practical implementation of the concepts introduced (in particular that a perfect hedge would be required).</p> <p>Many respondents also requested that the Board provides additional guidance.</p>	<p><b>Change proposed</b></p> <p>The terms “unbiased result” and “other-than-accidental offsetting” are withdrawn. Instead, a hedging relationship meets the effectiveness criteria:</p> <ul style="list-style-type: none"> <li>▶ If there is an economic relationship between the hedged item and the hedging instrument,</li> <li>▶ If applying the actual quantities used, results in weightings of the hedged item and the hedging instrument (i.e., hedge ratio) that would not deliberately create hedge ineffectiveness</li> </ul> <p>And</p> <ul style="list-style-type: none"> <li>▶ If the effect of credit risk does not dominate the value changes that result from the economic relationship.</li> </ul>
<b>Rebalancing of a hedging relationship</b>		
<p>Hedge relationships need to be rebalanced (i.e., adjustment of the hedge ratio) if they fail to meet the objective of hedge effectiveness while the risk management objective remains the same.</p>	<p>There were some concerns that, by mandatorily requiring rebalancing, the proposal might result in an accounting exercise rather than reflecting the risk management activities of an entity.</p> <p>The operational impact of frequent rebalancing would be significant.</p>	<p><b>Clarification proposed</b></p> <p>The Board decided to align the notion of rebalancing with the decision on the hedge effectiveness assessment. Therefore, rebalancing would be required if the hedge ratio used for risk management purposes changes, or if accounting rebalancing is required to prevent the existing risk management hedge ratio resulting in an imbalance that would deliberately create hedge ineffectiveness.</p>

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<b>Discontinuing hedge accounting</b>		
<p>A hedge relationship can only be discontinued when the hedging relationship ceases to meet the qualifying criteria (after taking into account any rebalancing).</p> <p>A voluntary discontinuation will not be permitted if the risk management objective remains unchanged.</p>	<p>Difficulties were anticipated in determining whether an entity's risk management objective has changed or not.</p> <p>Many respondents also believe voluntary discontinuation of hedging relationships is an important tool in dynamic hedging strategies (e.g., managing interest rate risk of an open loan portfolio). This is particularly relevant in the absence of a new macro hedge accounting model.</p>	<p><b>Confirmation proposed</b></p> <p>The prohibition of voluntary discontinuation in the ED will be retained.</p> <p>Additional guidance will be provided on the difference between the risk management strategy and the risk management objective. This will also clarify that discontinuation of individual hedges in a dynamic hedging strategy would be possible.</p>
<b>Accounting for fair value hedges</b>		
<p>The gain or loss on the hedging instrument and the hedged item should be presented in OCI with the ineffective portion presented in the income statement.</p> <p>The ED also proposed that the gain or loss on the hedged item that is attributable to the hedged risk should be presented as a separate line item in the balance sheet.</p>	<p>Whilst respondents generally supported the elimination of "mixed measurements" (i.e., part fair value and part cost-based) in the statement of financial position, many were concerned that several line items would unnecessarily be added to primary statements.</p>	<p><b>Change proposed</b></p> <p>The requirement in IAS 39 will be retained. Gains and losses from the hedging instruments and the hedged items will continue to be presented in profit or loss. In the statement of financial position, the hedged item will continue to be directly adjusted for the effects of fair value hedging.</p>
<b>Time value of options and forward points of forward contracts</b>		
<p>The ED introduced an "insurance premium view" for the time value of options (i.e., the time value is the cost of hedging). If the intrinsic element only is designated, changes in the time value would be recognised in OCI and then either expensed over the hedge period for time period related hedges or added to the cost of the hedged item for transaction related hedges.</p>	<p>Most respondents agreed that the initial time value of the option is better reflected as a form of insurance cost. However, a number believe that the proposals would significantly add to the complexity of hedge accounting.</p> <p>Some constituents requested a similar accounting for the forward points of foreign exchange forward contracts.</p>	<p><b>Change proposed</b></p> <p>The accounting for forward points in a forward contract is aligned to the accounting for the time value of options. If the spot element only is designated, the forward points that exist at inception of the hedging relationship are recognised in profit or loss over time. Subsequent fair value changes to the forward points are recognised in OCI.</p>

