New on the Horizon: Hedge accounting

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# Contents

## Closer alignment of hedge accounting and risk management

1. **Almost there**  
2. **How this could affect you**  
3. **Setting the standard**  
4. **Introduction**

5. **Scope and alternatives to hedge accounting**
   - 5.1 General hedge accounting
   - 5.2 Contracts to buy or sell a non-financial item
   - 5.3 Managing credit risk using credit derivatives

6. **Hedging instruments**
   - 6.1 Overview
   - 6.2 Cash instruments
   - 6.3 Purchased options
   - 6.4 Forward contracts

7. **Hedged risks and items**
   - 7.1 Overview
   - 7.2 Risk components
   - 7.3 Layer components and net positions
   - 7.4 Aggregated exposures
   - 7.5 Equity investments at fair value through other comprehensive income
   - 7.6 ‘Sub-LIBOR’ prohibition

8. **Hedge effectiveness**
   - 8.1 Overview
   - 8.2 Economic relationship between the hedged item and the hedging instrument
   - 8.3 Effect of credit risk
   - 8.4 Hedge ratio
   - 8.5 Frequency of and methods for assessing hedge effectiveness requirements
   - 8.6 Measurement of hedge ineffectiveness

9. **Rebalancing**
   - 9.1 Overview
   - 9.2 Mechanics
   - 9.3 Accounting outcome cannot be inconsistent with purpose of hedge accounting

10. **Discontinuation**

11. **Presentation**
   - 11.1 Cash flow hedges
   - 11.2 Fair value hedges
   - 11.3 Hedged groups

12. **Disclosures**
   - 12.1 Overview
   - 12.2 Risk management strategy
   - 12.3 Amount, timing and uncertainty of future cash flows

12.4 **Effects of hedge accounting on financial position and performance**

13. **Effective date and transition**

14. **Due process**
   - 14.1 Project timeline

15. **FASB proposals and convergence**

**About this publication**

**Acknowledgements**
Closer alignment of hedge accounting and risk management

We welcome the IASB's recent draft of its forthcoming IFRS on general hedge accounting (the ‘review draft’), issued on 7 September 2012.

Many preparers are also likely to support these revised proposals. In redeliberating the December 2010 exposure draft, the IASB seems to have responded to stakeholder requests for conceptual clarifications and more guidance around the new concepts, without losing the more principles-based approach that aligns hedge accounting more closely with risk management.

With the IASB’s macro hedging discussion paper expected later this year, some industries (such as banking and insurance) may believe that these proposals will not significantly change the ‘status quo’ from their perspective.

However, other industries may be keen to seize the opportunity to further align their hedge accounting with how they actually manage risk. Airlines, manufacturers and others that have to manage significant commodity price exposures are likely to benefit the most from the proposals to permit hedge accounting for risk components of non-financial items. And by removing the ‘bright line’ for assessing hedge effectiveness, the proposals will also allow for a more flexible principles-based approach to hedge accounting.

However, the application guidance in some areas remains complex. Significant effort may be needed to analyse the requirements and determine how best to apply them to a company’s particular circumstances. Although some entities may be eager to implement the proposals, they may need to apply a greater degree of judgement to comply with them. In addition, to complement a more principles-based approach, additional disclosures will be required to inform users of how an entity is managing its risks.

The review draft will be available until early December 2012, after which time the IASB intends to proceed to finalise the draft.

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1. Almost there

- Proposed hedge accounting requirements seek to deliver a more principles-based standard that aligns hedge accounting more closely with risk management
- The IASB has not changed the types of hedging relationships (fair value, cash flow and foreign operation net investment)
- There are new requirements to achieve, continue and discontinue hedge accounting
  - Hedge qualification will be based on qualitative, forward-looking hedge effectiveness assessments, rather than an arbitrary bright line
  - Hedging relationships may need to be rebalanced, without terminating hedge accounting, due to certain changes in circumstances
  - Voluntary termination of otherwise qualifying hedging relationships will be prohibited
- Additional exposures may be hedged items under the proposals
  - Risk components of non-financial items and non-contractually specified inflation
  - Net positions and layer components of items
  - Aggregated exposures (a combination of a non-derivative exposure and a derivative)
  - Equity investments at fair value through other comprehensive income (OCI)
- Proposals carry forward the prohibition of hedging sub-LIBOR components
- Cash instruments may be hedging instruments in additional circumstances
- The time value of purchased options and the forward element of forward contracts may be deferred or amortised
- New alternatives to hedge accounting are introduced
  - Certain credit exposures that are managed for credit risk with credit derivatives may be designated at fair value through profit or loss
  - Entities may elect the fair value option for certain own-use contracts
- Additional disclosures regarding an entity’s risk management and hedging activities are required, to complement a more principles-based approach
- Effective date and transition
  - The proposals would be effective for annual periods beginning on or after 1 January 2015
  - Early application would be permitted, provided that all existing requirements under IFRS 9 Financial Instruments are applied at the same time or have already been applied
  - Transition would be prospective with limited exceptions
2. How this could affect you

- **A more judgemental approach.** Proposals present a more principles-based approach that more closely aligns hedge accounting with risk management, including a qualitative, forward-looking effectiveness assessment that does not contain the current bright line.

- **Taking advantage of the new opportunities.** Entities will have to ensure that risk management and hedge accounting processes are robust enough to enable them to take advantage of the new opportunities to apply hedge accounting.

- **Application of judgement.** Entities would need to determine:
  - whether current or new hedge accounting documentation provides sufficient evidence to support the link between each individual hedging relationship and the related risk management objective;
  - whether the existing or new hedge relationships meet the hedge effectiveness criteria;
  - when rebalancing is appropriate;
  - when discontinuing a hedging relationship is appropriate; and
  - whether the hedged item is transaction-related or time period-related when hedging with purchased options.

- **New potential hedging strategies.**
  - **Risk components of non-financial items:** Entities will have to determine whether the relevant risk components are separately identifiable and reliably measurable based on the market structure.
  - **Non-contractually specified inflation:** Entities will have to determine whether they are capable of constructing an inflation curve using real interest rates to assert that an inflation component of a fixed-rate debt instrument is separately identifiable and reliably measurable.
  - **Net positions:** The net position approach will be a change from the current gross position approach in which it is required to identify an ‘over-hang’ position (e.g. excess of financial assets over financial liabilities) to designate as the hedged item. Cash flow hedges of net foreign currency positions will have to specify in which period the forecast transactions are expected to affect profit or loss.
  - **Aggregated exposures:** The ability to hedge an aggregated exposure (a combination of a derivative and a non-derivative exposure), which may or may not be designated in a hedging relationship, will provide flexibility but add complexity.

- **Systems concerns.** Proposals create additional systems requirements – for example, to:
  - track rebalanced hedge relationships;
  - measure risk components of non-financial hedged items;
  - calculate the fair value of components of forwards and purchased options; and
  - operationalise qualitative hedge effectiveness assessments.

- **Extensive new disclosures.** The increased level of judgement and relaxation of hedging requirements are complemented by extensive new disclosure requirements.
3. Setting the standard

The objective of the IASB’s multi-phased project to replace IAS 39 Financial Instruments: Recognition and Measurement is to improve and simplify the reporting for financial instruments. The IASB and the FASB (the Boards) are both working to overhaul the accounting for financial instruments. However, the Boards’ projects are not in sync, and the IASB’s work on hedge accounting has progressed at a quicker pace than the FASB’s corresponding project.

The IASB published ED/2010/13 Hedge Accounting (‘the exposure draft’) in December 2010. The exposure draft proposed significant changes to the current general hedge accounting requirements to respond to significant criticisms of the complexity, arbitrary rules and operational burden of hedge accounting. The proposed changes also sought to address the artificial mismatch in specific scenarios between risk management and hedge accounting strategies under the current requirements. However, the exposure draft did not propose to fundamentally change the three types of hedging relationships under IAS 39 – i.e. fair value hedge, cash flow hedge and foreign operation net investment hedge.

The IASB received nearly 250 comment letters on the exposure draft from a wide range of industries and constituents. Many respondents supported the objective of better aligning hedge accounting with risk management. However, there were requests for clarification in certain areas, including assessing hedge effectiveness.

The IASB redeliberated the proposals in the exposure draft through September 2011. It confirmed a majority of the proposals in the exposure draft and decided to clarify or modify others. The IASB decided that there was no formal due process requirement to re-expose the revised proposals for public comment. Instead, in September 2012 it made available a ‘review draft’ on its website for information purposes, so that constituents could familiarise themselves with the document. The review draft will be available until early December 2012, after which time the IASB intends to proceed to finalise the draft. The IASB is not seeking comments on the draft, but interested parties may provide comments to the IASB during this period.

The IASB is also working on a companion project to address macro hedge accounting. A discussion paper is targeted for late in 2012.
4. Introduction

The current hedge accounting model has been described as complex, not reflective of risk management strategies and excessively rules-based, resulting in arbitrary outcomes. The review draft aims to address these criticisms by:

- aligning hedge accounting more closely with risk management activities, resulting in more useful information;
- establishing a more principles-based approach to hedge accounting; and
- addressing inconsistencies and weaknesses in the existing model.

To meet its goals for the proposals, the IASB defined the objective of hedge accounting: to represent in the financial statements the effect of an entity's risk management activities when it uses financial instruments to manage exposures arising from particular risks that could affect profit or loss, or OCI in limited circumstances. Hedge accounting provides an exception to the normal recognition and measurement requirements in IFRS in situations where the information that results from the normal requirements without applying hedge accounting is not useful or complete.

Consistent with its goals, the IASB decided to permit additional hedging instruments, hedged risks and hedged items to qualify for hedge accounting. As a consequence, more hedging strategies that are used to manage risk will be eligible for hedge accounting.

**Observations – Expansion of strategies eligible for hedge accounting**

For corporates, the proposals will allow for significant widening of the breadth and complexity of hedging strategies that qualify for hedge accounting. Some entities may need to gain the expertise and put in place systems and processes to adequately implement, document and monitor these new strategies.

**Observations – Risk management strategies**

The review draft distinguishes between an entity's risk management strategy and its risk management objectives. The risk management strategy is established at the highest level at which an entity determines how it manages risk. Risk management strategies typically identify the risk to which the entity is exposed and set out how the entity responds to them. A risk management strategy is typically long-term in nature and may include flexibility to react to changes in circumstances (e.g. different interest rate or commodity price levels that result in a different extent of hedging). Risk management strategies normally cascade down an entity through policies containing more specific guidelines.

The risk management objective for a hedging relationship, however, applies at the level of the particular hedging relationship. Therefore, a risk management strategy can involve many different hedging relationships that have risk management objectives relating to executing that overall risk management strategy. The need to align risk management objectives with hedge accounting could create the need for an entity to rewrite its current risk management policies and/or create policies if they do not exist.
**Observations – Required alignment of hedge accounting with risk management objectives**

The qualifying criteria for hedge accounting in the review draft do not explicitly state that a hedging relationship needs to be aligned with the entity’s risk management objective for that relationship. However, the review draft states that if the risk management objective for a hedging relationship changes and is no longer aligned, then the entity would discontinue hedge accounting. Therefore, to qualify for hedge accounting, a hedging relationship would need to be aligned with the entity’s risk management objective for that relationship.

This publication has been structured to reflect the life cycle of a hedging relationship. The following diagram shows how the relevant chapters map to each stage of the life cycle.

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<th>Designation</th>
<th>Continuation</th>
<th>Discontinuation</th>
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<tbody>
<tr>
<td>5. Scope and alternatives to hedge accounting</td>
<td>8. Hedge effectiveness</td>
<td>10. Discontinuation</td>
</tr>
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5. Scope and alternatives to hedge accounting

5.1 General hedge accounting

The review draft addresses hedging relationships that include a single hedged item or a closed portfolio of a group of items that constitute a gross or net position. A closed portfolio is a portfolio to or from which items cannot be added, removed or substituted without treating each change as the transition to a new portfolio or a new layer.

An entity’s risk management strategy often assesses risk exposures on a continuous basis and at a portfolio level. Over time, new exposures are continually added to the hedged portfolio and other exposures are removed from it. Because such open portfolios may complicate hedge accounting, the IASB decided to address open portfolios (macro hedging) separately as part of its active agenda, with the objective of issuing a discussion paper. In the meantime, the requirements of IAS 39 are retained for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge).

Observations – Relationship of scope to open portfolios

The review draft does not address open portfolios. However, it incorporates the concepts of applying hedge accounting to:

- layers of cash flows;
- net positions;
- nil net positions; and
- rebalancing a hedging relationship’s hedging instruments and hedged items.

All of these situations inherently have an element of an open portfolio.

5.2 Contracts to buy or sell a non-financial item

One of the functions of hedge accounting is to mitigate the recognition and measurement mismatches between the accounting for the hedging instrument and the hedged item. The review draft provides a new election whereby an entity can mitigate measurement mismatches that would otherwise arise from certain contracts to buy or sell a non-financial item without using hedge accounting.

Under the current guidance, contracts to buy or sell a non-financial item that can be settled net in cash are excluded from the scope of IAS 39 if the contracts were entered into, and continue to be held, for the purpose of the receipt or delivery of those non-financial items. This is commonly referred to as the ‘own-use’ scope exception in IAS 39 and mostly applies to commodity purchases or sales.

Currently, if a commodity contract does not meet the own-use scope exception, then it is frequently accounted for as a derivative contract and measured at fair value through profit or loss. If an entity enters into a derivative contract to hedge the changes in fair value of the commodity contract, then the derivative is also measured at fair value through profit or loss. Therefore, the entity does not need to apply hedge accounting to achieve accounting offset.
RD BCA63 (BC24E–BC24F) However, if the first contract above meets the own-use scope exception, then it is accounted for as a normal purchase or sales contract — i.e. an executory contract. Therefore, if the entity enters into a derivative to economically hedge the changes in fair value of the executory contract, then there would be an accounting mismatch. To eliminate this accounting mismatch, an entity could apply hedge accounting. However, hedge accounting in these situations is administratively burdensome, because these contracts are typically entered into in large volumes and managed on a net basis.

RD C30 (IAS 32.8), RD C36 (IAS 39.5A) To provide relief from the accounting mismatch and to provide more meaningful information in line with an entity’s risk management approach, the IASB decided to amend IAS 32 Financial Instruments: Presentation and IAS 39. The amendments will allow an entity, at the contract execution date, to irrevocably designate a contract that meets the own-use scope exception to be measured at fair value through profit or loss (FVTPL). An entity may make the designation only if it eliminates or significantly reduces an accounting mismatch that would otherwise arise if the contract was accounted for as an unrecognised executory contract outside the scope of IAS 39.

The flowchart below summarises the analysis of contracts to buy or sell a non-financial instrument under the proposals.

5.3 Managing credit risk using credit derivatives

RD BC6.347 Many financial institutions frequently use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This may reduce the regulatory capital requirement for the loan or the loan commitment, while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve its relationship with the client. In another example, credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (e.g. a facility for a particular client) or the bank’s overall lending portfolio.
Financial institutions that manage credit risk using credit derivatives often do not achieve hedge accounting. This is because the spread between the risk-free rate and the market interest rate incorporates various elements, including credit risk, liquidity risk, funding risk and any other unidentified risk components and margin elements. Often, it is very difficult or impossible to isolate credit risk in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable.

As an alternative to hedge accounting, IFRS 9 currently permits an entity to designate a financial instrument that would otherwise be measured at amortised cost as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch (the ‘fair value option’). This election is available only at initial recognition and is irrevocable. Moreover, the financial instrument is required to be designated in its entirety (e.g. the full nominal amount of a loan). Because of the restrictions and scope of the fair value option, most financial institutions do not (and often cannot) apply the fair value option to their loans or loan commitments, which are typically managed for credit risk within a flexible and active risk management strategy. For example, credit managers may hedge less than one hundred percent of the loan or loan commitment, or hedge them for shorter periods than their contractual maturity.

Consequently, financial institutions that use credit default swaps to hedge the credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments. Because the changes in the fair value of the credit default swap are recognised in profit or loss every period, this creates an accounting mismatch and results in volatility in profit or loss. In many cases, this does not reflect the economic substance of the credit risk management strategy of financial institutions.

To accommodate the management of credit risk, the IASB introduced a new fair value option for certain credit exposures in the review draft as a substitute for hedge accounting. Under the new fair value option, if an entity uses a credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or a part of, a credit exposure, then it may designate that credit exposure (or a proportion of it) as measured at fair value through profit or loss.

A credit exposure may be a financial instrument within or outside the scope of IFRS 9 (e.g. loan commitments) that is managed for credit risk. The designation can be made only if:

- the name of the credit exposure (e.g. the borrower or the holder of a loan commitment) matches the reference entity of the credit derivative (‘name matching’); and
- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

An entity may make the designation at initial recognition or subsequently, or while the financial instrument is unrecognised. The entity is required to document the designation concurrently.

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

Under the proposals, if a financial instrument is designated as measured at fair value through profit or loss after its initial recognition, or was previously not recognised, then any difference between the carrying amount and the fair value at the time of designation would immediately be recognised in profit or loss.

An entity discontinues measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss if:

- the conditions described in 5.3 (i.e. name matching and seniority) are no longer met – for example:
  - the credit derivative or the related financial instrument that gives rise to the credit risk expires or is sold, terminated or settled; or
– the credit risk of the financial instrument is no longer managed using credit derivatives – e.g. because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and

• the financial instrument that gives rise to the credit risk is not otherwise required to be measured at fair value through profit or loss (i.e. the entity’s business model has not changed in the meantime so that a reclassification to fair value through profit or loss is required).

**Observations – Discontinuation of fair value designation for credit exposures**

Under the review draft, when the discontinuation criteria are met, discontinuation of the fair value designation for the underlying credit exposures is mandatory (rather than optional). This ensures alignment with the way that the exposure is managed – i.e. the credit risk would no longer be managed using credit derivatives.

**RD BC6.356**

On discontinuation, the fair value of the financial instrument at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through profit or loss should be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised cost would revert to that measurement and its effective interest rate would be recalculated based on its new carrying amount on the date of discontinuation. Similarly, a loan commitment or a financial guarantee contract would be measured at the higher of:

• the amount determined in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and

• the new carrying amount at the date of discontinuation less cumulative amortisation. The amortisation period is the remaining life of the instrument.

**Observations – Fair value designation subsequent to initial recognition**

An entity may make the fair value designation for a credit exposure after its initial recognition. This means that election is available again for an exposure that was designated at fair value through profit or loss previously.

Consider the following scenario under the proposed requirements. The credit risk of a volatile longer-term loan was previously deteriorating and the entity manages the credit risk using a credit derivative. The loan met the qualifying criteria and the entity designated the loan as measured at fair value through profit or loss. Subsequently, the credit risk of the loan improved and the entity sold the credit derivative. The fair value of the loan on the date on which the credit derivative was sold became the new carrying amount and the loan was subsequently measured at amortised cost. At a later date, the credit risk of the loan deteriorated again and the entity bought a new credit derivative to protect its exposure. The entity designated the loan at fair value through profit or loss (again) when it bought the new credit derivative. The difference between the amortised cost and fair value of the loan at the date of designation is recognised in profit or loss.

The above accounting outcome would therefore reflect the entity’s risk management strategy of protecting exposures that drop below a certain quality or risk level. This meets the IASB’s objective of aligning accounting with risk management.
6. Hedging instruments

6.1 Overview

Under the review draft, the following would qualify as hedging instruments.

- All derivatives (including zero-cost collars), except:
  - written options not designated as offsets to purchased options; and
  - derivatives embedded in hybrid contracts that are not separately accounted for.

- Non-derivative financial assets or non-derivative financial liabilities (i.e. cash instruments) measured at fair value through profit or loss, except:
  - financial liabilities at fair value through profit or loss for which the amount of changes in fair value attributable to changes in credit risk is presented in OCI.

6.2 Cash instruments

RD 6.2.2

Under the review draft, non-derivative financial assets or non-derivative financial liabilities (i.e. cash instruments) measured at fair value through profit or loss may be designated as hedging instruments in hedging relationships of any risk – not only foreign currency risk.

RD B6.2.5

For hedges other than hedges of foreign currency risk, the non-derivative financial instrument is required to be designated in its entirety or a proportion of it.

RD 6.2.4(c)

For hedges of foreign currency risk, an entity may designate the foreign currency risk component of a non-derivative financial instrument as the hedging instrument. This is permitted only if the financial instrument is not an investment in an equity instrument for which an entity has elected to present changes in fair value in OCI.

Observations – Non-derivative financial instruments designated as hedging instruments in their entirety (or proportionally)

For hedges other than hedges of foreign currency, the total change in fair value of the non-derivative hedging instrument (or a proportion of it) is required to form part of the hedging relationship. This may limit the situations in which the hedge effectiveness requirements are met, or it may generate additional ineffectiveness.

RD 6.2.2

Financial liabilities designated as at fair value through profit or loss, for which the changes in fair value attributable to changes in the credit risk of the liability are presented in OCI, are not eligible.

Observations – Non-derivative financial instruments measured at fair value through profit or loss designated as hedging instruments

The review draft allows for a non-derivative financial instrument measured at fair value through profit or loss to be designated as a hedging instrument. If such an instrument were designated in a cash flow hedge, then the change in its value that is determined to be effective would be recognised in OCI, rather than in profit or loss.
Whether a non-derivative financial instrument accounted for at fair value through profit or loss as a result of electing the fair value option may be used as a hedging instrument depends on relevant facts and circumstances underlying the fair value option designation. Any designation as a hedging instrument should not contradict the entity’s election of the fair value option – i.e. it should not recreate the accounting mismatch that the fair value option addressed.

6.3 Purchased options

Under the review draft, an entity may separate the intrinsic value and the time value of a purchased option contract and designate only the change in intrinsic value as the hedging instrument.

If an entity designates only the change in intrinsic value of a purchased option as the hedging instrument in a fair value or cash flow hedge, then the change in fair value of the time value of the option is recognised in OCI to the extent that it relates to the hedged item. The method used to reclassify the amounts from equity to profit or loss is determined by whether the hedged item is:

- a transaction-related hedged item; or
- a time period-related hedged item.

Observations – Change in fair value of the time value of a purchased option recognised in OCI

The recognition of the change in fair value of the time value of the option in OCI results in less profit or loss volatility, but more OCI volatility.

This issue is also relevant in the context of zero-cost collars (see below) and forward contracts (see 6.4).