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<b>Hedges of group of items and net positions</b>		
<p>A group of items can be hedged together (as one hedged item) if the items in the group are managed on a group basis for risk management purposes and all individual items in the group are eligible as hedged items.</p> <p>A group of forecast transactions resulting in a net position may be an eligible hedged item provided that the individual cash flows affect profit or loss in the same reporting period.</p>	<p>A number of respondents disagreed with the Board's proposal that for cash flow hedges the offsetting hedged items must affect profit or loss in the same reporting period.</p>	<p><b>Change proposed</b></p> <p>The Board decided to remove the restriction that the offsetting of cash flows in a net position must affect profit or loss in the same reporting period. Instead, hedging of net positions is only permitted for foreign exchange risk and the hedge documentation at inception must specify the nature and amount of the items within the net position and the pattern in which the individual items are expected to affect profit or loss.</p> <p>For accounting purposes, the change in fair value of the cash flows that affect profit or loss in an earlier period must be deferred to OCI, with a reclassification to profit or loss once the later cash flows affect profit or loss.</p>
<b>Disclosures</b>		
<p>Entities need to disclose</p> <ul style="list-style-type: none"> <li>▶ Their risk management strategy and how it is applied to manage risks</li> <li>▶ How hedging activities may affect the amount, timing and uncertainty of future cash flows</li> <li>▶ The overall effect that hedge accounting has had on the entity's financial statements.</li> </ul> <p>The disclosures are required for hedging strategies where hedge accounting is applied.</p>	<p>Respondents generally agreed but had concerns with respect to the commercial sensitivity of disclosing forward looking information and the hedged rates that the entity has locked itself into for future periods.</p>	<p><b>Change proposed</b></p> <p>Guidance will be included on how an entity should describe the risk management strategy.</p> <p>The disclosure of the average hedged price or rate is still required. However, the total forecast transactions exposed to a hedged risk need not to be disclosed anymore.</p> <p>For dynamic hedging relationships the disclosure of the terms and conditions of the hedging instruments is not required. Instead the risk management approach is to be described in more detail.</p>
<b>Own use contracts</b>		
<p>"Own use" non-financial contracts which can be "settled net in cash" must be recognised at FVTPL if an entity's risk management strategy for those contracts is fair-value based.</p>	<p>Some respondents raised concerns that mandatory fair value accounting could lead to an accounting mismatch.</p>	<p><b>Change proposed</b></p> <p>The fair value option in IFRS 9 is extended to include own use contracts if applying fair value accounting eliminates or significantly reduces an accounting mismatch.</p>

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<b>Hedging credit risks using credit derivatives</b>		<b>Change proposed</b>
<p>The IASB deliberated whether it is possible to permit hedge accounting when credit derivatives are used to economically hedge credit risk, but do not qualify because the credit risk component cannot be reliably measured. The ED requested feedback on four alternative approaches to tackling this issue.</p>	<p>Responses on this issue were mixed. Some respondents believe that the alternatives will add too much complexity while others said that none of the alternatives are appropriate.</p>	<p>An entity may, at any time, elect to account for a loan or loan commitment (the hedged item) at FVTPL. The measurement adjustment (i.e., the difference on switching from amortised cost to fair value) would be immediately recognised in profit or loss. The credit derivative would also be accounted at FVTPL. The election can also be revoked, in which case the fair value of the loan becomes its deemed amortised cost and the fair value of a loan commitment is amortised over the commitment period.</p>
<b>Transition requirements</b>		<b>Change proposed</b>
<p>The new standard will be applied prospectively. The disclosure requirements need not be applied in comparative information for periods before the initial application.</p>	<p>Some respondents noted that the Board needs to consider the implications for comparative information. Some also raised concerns about transitional aspects with respect to classification and measurement and how that might influence the proposed hedge accounting transition requirements.</p>	<p>The requirement for prospective application was confirmed. However, the Board has identified two specific areas where a retrospective application would give a more meaningful presentation and increase the comparability (i.e., the accounting for the time value of options and the forward points of forward contracts).</p>



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