6.3.1 Transaction-related vs time period-related hedged item

Under the review draft, an entity would determine whether a purchased option hedges a transaction-related or a time period-related hedged item based on the nature of the hedged item, including how and when it affects profit or loss, regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge.

The time value of a purchased option relates to a transaction-related hedged item if the nature of the hedged item is a transaction for which the time value has the character of the costs of the transaction.

An example of a transaction-related hedged item arises when an entity hedges the future purchase of a commodity against commodity price risk, and the transaction costs are included in the initial measurement of the inventory.

The time value of a purchased option relates to a time period-related hedged item if the nature of the hedged item is such that:

- the time value has the character of the cost for obtaining protection against a risk over a particular period of time; but
- the hedged item does not result in a transaction that involves the notion of transaction cost as noted above.

An example of a time period-related hedged item is an entity hedging its commodity inventory for six months using a commodity option with a corresponding life. Another example is the hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange option.
6.3.2 Accounting for the time value of a purchased option

Transaction-related hedged items

Under the review draft, the change in fair value of the time value of a purchased option that hedges a transaction-related hedged item is recognised in OCI to the extent that it relates to the hedged item. The cumulative change in fair value is presented as a separate component of equity.

The hedged item may subsequently result in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied. In such cases, the entity removes the amount from the separate component of equity and includes it directly in the initial cost or other carrying amount of the item. This is not a reclassification adjustment under IAS 1 Presentation of Financial Statements and therefore does not affect OCI. In other cases, the entity would reclassify the amount from the separate component of equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss.

Any portion of the time value of a purchased option recognised in OCI that is not expected to be recovered in future periods would be immediately reclassified into profit or loss as a reclassification adjustment.

Time period-related hedged items

The change in fair value of the time value of a purchased option that hedges a time period-related hedged item is recognised in OCI to the extent that it relates to the hedged item and is accumulated in a separate component of equity. The time value at the date of designation of the option as a hedging instrument, to the extent that it relates to the hedged item, is amortised on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or OCI, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI). This is also likely to be the hedged period. Therefore, in each reporting period, the amortisation amount is reclassified from the separate component of equity to profit or loss as a reclassification adjustment.

However, if the hedging relationship that has the intrinsic value of an option is discontinued, then the net amount that has been accumulated in the separate component of equity, inclusive of cumulative amortisation, is reclassified immediately into profit or loss as a reclassification adjustment.

Example – Period over which to amortise the time value of a purchased option that hedges a time period-related hedged item

An entity buys an interest rate option (a cap) to protect against increases in the interest expense on a floating-rate bond. The time value paid for the cap is amortised to profit or loss over the same period over which any intrinsic value of the cap would affect profit or loss (i.e. the hedged period).

Example 1

Assume that the cap hedges increases in interest rates for the first three years out of a total life of the floating-rate bond of five years. In this case, the time value paid for that cap is amortised over the first three years.

Example 2

Assume that the cap is a forward start option that hedges increases in interest rates for years 2 and 3 out of a total life of the floating-rate bond of five years. In this case, the time value paid for that cap is amortised during years 2 and 3.
Zero-cost collars

The accounting for the time value of purchased options described above also applies to a combination of a purchased and a written option (one being a put option and one being a call option) that at the date of designation as a hedging instrument has a net zero time value – i.e. a ‘zero-cost collar’. In this case, an entity recognises any changes in time value in OCI – even though the cumulative change in time value over the total period of the hedging relationship is zero.

Therefore, if the time value of the collar relates to a:

- transaction-related hedged item, then the amount of time value that adjusts the hedged item or is reclassified to profit or loss at the end of the hedging relationship would be zero; and
- time period-related hedged item, then the total amortisation expense for the time value is zero. This is because the amortisation expense is based on the time value at the date of designation as the hedging instrument, which is zero.

Observations – Zero-cost collars

A zero-cost collar has no time value at inception; however, its time value fluctuates during the life of the hedge. Time value is subject to ‘time decay’, and both the purchased and the written option will lose their time value over time as the collar approaches expiry. Recognising the time value of zero-cost collars in OCI reduces volatility in profit or loss, but increases volatility in OCI.

Aligning the accounting treatment for changes in the time value of purchased options and zero-cost collars in OCI rather than profit or loss potentially expands the use of a zero-cost collar as a hedging instrument under the review draft.

IAS 39 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that combines a written option component and a purchased option component cannot qualify as a hedging instrument unless factors indicate that the combined instrument is not a net written option. Such factors include consideration as to:

- whether any net premium is received either at inception or over the life of the combined instrument; and
- whether the critical terms and conditions of the written option component and the purchased component are the same.

Observations – Transaction-related vs time period-related hedged items

If an entity designates the intrinsic value of a purchased option as a hedging instrument, then the accounting for that option’s time value depends on whether the hedged item relates to a transaction or a time period. Entities will need to analyse their hedging strategies that use purchased options to make this determination, because they may not have previously documented their option strategies in this manner.

6.3.3 Aligned time value vs actual time value

Under the review draft, the specific accounting guidance for the time value of purchased options described above applies only to the extent that the time value relates to the hedged item. This is referred to as the ‘aligned time value’. An entity determines the aligned time value using the valuation of the option that would have critical terms perfectly matching the hedged item.
The aligned time value is the time value of a purchased option with critical terms that perfectly match the hedged item. An entity would need to determine which features of the option it considers to be critical, including what type of option is appropriate – i.e. American, European, Bermudan etc. This would require the entity to use its judgement, which should be applied consistently.

The actual time value of the option – i.e. the time value included in the premium paid – may differ from the aligned time value. In this case, the entity would use the following method to account for the difference during the hedging relationship.

If, at inception of the hedging relationship, the actual time value is higher than the aligned time value, then the entity:

- determines the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
- accounts for the differences in the fair value changes between the two time values in profit or loss.

However, if at inception of the hedging relationship, the actual time value is lower than the aligned time value, then the entity:

- determines the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of the actual time value and the aligned time value; and
- recognises in profit or loss any remainder of the change in fair value of the actual time value.

Under IAS 39, in applying the hypothetical derivative method to measure hedge ineffectiveness in a cash flow hedge relationship, the time value of a purchased option is typically excluded from the effectiveness tests. Any changes in the fair value of the time value of the option are recognised immediately in profit or loss.

Under the proposals, the accounting for the time value of a purchased option depends on whether the actual time value is higher or lower than the aligned time value.

If at inception of the hedging relationship, the actual time value is higher than the aligned time value – i.e. the entity pays a higher premium than would reflect the costs of hedging – then the amount that is recognised in OCI should be determined only on the basis of the aligned time value. The remainder of the actual time value is accounted for as a derivative at fair value through profit or loss.

Conversely, if at the inception of the hedging relationship the actual time value is lower than the aligned time value – i.e. the entity actually pays a lower premium than it would have to pay to cover the risk fully – then the amount that is recognised in OCI is the lower of the cumulative fair value change of the actual time value and the aligned time value. This is to avoid accounting for more time value of a purchased option than was actually paid for.
Example – Aligned time value vs actual time value

Entity E uses purchased options to hedge its forecast commodity purchase. In doing so, it designates the option’s intrinsic value as a hedging instrument.

In this case, the time value of the purchased option relates to a transaction-related hedged item, because the transaction costs would be included in the initial measurement of the inventory when the forecast commodity purchase occurs.

The accounting for the time value of such an option depends on whether its time value at inception of the hedging relationship is higher or lower than the aligned time value.

Scenario 1 – Actual time value is higher than aligned time value

Entity E pays an up-front premium of 13 for the purchased option. On that day, it determines that the aligned time value is 10.

In accordance with the requirements in RD B6.5.32 and B6.5.33, E accounts for the time value of the option as follows.

<table>
<thead>
<tr>
<th>Overview of fair value of actual and aligned time value</th>
<th>Actual</th>
<th>Aligned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term (periods)</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Time value</td>
<td>13</td>
<td>10</td>
</tr>
<tr>
<td>Period (end)</td>
<td>t₀      t₁  t₂  t₃  t₄  t₅</td>
<td></td>
</tr>
<tr>
<td>Fair value of actual time value</td>
<td>13</td>
<td>11</td>
</tr>
<tr>
<td>Fair value of aligned time value</td>
<td>10</td>
<td>7</td>
</tr>
</tbody>
</table>

**Statement of financial position**

Financial asset (option) – time value only; excludes intrinsic value to simplify example

<table>
<thead>
<tr>
<th></th>
<th>t₀</th>
<th>t₁</th>
<th>t₂</th>
<th>t₃</th>
<th>t₄</th>
<th>t₅</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset (option)</td>
<td>13</td>
<td>11</td>
<td>13</td>
<td>9</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Retained earnings (gain)/loss</td>
<td>0</td>
<td>(1)</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Accumulated OCI – cumulative changes in fair value of aligned time value (gain)/loss</td>
<td>0</td>
<td>3</td>
<td>(1)</td>
<td>2</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
</tbody>
</table>

**Statement of comprehensive income**

<table>
<thead>
<tr>
<th></th>
<th>t₀</th>
<th>t₁</th>
<th>t₂</th>
<th>t₃</th>
<th>t₄</th>
<th>t₅</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit or loss – period-to-period movement in fair value of actual time value that does not relate to the hedged item (gain)/loss</td>
<td>(1)</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>OCI – period-to-period movement in fair value of aligned time value (gain)/loss</td>
<td>3</td>
<td>(4)</td>
<td>3</td>
<td>2</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>2</td>
<td>(2)</td>
<td>4</td>
<td>2</td>
<td>7</td>
<td>13</td>
</tr>
</tbody>
</table>
Scenario 2 – Actual time value is lower than aligned time value

Entity E pays an up-front premium of 10 for the purchased option. On that day, it determines that the aligned time value is 12.

In accordance with the requirements in RD B6.5.32 and B6.5.33, E accounts for the time value of the option as follows.

### Overview of fair value of actual and aligned time value

<table>
<thead>
<tr>
<th>Term (periods)</th>
<th>Actual</th>
<th>Aligned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time value</td>
<td>10</td>
<td>12</td>
</tr>
</tbody>
</table>

### Period (end)

<table>
<thead>
<tr>
<th>Fair value of actual time value</th>
<th>$t_0$</th>
<th>$t_1$</th>
<th>$t_2$</th>
<th>$t_3$</th>
<th>$t_4$</th>
<th>$t_5$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of aligned time value</td>
<td>10</td>
<td>12</td>
<td>9</td>
<td>8</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Cumulative change of actual time value</td>
<td>2</td>
<td>-1</td>
<td>-2</td>
<td>-5</td>
<td>-10</td>
<td></td>
</tr>
<tr>
<td>Cumulative change of aligned time value</td>
<td>3</td>
<td>-1</td>
<td>-1</td>
<td>-5</td>
<td>-12</td>
<td></td>
</tr>
</tbody>
</table>

### Lower of cumulative change

<table>
<thead>
<tr>
<th>Lower of cumulative change</th>
<th>$t_0$</th>
<th>$t_1$</th>
<th>$t_2$</th>
<th>$t_3$</th>
<th>$t_4$</th>
<th>$t_5$</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2</td>
<td>-1</td>
<td>-1</td>
<td>-5</td>
<td>-10</td>
<td></td>
</tr>
</tbody>
</table>

### Statement of financial position

- **Financial asset (option) – time value only; excludes intrinsic value to simplify example**
  - $t_0$: 10
  - $t_1$: 12
  - $t_2$: 9
  - $t_3$: 8
  - $t_4$: 5
  - $t_5$: 0
- **Retained earnings (gain)/loss**: 0 0 0 1 0 0
- **Accumulated OCI – Lower of cumulative change (gain)/loss**: 0 (2) 1 1 5 10

### Statement of comprehensive income

- **Profit or loss – period-to-period movement of remainder of change in fair value of actual time value (gain)/loss**: 0 0 1 (1) 0
- **OCI – period-to-period movement of the lower of cumulative change (gain)/loss**: (2) 3 0 4 5
- **Total comprehensive income**: (2) 3 1 3 5

The aligned time value is determined using the valuation of an option that would have critical terms that perfectly match the hedged item.

Note that the amount that is accumulated in OCI is determined by reference to the lower of the cumulative fair value change of the actual time value and the aligned time value – i.e. 10. The cumulative fair value change of the excess of the aligned time value over the actual time value of 2 (12-10) is not recognised in profit or loss/retained earnings. This avoids accounting for more time value than was actually paid for.
6.4 Forward contracts

Under the review draft, similar to the accounting for purchased options, an entity can separate the forward element and the spot element of a forward contract and then designate only the change in the spot element as the hedging instrument in a fair value hedge or a cash flow hedge.

6.4.1 Accounting for the forward element of forward contracts

When this designation is used, the change in fair value of the forward element may be recognised in OCI to the extent that it relates to the hedged item and accumulates in a separate component of equity. The forward element that exists at the inception of the hedging relationship is amortised on a systematic and rational basis over the period to which the forward element relates, to the extent that the forward element relates to the hedged item. Therefore, in each reporting period the amortisation amount is reclassified from the separate component of equity to profit or loss as a reclassification adjustment.

However, if the hedging relationship that includes the change in the spot element as the hedging instrument is discontinued, then the net amount that has been accumulated in the separate component of equity, inclusive of cumulative amortisation, is reclassified immediately into profit or loss as a reclassification adjustment.

Observations – Change in fair value of the forward element recognised in OCI

Similar to the earlier discussion in the context of purchased options and zero-cost collars (see 6.3), the recognition of the change in fair value of the forward element in OCI results in less profit or loss volatility, but more volatility in OCI.

6.4.2 Aligned forward element

Under the review draft, the specific accounting guidance for the forward element of forward contracts described above would apply only to the extent that the forward element relates to the hedged item. This is referred to as the ‘aligned forward element’. An entity would determine the aligned forward element using the valuation of the forward contract that has critical terms perfectly matching the hedged item.

Observations – Accounting for forward elements

Some entities may have more funding in their functional currency than they could invest in financial assets in their functional currency. To generate an economic return on their surplus funds, such entities exchange these funds into a foreign currency and invest in assets denominated in that foreign currency. To manage their exposure to foreign exchange risk (and to stabilise their interest margin), such entities commonly enter into foreign exchange derivatives – e.g. a foreign-currency forward. Usually, such transactions simultaneously involve the following components:

- swapping the functional-currency surplus funds into a foreign currency;
- investing the foreign-currency funds in a foreign currency-denominated financial asset for a period of time; and
- entering into a foreign-currency forward, to convert the foreign-currency funds back into the functional currency at the end of the investment period. This amount typically covers the principal plus interest at maturity.
The combination of the three components described above effectively allows the entity to ‘lock in’ a net interest margin and generate a fixed economic return over the investment period.

The review draft permits the forward points of the forward contract that exist at inception of the hedging relationship to be recognised in profit or loss over time on a systematic and rational basis and to accumulate subsequent fair value changes through OCI. Some constituents believe that this accounting treatment would provide a better representation of the economic substance of the transaction and the performance of the net interest margin for those entities that choose to apply this method of hedge accounting for forward points.
7. Hedged risks and items

7.1 Overview

The review draft permits the following additional exposures to be designated as hedged items:

- risk components of non-financial items and non-contractually specified inflation;
- net positions and layer components of items; and
- aggregated exposures (a combination of a non-derivative exposure and a derivative).

Equity investments at fair value through OCI may also be hedged items – this represents a modification of an entity’s ability to hedge equity investments classified as available-for-sale under IAS 39. In addition, the review draft carries forward the existing prohibition of hedging sub-LIBOR components.

7.2 Risk components

Under the review draft, an entity may hedge a risk component of a non-financial asset or non-financial liability. Currently under IAS 39, foreign currency risk is the only risk component of a non-financial asset or non-financial liability that can be designated in a hedge relationship. To be eligible for designation as a hedged item:

- a risk component is required to be a separately identifiable component of the financial or non-financial item; and
- the changes in the cash flows or fair value of the item attributable to changes in that risk component are required to be reliably measurable.

Under the proposals, when determining if a risk component is eligible for designation as a hedged item, an entity would assess the component in the context of the particular market structure to which the risk relates and in which the hedging activity takes place. This is true for both contractually specified and non-contractually specified risks, as well as for risks related to both financial and non-financial items.

Observations – Evaluation of separately identifiable and reliably measurable

The evaluation of whether a risk component is separately identifiable and reliably measurable may require judgement. If a component is explicitly specified in a contract (e.g. pricing formula that uses a reference to a benchmark commodity price), then concluding that it is separately identifiable will be straightforward. If the component is not contractually specified, then the entity will need to consider factors such as whether it is a physical component or a price component of the entire item (e.g. cocoa is a physical component of a chocolate bar whereas a crude oil price is a price component of a jet fuel price). Whether sufficient observable forward transactions for the component exist may be a factor to consider in concluding whether a component is reliably measurable. Knowledge of the relevant market structure will also be critical. There is no requirement that the component be the main or largest component, or that the movement of the fair value of the component be in the same direction as the value of the entire item.
This decision tree describes one potential approach to performing the evaluation.

**Evaluating whether a risk is separately identifiable**

- Is there a contract? (No)
  - Does the contract specify how the risk is priced into the contract? (No)
    - Is the risk separately considered in pricing the hedged item based on an analysis of the related market structure? (No)
      - Risk is not separately identifiable (not permitted hedged risk)
    - Risk is separately identifiable (permitted hedged risk if also ‘reliably measurable’)
  - Yes

**Evaluating whether a risk is reliably measurable**

- Are the inputs to measuring the effect of the risk observable? (No)
  - Are the unobservable inputs insignificant to the measurement? (No)
    - Risk is not reliably measurable (not permitted hedged risk)
  - Yes
    - Risk is reliably measurable (permitted hedged risk)

**Observations – Qualifying items: risk components of non-financial items**

IAS 39 treats financial and non-financial items differently regarding the risk components that may be designated as hedged items.

Under IAS 39, financial items may be hedged for risks that are separately identifiable and reliably measurable, but non-financial items may only be hedged in their entirety for all risks or for foreign exchange risk. This has caused inconsistencies between risk management strategies and hedge accounting, which were commonly noted as concerns during the IASB’s outreach activities.

The review draft applies the separately identifiable and reliably measurable criteria to both financial and non-financial items.
Manufacturers often hedge their inventory with derivatives that have underlyings related to the raw materials used to produce that inventory. For example, a tyre manufacturer may use a rubber forward contract to hedge its tyre inventory. Currently under IAS 39, the manufacturer can hedge the entire price risk in the inventory, but not the rubber component only. Also, entities may use derivative contracts to hedge the forecast sales or purchases of a commodity of a different grade. For example, a manufacturer of premium chocolate may use an exchange grade quality cocoa forward contract to hedge its forecast purchase of premium grade cocoa. Under IAS 39, the price risk of the entire purchase can be hedged, but not the exchange grade quality component only.

Under the review draft, such risk components may be eligible for hedge accounting. This would allow entities that use commodity derivatives greater flexibility in applying hedge accounting.

**Example – Contractually specified risk component**

RD B6.3.10

Company B has a long-term supply contract to buy natural gas. The contract is priced using a contractually specified formula that references gas oil, fuel oil and transportation charges. B’s risk management strategy is to hedge 100% of its exposure to gas oil price risk, and B enters into gas oil forward contracts to hedge that price risk. The contract completely specifies how the gas oil component is determined. In addition, there is a market for gas oil forward instruments that extends to the maturity of the supply contract. Thus, B determines that the gas oil price exposure is separately identifiable and reliably measurable. Therefore, the gas oil price exposure is an eligible risk component for designation as a hedged item.

**Example – Non-contractually specified risk component**

RD B6.3.10

Company C has a long-term supply contract to buy jet fuel. C’s risk management strategy is to hedge a portion of its exposure to jet fuel price risk based on expected consumption up to 24 months before delivery. C then increases the coverage volume as delivery gets nearer. C uses the following derivatives as hedging instruments based on the liquidity of the derivatives’ markets and the time remaining until the forecast purchase:

- 12 months to 24 months: crude oil contracts;
- six months to 12 months: gas oil contracts; and
- under six months: jet fuel contracts.

Crude oil and gas oil are not contractually specified components of jet fuel prices. Therefore, C has to determine whether crude oil and gas oil are separately considered in pricing jet fuel. C analyses the market structure for oil and oil products and determines that there is a relationship between crude oil and gas oil prices, and jet fuel prices. C determines that the relationship results from different refining margins (also known as ‘cracking spreads’) that allow the price of jet fuel to be made up of building blocks. Therefore, C is exposed to these two risk components, even though they are not specified contractually: crude oil and gas oil prices. If C determines that the two risk components are separately identifiable and reliably measurable, then it may designate crude oil or gas oil as risk components of the forecast jet fuel purchases.

RD B6.3.13–B6.3.15

The review draft states that there is a rebuttable presumption that, unless inflation is contractually specified, it is not separately identifiable and reliably measurable. Therefore, it is not an eligible risk component.
The review draft notes that in limited cases it is possible to designate non-contractually specified inflation as a risk component because of the particular circumstances of the inflation environment and the relevant debt market.

**Observations – Qualifying items: inflation**

If an entity wishes to hedge non-contractually specified inflation as a risk component, then it will have to determine whether it is capable of constructing an inflation curve using real interest rates for the hedge period to rebut the presumption that non-contractually specified inflation is not separately identifiable and reliably measurable. This may be challenging for some entities.

### 7.3 Layer components and net positions

#### 7.3.1 Components of nominal amounts

**RD 6.3.7(c), B6.3.16** Under the review draft, two types of components of nominal amounts can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component.

**RD B6.3.17** An example of a component that is a proportion of an entire item is designating 50 percent of the interest payments of a fixed-rate bond as the hedged item in a fair value hedging relationship.

**RD B6.3.18−B6.3.19** A layer component may be specified from:

- a defined, but open, population; or
- a defined nominal amount.

The layer component may be designated as the hedged item in a fair value hedging relationship; in this case, an entity would specify it from a defined nominal amount. The ability to designate such a component is a change from current accounting under IAS 39.

**RD B6.3.20** Under the proposals, a layer component of a contract that includes a prepayment option whose fair value is affected by changes in the hedged risk would be eligible as a hedged item in a fair value hedge only if the effect of the option were included in determining the change in fair value of the hedged item.

**Observations – Layer component of a nominal amount**

Designating a layer or proportion component of a nominal amount as the hedged item can give rise to different accounting outcomes.

For example, assume that a five-year, 100 million debt instrument repays 20 million per year. If the hedged component is designated as 20% of the debt instrument – i.e. a proportion component – then the determination of the gain or loss on the hedged component due to the hedged risk would consider the cash flows of the instrument over its entire life multiplied by 20%. Alternatively, if the hedged component were the last 20 million of principal of the debt instrument – i.e. a bottom layer – then the determination of the gain or loss on the hedged component would consider only the last payment of 20 million. This may result in a more effective hedging relationship.

#### 7.3.2 Eligibility of a group of items as the hedged item

**RD 6.6.1** Under the review draft, a group of items, including both gross and net positions, would be an eligible hedged item if:

- the position consists of items, including components of items, that would individually be eligible hedged items;
the items in the group are managed together on a group basis for risk management purposes; and

- for a cash flow hedge of a group of items whose variability in cash flows are not expected to be approximately proportional to the overall variability in cash flows so that an offsetting risk position arises, then the net position is eligible as a hedged item only if:
  - it is a hedge of foreign currency risk; and
  - the designation specifies the reporting period in which the forecast transactions are expected to affect profit or loss as well as their nature and volume.

**Observations – Hedges of gross positions**

Under IAS 39, for a group of items to qualify for hedge accounting, they need to meet additional criteria:

- the individual items within the group are required to have similar risk characteristics; and

- the change in the fair value attributable to the hedged risk for each individual item in the group is required to be approximately proportional to the overall change in the fair value of the group for the hedged risk.

These restrictions are not consistent with the way that many entities manage risk. The review draft does not require entities to meet such criteria to hedge a gross position. Therefore, the proposals may allow hedge accounting in some cases where the ‘approximately proportional’ test could not be met under IAS 39.

**Observations – Hedges of net positions**

Business units within an entity are exposed to various risks in the normal course of business. These business units often transfer the risks to one central business unit within the entity, using internal derivatives. Many of the risks transferred to the central business unit offset naturally. The central business unit in turn transfers risk to external parties on a net basis. This is a common risk management strategy because it reduces transaction costs and counterparty credit risk exposure.

IAS 39 does not allow net position hedging, which is inconsistent with the risk management strategy described above. By allowing net position hedging, the review draft better aligns hedge accounting and such a risk management strategy.

Entities will need to consider what information systems and internal procedures they need in order to operationalise hedge accounting on a net position basis.

A group that is a nil net position – i.e. the hedged items among themselves fully offset the risk that is managed on a group basis – would be eligible to be designated as the hedged item in a hedging relationship that does not include a hedging instrument if:
the hedge is part of a rolling net risk hedge strategy for a hedged position that changes in size over time;

over the life of the rolling net risk hedge strategy, eligible hedging instruments would be used to hedge the net risk when the net position is not nil;

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

not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

The IASB noted that a group that is a nil net position would be coincidental and would therefore be rare in practice.

**Designating a component of a nominal amount of a group of items**

Under the review draft, an entity could designate a proportion of an eligible group of items as a hedged item if it is consistent with the entity’s risk management objective. An entity can also designate a layer component of an eligible group of items – such as the bottom layer – if the following requirements are met:

- the layer is separately identifiable and reliably measurable;
- the risk management objective is to hedge a layer component;
- the items in the overall group from which the layer is identified are exposed to the same hedged risk;
- for hedges of existing items, an entity can identify and track the overall group of items from which the hedged layer is defined; and
- the change in fair value of the hedged layer in a fair value hedge considers the effect of the prepayment options of the individual items that comprise the group.

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

**Aggregated exposures**

An aggregated exposure consists of a non-derivative exposure that could qualify for a hedged item and a derivative. Such a combination may create a different exposure that is managed as a single exposure for a particular risk or risks. Under the review draft, an entity may designate such an aggregated exposure as the hedged item. The components that make up the aggregated exposure do not need to be designated in a separate hedging relationship.
Entities are sometimes required economically to enter into transactions that can result in different aggregated risk exposures. These transactions may include a derivative. Under an entity’s risk management strategy, these exposures may be managed together or separately. Under the review draft, entities will be allowed to hedge these exposures as one even though they include a derivative.

Example – Aggregated exposure: cash flow hedge/cash flow hedge

Entity X is a euro functional currency entity. It hedges its US dollar-denominated 1,000 tonne forecast purchase of steel using a US dollar-denominated steel forward contract. The forward contract has a delivery date that matches the expected delivery of the forecast purchase. X documents this as a cash flow hedge and designates:

- the forecast steel purchase as the hedged item;
- the variability in US dollar cash flows from the forecast purchase due to steel prices as the hedged risk; and
- the forward steel contract as the hedging instrument.

One month later, X enters into a foreign currency forward contract to hedge the foreign exchange risk between the euro and the US dollar arising from both the US dollar-denominated forecast steel purchase and the US dollar-denominated forward contract because it views the two collectively as a US dollar aggregated exposure.

The proposals would allow X to document this second-level hedge as a cash flow hedge in which it would designate:

- the aggregated US dollar exposure as the hedged item;
- the variability in euro cash flows related to the euro/US dollar foreign exchange risk as the hedged risk; and
- the foreign currency forward contract as the hedging instrument.
Example – Aggregated exposure: fair value hedge/cash flow hedge

Entity Y is a euro functional currency entity. It issues a 20-year, USD10,000,000, fixed-rate debt that pays interest semi-annually. It hedges the change in fair value of the debt due to foreign currency and interest rate risks by entering into a cross-currency interest rate swap. Y documents this as a fair value hedge and designates:

- the debt as the hedged item;
- the change in fair value of the debt due to foreign currency and interest rate as the hedged risks; and
- the cross-currency interest rate swap as the hedging instrument.

One year later, Y decides to hedge the variability of cash flows due to interest rate risk associated with this aggregated exposure for the next five years using a five-year euro-denominated interest rate swap. Y views its US dollar-denominated fixed-rate debt and the cross-currency interest rate swap collectively as a euro-denominated variable-rate 20-year aggregated exposure.

The proposals would allow Y to document this second-level hedge as a cash flow hedge in which it would designate:

- the next five years of interest payments from the 20-year aggregated exposure as the hedged item;
- the variability of euro cash flows from this aggregate exposure due to interest rate risk for the next five years as the hedged risk; and
- the five-year interest rate swap as the hedging instrument.

Example – Aggregated exposure: cash flow hedge/fair value hedge

If Entity Y’s US dollar-denominated debt had a variable rate, then it could use a cross-currency interest rate swap to fix the cash flows and designate the hedge as a cash flow hedge. The aggregated exposure of the debt and cross-currency interest rate swap could then be the hedged item in a fair value hedge.

To the extent that the first-level cash flow hedge is effective, the accounting for the aggregated exposure would be analogous to that of a financial asset that is classified as available-for-sale. That is, the effective portion of the cross-currency interest rate swap in the first-level hedge would be recorded in OCI, as would the change in fair value of an available-for-sale asset.

As part of the accounting for the second-level fair value hedge, the change in fair value of the aggregated exposure attributable to the hedged risk would be reclassified from OCI to profit or loss, as would the change in fair value of an available-for-sale asset attributable to the hedged risk if it were a hedged item in a fair value hedge.

Observations – Interaction between first-level and second-level hedges

There is no need to de-designate and re-designate the first-level hedge when establishing the second-level hedge. This avoids complexity and increased ineffectiveness, because the derivative in the first hedge would probably have a fair value other than zero at that time.

Furthermore, the proposals do not require hedge accounting to be applied at the first level to apply hedge accounting to a second-level hedge. That is, if an entity fails to achieve hedge accounting for a first-level hedge or designated the derivative in the first level as held-for-trading, then the second-level hedge may qualify for hedge accounting.
7.5 Equity investments at fair value through other comprehensive income

*IFRS 9.5.75, RD BC6.16–BC6.27*

In line with IFRS 9, an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in OCI. Under the review draft, an entity can designate such instruments as hedged items in a fair value hedge. Changes in the fair value of the derivatives and hedged items would be reflected in OCI; therefore, any hedge ineffectiveness would be recognised in OCI. Such amounts are never reclassified from accumulated other comprehensive income (AOCI) to profit or loss.

7.6 ‘Sub-LIBOR’ prohibition

*RD B6.3.21–B6.3.22*

The review draft retains the requirement from IAS 39 that a component of the cash flows of a financial or non-financial item designated as the hedged item should be less than or equal to the total cash flows of the entire item. However, the review draft reiterates that all of the cash flows of the entire item may be designated as the hedged item and hedged for only one particular risk. For example, in the case of a financial liability that has an effective interest rate below LIBOR, an entity cannot designate both:

- a component of the liability equal to interest at LIBOR (plus the principal amount in the case of a fair value hedge); and
- a negative residual component.

*RD B6.3.23*

However, for example, in the case of a fixed rate financial liability whose effective interest rate is below the benchmark rate (e.g. 100 basis points below LIBOR), an entity may designate as the hedged item the change in the value of the entire liability (i.e. principal plus interest at LIBOR minus 100 basis points).

*RD B6.3.23*

In addition, if a fixed rate financial instrument is hedged some time after its origination, and interest rates have changed in the meantime, then an entity can designate a risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designated the hedged item.

Example – Sub-LIBOR issue in a non-financial context

*RD B6.3.25*

An entity has forecast sales of a specific type of crude oil from a particular oil field that is valued using Brent crude oil. Suppose that it sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at Brent minus 10 with a floor of 15. In this case, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in Brent. Therefore, as long as the forward price (for each delivery) does not fall below 25, the hedged item has the same cash flow variability as a crude oil sale at Brent (or with a positive spread). However, if the forward price for any delivery falls below 25, then the hedged item has a lower cash flow variability than a crude oil sale at Brent (or with a positive spread).
8. Hedge effectiveness

8.1 Overview

RD B6.4.1 ‘Hedge effectiveness’, on the one hand, is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item. ‘Hedge ineffectiveness’, on the other hand, is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item.

RD B6.4.2 Under the review draft, when designating a hedging relationship, and on an ongoing basis, an entity would analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis would serve as the basis for the entity’s assessment of meeting the hedge effectiveness requirements.

RD 6.4.1(c) A hedging relationship would meet the hedge effectiveness requirements if:

- 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 the economic relationship;
- the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:
  - the hedged item that the entity actually hedges; and
  - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and
- the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness (whether or not recognised) to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

8.2 Economic relationship between the hedged item and the hedging instrument

RD B6.4.3 Having an ‘economic relationship’ means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk – i.e. the hedged risk.

In other words, there is required to be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either:

- the same underlying; or
- underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged (e.g. Brent and West Texas Intermediate (WTI) crude oil).

RD B6.4.4 It may be that the underlyings are not the same but are economically related. In this case, there can be situations when the values of the hedging instrument and the hedged item move in the same direction. An example is when the price differential between two related underlyings changes while the underlyings themselves do not move significantly. Such situations still meet the ‘economic relationship’ test if the values of the hedging instrument and the hedged item are still typically expected to move in the opposite direction when the underlyings move.

RD B6.4.5 An entity analyses the possible behaviour of the hedging relationship during its term, to ascertain whether the relationship can be expected to meet the risk management objective. The mere existence of a statistical correlation between two variables does not, by itself, demonstrate that an economic relationship exists.
8.3 Effect of credit risk

The hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item. Therefore, the effect of credit risk on the value of both the hedging instrument and the hedged item will impact hedge effectiveness.

The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item, so great that the credit risk dominates the value changes that result from the economic relationship. That is, the loss (or gain) from credit risk frustrates the effect of changes in the underlyings on the value of the hedging instrument or the hedged item – even if those changes were significant.

Conversely, if during a particular period there is little change in the underlyings, then even small credit risk-related changes in the value of the hedging instrument or hedged item might affect the value more than the underlyings. However, this does not create dominance.

An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, then the effect of changes in the counterparty’s credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas the changes in the value of the hedged item depend largely on the commodity price changes.

8.4 Hedge ratio

The hedge effectiveness guidance requires the hedge ratio of the hedging relationship to be the same as that resulting from the actual quantities of:

- the hedged items hedged; and
- the hedging instruments used.

For example, an entity hedges 85 percent of the exposure on an item. The hedging relationship should be designated using a hedge ratio resulting from:

- 85 percent of the exposure; and
- the quantity of the hedging instrument that the entity actually uses to hedge that 85 percent.

Similarly, suppose that an entity hedges an exposure using a nominal amount of 40 units of a financial instrument. It should therefore designate the hedging relationship using a hedge ratio that is the same as that resulting from:

- that quantity of 40 units (and not based on a higher or lower quantity); and
- the quantity of the hedged item that it actually hedges with those 40 units.

The hedged item and hedging instrument should not be intentionally weighted to reflect an imbalance that would create hedge ineffectiveness (whether or not recognised) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. An entity adjusts the hedge ratio if doing so is necessary to avoid such an imbalance.
Observations – Risk management and hedge effectiveness assessment

Establishing an appropriate hedge ratio is primarily a risk management decision. In other words, an entity should analyse the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective.

Entities are responsible for clearly defining and consistently applying their effectiveness assessment policies. Management information (or analysis) used for decision-making purposes can be used as a basis to assess whether a hedging relationship meets the hedge effectiveness requirements.

An entity cannot, under the guise of risk management, use a hedge ratio that results in a deliberate mismatch that creates ineffectiveness to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. This will be a judgement call.

In assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting, an entity considers:

- whether the intended hedge ratio is established:
  - to avoid recognising hedge ineffectiveness for cash flow hedges; or
  - to achieve fair value hedge adjustments for more hedged items, with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and
- whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument even though that creates hedge ineffectiveness.

Observations – Commercial reason for particular weightings of the hedged item and the hedging instrument

The review draft states that in deriving the hedge ratio, the hedged item and hedging instrument should not be intentionally weighted to reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that is inconsistent with the purpose of hedge accounting. It provides the following example of a plausible scenario in which there may be a commercial reason for particular weightings of the hedged item and the hedging instrument even though they create hedge effectiveness.

Example

An entity enters into and designates a quantity of the hedging instrument. This is not the quantity that it determined as the best hedge of the hedged item, because the standard volume of the hedging instrument does not allow it to enter into that exact quantity of hedging instrument (a ‘lot size issue’).

For example, an entity hedges 100 tonnes of coffee purchases with standard coffee futures contracts that have a contract size of 37,500lb (pounds). The entity could use only either five or six contracts (equivalent to 85.0 and 102.1 tonnes respectively) to hedge the purchase volume of 100 tonnes.

In this case, the entity designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

However, the entity may be able to designate a proportion (e.g. a percentage of the nominal amount) of the coffee futures contract as the hedging instrument in the hedging relationship to improve hedge effectiveness.
8.5 Frequency of and methods for assessing hedge effectiveness requirements

RD B6.4.11 Under the review draft, an entity would assess hedge effectiveness:

- at the inception of the hedging relationship; and
- on an ongoing basis – at a minimum, each reporting period or on a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.

The assessment relates to expectations about hedge effectiveness; therefore, the test would be only forward-looking or prospective.

RD B6.4.12 The review draft does not specify a methodology, either quantitative or qualitative, for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity would use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness.

RD B6.4.13 If the critical terms of the hedging instrument and the hedged item – e.g. the nominal amount, maturity and underlying – match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

RD B6.4.15 Conversely, if the critical terms were not closely aligned, then there would be increased uncertainty about the extent of offset. Therefore, an entity may need to use a quantitative effectiveness assessment methodology to support its conclusion that an economic relationship exists between the hedged item and the hedging instrument. Similarly, the entity might also need a quantitative assessment of whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements.

Observations – Qualitative or quantitative assessment

If the critical terms of the hedging instrument and the hedged item match or are closely aligned, then a qualitative effectiveness assessment may be appropriate. In other cases, a quantitative assessment may be more appropriate. The review draft provides examples of critical terms, but does not define ‘critical terms’ or ‘closely aligned’. These concepts are important in determining the type of effectiveness assessment that should be used; therefore, an entity will have to use its judgement in developing accounting policies to identify which terms it considers critical and what it considers to be closely aligned.

RD B6.4.16 An entity would have to consider the need to change assessment methodologies, if there were changes in circumstances that affected hedge effectiveness. This is to ensure that all relevant characteristics of the hedging relationship, including sources of hedge ineffectiveness, are still captured.

Observations – No more bright line

The hedge effectiveness assessment under the review draft is forward-looking only and it does not prescribe an arbitrary bright line effectiveness range. This will require changes to systems and procedures, because they are currently focused on documenting that hedging relationships are retrospectively (and in some cases prospectively) effective within a range of 80 to 125 percent. Judgement will have to be applied to determine whether the entity’s new hedge accounting documentation provides sufficient evidence that the hedging relationship meets the hedge effectiveness requirements.
8.6 Measurement of hedge ineffectiveness

**RD BC6.189–BC6.190**

Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

**RD B6.5.5**

To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item. This is commonly referred to as a ‘hypothetical derivative’. The review draft clarifies that using a hypothetical derivative is not a method in its own right, but a mathematical expedient that can only be used to calculate the value of the hedged item.

**Observations – Using a hypothetical derivative to measure hedge ineffectiveness**

**RD B6.5.5**

The review draft clarifies that a hypothetical derivative cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (and not the hedged item).

For example, a debt is denominated in a foreign currency. When using a hypothetical derivative to calculate the present value of the cumulative change in cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies – even though actual derivatives under which different currencies are exchanged might include such a charge (e.g. cross-currency interest rate swaps).

Entities may have to reassess their current hedging strategies to ensure that their current methods of assessing effectiveness and measuring ineffectiveness are compliant with the requirements under the proposals.
9. Rebalancing

9.1 Overview

RD 6.5.5, B6.5.15 A hedging relationship may subsequently fail to meet the hedge effectiveness requirement regarding the hedge ratio; however, the entity’s risk management objective for that designated hedging relationship may remain the same. In such circumstances, under the review draft an entity would adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again. If the risk management objective for that designated hedging relationship has changed, then rebalancing does not apply. Instead, hedge accounting for that designated hedging relationship is discontinued.

RD B6.5.7– B6.5.21 The following decision tree illustrates the rebalancing model when there is a change in the extent of offset of the hedging relationship.

- Is the risk management objective still the same?
  - Yes: Continue hedge accounting
  - No: Discontinue hedge accounting
- Does the hedged ratio continue to appropriately reflect the expected relationship between the hedging instrument and the hedged item?
  - Yes: Continue hedge accounting
  - No: Rebalance

RD B6.5.8 Rebalancing a hedging relationship would allow hedge accounting to continue in situations where the change in the relationship of the hedging instrument and the hedged item can be compensated for by adjusting the hedge ratio. Any hedge ineffectiveness to date would be recognised in profit or loss immediately before rebalancing the hedging relationship.

RD B6.5.9 By adjusting the hedge ratio, an entity would be allowed to compensate for changes in the relationship between the hedging instrument and the hedged item arising from the underlyings or risk variables. This adjustment would allow an entity to continue the hedging relationship when the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.

RD B6.5.11 Not every change in the extent of offset constitutes a change in the relationship between the hedging instrument and hedged item. An entity would determine whether the changes in offset are:

- fluctuations around a hedge ratio that remains valid; or
- an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.
Example – Evaluating changes in offset

Background

Company B hedges its price risk exposure to a forecast purchase of a commodity in Location C with exchange-traded contracts for the same commodity but of a different grade in Location D.

Hedge ratio remains valid – B should not rebalance

Due to fluctuations in transportation costs of the commodity in Location C, B recognises some ineffectiveness on the hedge relationship. B determines that:

- the fluctuations in transportation costs are within the expected range of fluctuations in its risk management policy; and
- there has not been a change in the relationship between the price of the commodity in Location C and the price of the exchange-traded contracts for the commodity in Location D.

The amounts of the hedged item and the hedging instruments have not changed for risk management purposes; therefore, there would be an expectation that the hedging relationship would remain within the expected range. The change in the extent of offset is therefore a matter of measuring and recognising hedge ineffectiveness, but not of adjusting the hedge ratio.

Hedge ratio is no longer appropriate – B should rebalance

Assume that there is a change in the relationship between the two commodities; therefore, the correlation between the price of the commodity in Location C and the price of the exchange-traded commodity contracts in Location D is altered. In this case, rebalancing the hedging ratio to reflect the new correlation would ensure that the hedging relationship maintains a hedge ratio that complies with the hedge effectiveness requirements. An example of such a change might be a new use for one of the commodities, such that demand for it has been increased for the foreseeable future.

Hedge ratio is no longer appropriate – B should discontinue hedge accounting

If there was a default by the counterparty of the derivative commodity contract, then changing the hedge ratio would not ensure that the hedging relationship meets the hedge effectiveness requirements. Therefore, rebalancing does not enable B to continue a hedging relationship when the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.

If an entity rebalances a hedging relationship, then it updates its hedge documentation. This includes analysing the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term.

9.2 Mechanics

Under the review draft, a rebalancing adjustment of the hedging relationship can be effected as follows:

- an entity can increase the weighting of the hedged item either by increasing the volume of the hedged item or by decreasing the volume of the hedging instrument; or
- it can increase the weighting of the hedging instrument either by increasing the volume of the hedging instrument or by decreasing the volume of the hedged item.

The changes in volume refer to the quantities that are part of the hedging relationship. Decreases in volume do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur; instead, they mean that the items or transactions are not part of the hedging relationship.
The following chart summarises the mechanics of rebalancing.

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>Measurement of fair value changes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Hedged item</td>
</tr>
<tr>
<td>Increase volume of hedged item</td>
<td>Previously designated volume unchanged; additional volume is included from date of rebalancing</td>
</tr>
<tr>
<td>Decrease volume of hedged item</td>
<td>Reduced volume unchanged; decrease in volume is discontinued from date of rebalancing</td>
</tr>
<tr>
<td>Increase volume of hedging instrument</td>
<td>Unchanged</td>
</tr>
<tr>
<td>Decrease volume of hedging instrument</td>
<td>Unchanged</td>
</tr>
</tbody>
</table>

**Observations – Beginning amortisation after rebalancing**

Rebalancing a fair value hedging relationship may involve decreasing the volume of a hedged item that is a financial instrument. In this case, the entity may need to begin amortising the amount related to the volume that is no longer part of the hedging relationship. This means that entities will have to keep track of the accumulated gains or losses for the risk being hedged at the level of the individual hedged items.

**Observations – Effect of rebalancing on subsequent changes in value**

Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect the measurement of the hedged item or the measurement of the previously designated hedging instrument. However, increasing the volume of the hedging instrument affects subsequent changes in the value of the instrument in two ways:

- subsequent changes in the value of the hedging instrument will reflect the increase in the volume of the hedging instrument; and
- it is likely that the original hedging instrument and the additional hedging instrument have different terms, because they were entered into at different times. Therefore, subsequent changes in the value of the hedging instrument would be different, reflecting the difference in terms.

A similar effect occurs when an entity adjusts the hedge ratio by increasing the volume of the hedged item, such as increasing the size of a forecast transaction.

An entity may need to enhance its hedge accounting systems to be able to perform the necessary calculations for the above situations.
9.3 Accounting outcome cannot be inconsistent with purpose of hedge accounting

RD B6.4.9–B6.4.10

The adjustments to the hedge ratio should typically reflect adjustments in the quantities of the hedging instrument and the hedged item that the entity actually uses for risk management purposes. However, an entity is not permitted to adjust the hedged ratio in a way that creates ineffectiveness (whether recognised or not) to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. The following are relevant considerations in assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting:

- whether the hedge ratio is established to avoid recognising hedge ineffectiveness in cash flow hedges;

- whether the hedge ratio is established to achieve fair value hedge adjustments for more hedged items to increase the use of fair value accounting without offsetting changes in the fair value of the hedging instrument; and

- whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though they create ineffectiveness.
10. Discontinuation

RD 6.5.6, B6.5.26

Under the review draft, an entity discontinues hedge accounting prospectively only when the hedging relationship ceases to meet the qualifying criteria after considering the rebalancing of the hedging relationship (if applicable). Voluntary discontinuation when the qualifying criteria are met is prohibited. Examples of when discontinuation would be required include the following scenarios:

- the risk management objective for the hedging relationship has changed;
- the hedging instrument expires or is sold, terminated or exercised;
- there is no longer an economic relationship between the hedged item and hedging instrument; or
- the effect of credit risk starts dominating the value changes that result from the economic relationship.

The second example above excludes scenarios in which the expiration or termination is a replacement or rollover of a hedging instrument into another that is part of, and consistent with, the entity’s documented risk management objective. Discontinuation would not be required in these scenarios.

RD B6.5.28

If an entity discontinues a hedging relationship, then it can designate a new hedging relationship that involves the hedging instrument or the hedged item; however, that designation constitutes the start of a new hedging relationship, not the continuation of the old one.

Observations – Discontinuing a hedging relationship and starting a new hedging relationship with the same hedging instrument

Beginning a new hedge relationship with an existing hedging instrument that has a fair value other than zero may result in hedge ineffectiveness. This is because the initial fair value of the instrument is itself subject to change with market changes. Unless an offsetting fair value effect is also present in the hedged item, hedge ineffectiveness may result.

RD B6.5.26–B6.5.27

A hedging relationship is discontinued in its entirety when as a whole it ceases to meet the qualifying criteria. A part of a hedging relationship is discontinued when only part of the hedging relationship ceases to meet the qualifying criteria. When partial discontinuation applies, hedge accounting continues for the remainder of the hedging relationship.

RD B6.5.27

For example, an entity fails to predict its volume of highly probable forecast transactions accurately. As a result, the expected volume is lower than the originally designated volume. In this case, partial discontinuation would be appropriate. However, if an entity has a history of such downward adjustments of its forecasts, then this may call into question:

- the entity’s ability to predict forecast transactions accurately; and
- whether similar forecast transactions would be highly probable and therefore eligible as hedged items.
11. Presentation

11.1 Cash flow hedges

Under the review draft, for a hedge of a forecast transaction resulting subsequently in the recognition of a non-financial item, an entity would:

- remove the entire amount related to that transaction in the cash flow hedge reserve from equity; and
- include it directly in the initial cost or other carrying amount of the item.

This accounting would also apply to a forecast transaction resulting subsequently in the recognition of a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied.

For all other cash flow hedges (e.g. cash flow hedges over forecast transactions resulting in the recognition of financial instruments), the amount related to the transaction in the cash flow hedge reserve would be reclassified to profit or loss in the same period or periods during which the hedged cash flows affect profit or loss.

**Observations – Cash flow hedges that result in recognising non-financial items**

Under IAS 39, if a hedge of a forecast transaction later results in the recognition of a non-financial item, then an entity has the option to:

- treat the associated gains and losses that were accumulated in the cash flow hedge reserve as a basis adjustment; or
- retain these amounts in the reserve and reclassify them to profit or loss as the asset acquired or liability assumed affects profit or loss.

This accounting would also apply to a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied.

The review draft removes this accounting policy election.

**Observations – Reclassification adjustments vs basis adjustments**

Cash flow hedge reserves related to a non-financial item are recognised as an adjustment to the basis of the non-financial item. Such basis adjustments are not presented in the statement of comprehensive income. They are removed from the cash flow reserve (i.e. from equity). Those adjustments will affect profit or loss (and be reflected in the statement of comprehensive income) in the same manner and periods as the non-financial items to which they relate (e.g. through depreciation expense for items of property, plant and equipment; cost of sales for inventories; or impairment because the adjustments are automatically included when a non-financial asset is tested for impairment).

However, the basis of a financial item is not adjusted for cash flow hedge reserves. The related cash flow hedge reserves remain in equity until the financial item affects profit or loss. The direct reclassifications from the cash flow hedge reserve in equity to profit or loss meet the definition of a ‘reclassification adjustment’ under IAS 1. All reclassification adjustments are reflected in the statement of comprehensive income in the period during which they happen.

An entity’s financial reporting systems will need to correctly distinguish between basis adjustments and reclassification adjustments arising from hedge accounting to prepare the statement of comprehensive income and related disclosures.
11.2 Fair value hedges

RD BC6.231–BC6.248 The IASB considered reducing the complexity of hedge accounting and improving the usefulness of the reported information by proposing some changes to the presentation and mechanics of fair value hedge accounting in the exposure draft. Most respondents supported providing the information proposed in the exposure draft; however, many disagreed with providing it on the face of the financial statements or changing the fair value hedge accounting mechanics. Consequently, during redeliberations the IASB decided to retain the fair value hedge accounting mechanics in IAS 39; however, they proposed additional disclosure requirements so that users of financial statements could further understand the effects of hedge accounting on the financial statements.

11.3 Hedged groups

RD 6.6.4, B6.6.15–B6.6.16 Under the review draft, if a group of items in a fair value or cash flow hedge has offsetting risk positions affecting different line items in the statement of comprehensive income, then any hedging instrument gains or losses in profit or loss (reclassified profit or loss for cash flow hedges) would be presented in a separate line from those affected by the hedged items. This is to avoid grossing up a single hedging instrument’s net gains or losses into offsetting gross amounts and recognising them in different line items in the statement of comprehensive income.

RD B6.6.14, B6.6.16 In a cash flow hedge or a fair value hedge, the group of items may not have any offsetting risk positions. In this case, the hedging instrument gains or losses (reclassified profit or loss for cash flow hedges) would be apportioned to the line items in the statement of comprehensive income affected by the hedged items on a rational basis. The net gains or losses arising from a single hedging instrument would not be grossed up.
12. Disclosures

12.1 Overview

For those risk exposures that an entity hedges, and for which it elects to apply hedge accounting, an entity discloses:

- its risk management strategy and how it applies that strategy to manage risk;
- how its hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on its financial position and performance.

**Observations – Judgement needed for new disclosures**

RD BCA26 (IFRS 7BC35C–BC35D)

Financial statement users have expressed to the IASB that they do not find current hedge accounting disclosures helpful, or that the disclosures did not provide transparency on an entity’s hedging activities. The IASB has therefore designed the new disclosure requirements to address these concerns.

The increased level of judgement inherent in the proposed hedge accounting requirements is complemented by extensive new disclosure requirements. Financial statement preparers will need to give thoughtful consideration and exercise judgement in providing information that is useful and relevant to users of the financial statements.

RD C11 (IFRS 721B)

Under the review draft, an entity would present the required disclosures in a single note or separate section in its financial statements. However, it would not need to duplicate information that is already presented elsewhere (e.g. management commentary or risk report) – provided that this information is incorporated by cross-reference and is available to users of the financial statements on the same terms of the financial statements and at the same time.

RD C11 (IFRS 721C)

For those disclosures that would require an entity to separate by risk category the information disclosed, each category of risk would be determined on the basis of the risk exposures that the entity decides to hedge and for which hedge accounting is applied. Such determinations would be made consistently for all hedge accounting disclosures.

RDC11 (IFRS 721D)

Although an entity would be allowed to determine the extent of aggregation or disaggregation of the disclosures, it should consider the level of aggregation that it uses for other disclosure requirements in IFRS 7 Financial Instruments: Disclosures and IFRS 13 Fair Value Measurement.

12.2 Risk management strategy

The review draft includes the concept that an entity would explain its risk management strategy for each risk category of risk exposures that it decides to hedge and for which hedge accounting would be applied. The explanation should enable users of financial statements to evaluate, for example:

- how each risk arises;
- how the entity manages each risk, including whether the entity hedges an item in its entirety for all risks or hedges a risk component(s) of an item and why; and
- the extent of risk exposures that the entity manages.
Minimum disclosures to meet the above requirements would include a description of:

- the hedging instruments and how they are used to hedge risk exposures;
- how the entity determines the economic relationship between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness; and
- how the entity establishes the hedge ratio and what the sources of hedge ineffectiveness are.

When an entity designates a specific risk component as a hedged item, it should disclose additional qualitative or quantitative information about:

- how it determined the risk component that is designated as the hedged item, including a description of the nature of the relationship between the risk component and the item as a whole; and
- how the risk component relates to the item in its entirety – e.g. the designated risk component historically covered on average 80 percent of the changes in fair value of the item as a whole.

### 12.3 Amount, timing and uncertainty of future cash flows

Under the review draft, an entity discloses, by risk category, quantitative information to enable users of its financial statements to evaluate:

- the terms and conditions of hedging instruments; and
- how they affect the amount, timing and uncertainty of future cash flows of the entity.

The following breakdown is required to meet the above requirement:

- a profile of the timing of the nominal amount of the hedging instrument; and
- if applicable, the average price or rate (e.g. strike or forward prices etc.) of the hedging instrument.

There are situations in which an entity frequently resets (i.e. discontinues and restarts) hedging relationships because both the hedging instrument and the hedged item frequently change – i.e. the entity uses a dynamic process in which both the exposure and the hedging instruments used to manage that exposure do not remain the same for long. In such situations, the entity is exempted from providing the above quantitative disclosures. Instead, it discloses:

- information about what the ultimate risk management strategy is in relation to those hedging relationships;
- a description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
- 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.

When the volume of hedging relationships to which the above exemption applies is unrepresentative of normal volumes during the period (i.e. the volume at the end of the reporting period does not reflect the volumes during the period), an entity discloses that fact and the reason it believes the volumes are unrepresentative.

For each risk category, an entity discloses a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. If other sources of hedge ineffectiveness emerge in the hedging relationship, then an entity:

- discloses those sources; and
- explains the resulting hedge ineffectiveness.
For cash flow hedges, an entity discloses a description of any forecast transaction for which hedge accounting was used in the previous period, but that is no longer expected to occur.

**12.4 Effects of hedge accounting on financial position and performance**

Users of financial statements have informed the IASB that they do not analyse an entity’s hedging activities by type of hedging relationship – e.g. cash flow hedge or fair value hedge. Instead, users want to understand the risks that an entity manages and the results after hedging. However, to be effective, information on the effects of hedge accounting on financial position and performance should reflect the applied accounting treatment – e.g. cash flow hedge accounting or fair value hedge accounting. The IASB believes that information presented in a tabular format, prepared by risk category and by type of hedge, would provide sufficient links between the accounting information and the risk management information.

**12.4.1 Hedging instrument**

Under the review draft, an entity discloses, in a tabular format, the following amounts related to items designated as hedging instruments, separately by risk category for each type of hedge:

- the carrying amount of the hedging instruments, separating financial assets from financial liabilities;
- the location of the hedging instrument in the statement of financial position;
- the change in fair value of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period; and
- the nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.

The following example illustrates how the above information might be disclosed.

<table>
<thead>
<tr>
<th>Nominal amount of the hedging instrument</th>
<th>Carrying amount of the hedging instrument</th>
<th>Line item in the statement of financial position where the hedging instrument is located</th>
<th>Changes in fair value used for calculating hedge ineffectiveness for 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow hedges</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity price risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Forward sales contracts</td>
<td>xx</td>
<td>xx</td>
<td>Line item xx</td>
</tr>
<tr>
<td>Fair value hedges</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Interest rate swaps</td>
<td>xx</td>
<td>xx</td>
<td>Line item xx</td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Foreign currency loan</td>
<td>xx</td>
<td>xx</td>
<td>Line item xx</td>
</tr>
</tbody>
</table>

**12.4.2 Hedged item**

An entity discloses, in a tabular format, the following amounts related to hedged items separately by risk category for the types of hedges as follows.
**Fair value hedges**

- The carrying amount of the hedged item recognised in the statement of financial position, separating assets from liabilities.
- The accumulated amount of fair value hedge adjustments on the hedged item included in the above carrying amount.
- The location of the hedged item in the statement of financial position.
- The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period.
- The balance of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses.

**Cash flow hedges and hedges of a net investment in a foreign operation**

- The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period.
- The balances in the cash flow hedge reserve and the foreign currency translation reserve that relates to continuing hedges.
- The balances remaining in the cash flow hedge reserve and the foreign currency translation reserve that relates to any hedging relationships for which hedge accounting is no longer applied.

The following example illustrates how the above information might be disclosed.

<table>
<thead>
<tr>
<th>Line item</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Carrying amount of the hedged item</th>
<th>Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item</th>
<th>Line item in the statement of financial position in which the hedged item is included</th>
<th>Change in value used for calculating hedge ineffectiveness for 20XX</th>
<th>Cash flow hedge reserve</th>
<th>Foreign currency translation reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair value hedges</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Loan payable</td>
<td>-</td>
<td>xx</td>
<td>-</td>
<td>xx</td>
<td>Line item xx</td>
<td>xx</td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>• Discontinued hedges (loan payable)</td>
<td>-</td>
<td>xx</td>
<td>-</td>
<td>xx</td>
<td>Line item xx</td>
<td>xx</td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Firm commitment</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
<td>Line item xx</td>
<td>xx</td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td><strong>Cash flow hedges</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity price risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Forecast sales</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>xx</td>
<td>xx</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Discontinued hedges (forecast sales)</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>xx</td>
<td>xx</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Hedges of net investment in a foreign operation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Long-term receivable from subsidiary</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>xx</td>
<td>N/A</td>
<td>xx</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Discontinued hedges (long-term receivable from subsidiary)</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>xx</td>
<td>N/A</td>
<td>xx</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
12.4.3 Hedge ineffectiveness and hedging gains or losses

An entity discloses, in a tabular format, the following amounts separately by risk category for each type of hedge.

**Fair value hedges**
- Hedge ineffectiveness (i.e. the difference between the hedging gains or losses of the hedging instrument and the hedged item) recognised in profit or loss (or OCI for hedges of an equity instrument for which an entity has elected to present changes in fair value in OCI).
- The location of the recognised hedge ineffectiveness in the statement of comprehensive income.

**Cash flow hedges and hedges of a net investment in a foreign operation**
- Hedging gains or losses of the reporting period that were recognised in OCI.
- Hedge ineffectiveness recognised in profit or loss.
- The location of the recognised hedge ineffectiveness in the statement of comprehensive income.
- The amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (see IAS 1), differentiating between:
  - amounts for which hedge accounting has previously been used, but for which the hedged future cash flows are no longer expected to occur; and
  - amounts that have been transferred because the hedged item has affected profit or loss.
- The location of the reclassification adjustment (see IAS 1) in the statement of comprehensive income.
- For hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive income.

The following example illustrates how the above information might be disclosed.

<table>
<thead>
<tr>
<th>Fair value hedges</th>
<th>Ineffectiveness recognised in profit or loss</th>
<th>Ineffectiveness recognised in OCI</th>
<th>Line item(s) in profit or loss and OCI (that include(s) hedge ineffectiveness)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate risk</td>
<td>xx</td>
<td>N/A</td>
<td>Line item xx</td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td>xx</td>
<td>N/A</td>
<td>Line item xx</td>
</tr>
<tr>
<td>Equity price risk</td>
<td>N/A</td>
<td>xx</td>
<td>Line item xx</td>
</tr>
</tbody>
</table>
Separate line item recognised in profit or loss as a result of a hedge of a net position
Change in the value of the hedging instrument recognised in OCI
Hedge ineffectiveness recognised in profit or loss
Line item in profit or loss (that includes hedge effectiveness)
Amount reclassified from the cash flow hedge reserve to profit or loss
Amount reclassified from the foreign currency translation reserve to profit or loss
Line item affected in profit or loss because of the reclassification

### Cash flow hedges

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Commodity price risk</th>
<th>Foreign exchange risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity X</td>
<td>N/A</td>
<td>xx</td>
</tr>
<tr>
<td>Discontinued hedge</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

### Hedges of net investment in a foreign operation

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Foreign exchange risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term receivable from subsidiary</td>
<td>N/A</td>
</tr>
<tr>
<td>Discontinued hedges (long-term receivable from subsidiary)</td>
<td>N/A</td>
</tr>
</tbody>
</table>

(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.
(b) This disclosure applies only to cash flow hedges of foreign currency risk.

### Observations – Hedge ineffectiveness recognised in profit or loss

Entities are required to disclose the change in fair value of the hedging instrument and the change in value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of comprehensive income.

The difference between these amounts in the table for hedged items and in the table for hedging instruments should be equal to the amount disclosed in the table for hedge ineffectiveness recognised in the statement of comprehensive income.

### Reconciliation

An entity provides a reconciliation of AOCI in accordance with IAS 1, either in the statement of changes in equity or in the notes to the financial statements, separately by risk category. The reconciliation should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of comprehensive income. Therefore, the reconciliation should differentiate, at a minimum, between:

- hedging gains or losses of the reporting period that were recognised in OCI in respect of cash flow hedges and hedges of a net investment in a foreign operation;
- the amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (differentiating between amounts for which hedge accounting was previously used but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss);
- the amount removed from the cash flow hedge reserve and included directly in the initial cost or other carrying amount of...
– a non-financial asset or a non-financial liability that is recognised subsequent to a hedged forecast transaction; or
– a firm commitment that results from a hedged forecast transaction for a non-financial asset or non-financial liability for which fair value hedge accounting is applied;

- the amount reclassified from the cash flow hedge reserve into profit or loss as a reclassification adjustment in relation to a loss (or a portion of it) that the entity does not expect to recover in one or more future periods;
- the amounts associated with the time value of purchased options that hedge transaction-related hedged items and amounts associated with the time value of purchased options that hedge time period-related hedged items (when an entity designates as the hedging instrument only the change in intrinsic value of the option); and
- the amounts associated with the forward element of a forward contract (when an entity designates as the hedging instrument only the change in the value of the spot element of the forward contract).

12.4.5 Credit exposures designated at fair value through profit or loss

RD C11 (IFRS 724G) Under the review draft, if an entity designated a financial instrument, or a proportion of it, as measured at fair value through profit or loss because it uses a credit derivative to manage the credit risk of that financial instrument, then it would disclose:

- a reconciliation of each of the nominal amount and the fair value at the beginning and end of the period of the credit derivatives that have been used to manage the credit risk;
- the gain or loss recognised in profit or loss on designation of a financial instrument (or a proportion of it) as measured at fair value through profit or loss; and
- on discontinuation of measuring a financial instrument (or a proportion of it) at fair value through profit or loss, that financial instrument’s fair value that has become the new carrying amount and the related nominal or principal amount¹.

¹ Except for providing comparative information in accordance with IAS 1, an entity does not need to continue this disclosure in subsequent periods.
13. Effective date and transition

RD 7.1.1 The effective date for the new hedge accounting requirements resulting from the review draft is for annual periods beginning on or after 1 January 2015. This aligns the effective date of the new hedge accounting requirements with the amended effective date for the classification and measurement phase of IFRS 9.

RD 7.2.17, 7.2.21 The new hedge accounting requirements would be applied prospectively with limited exceptions.

- Retrospective application of the accounting for the time value of purchased options would be required for all hedging relationships in which the hedging instrument is designated under IAS 39 as the intrinsic value of an option.

- Retrospective application of the accounting for the forward element of a forward contract would be permitted for hedging relationships in which the hedging instrument is designated under IAS 39 as the spot element of a forward contract, provided that this election is applied consistently.

RD 7.1.1 Earlier application is permitted. However, the hedge accounting requirements in IFRS 9 may be applied only if all existing IFRS 9 requirements are applied at the same time or have already been applied.

RD 7.2.18, 7.2.20(a) All qualifying criteria are required to be met as at the date of initial application of the new hedge accounting requirements in order to apply hedge accounting from that date. An entity may start to apply the new hedge accounting requirements from the point in time at which it ceases to apply the hedge accounting requirements in IAS 39. This would avoid any time lag and thus significant changes in fair value on transition to the new model.

RD 7.2.19, 7.2.20(b) Hedging relationships that qualify for hedge accounting in accordance with IAS 39 that would also qualify under the final standard (after taking into account any rebalancing on transition) would be regarded as continuing hedging relationships. When applicable, an entity is required to use the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship. Any gain or loss from such a rebalancing is recognised in profit or loss.

Observations – Transition

The new hedge accounting requirements would be applied prospectively to all hedging relationships – these include new hedging relationships as well as existing qualifying hedging relationships under IAS 39. For an existing qualifying hedging relationship under IAS 39 to be regarded as a continuing hedging relationship under the new hedge accounting requirements, the hedging relationship is required to meet all of the new hedge accounting requirements, including the hedge effectiveness requirements, at the time of transition to the new model. These include:

- ascertaining that an economic relationship exists between the hedged item and the hedging instrument (i.e. the hedging instrument and the hedged item have values that generally move in the opposite direction because of the hedged risk during the remaining term of the hedging relationship);

- ascertaining that the effect of credit risk does not dominate the value changes that result from the economic relationship; and

- identifying the sources of ineffectiveness and determining the hedge ratio. When applicable, an entity rebalances the hedge ratio using the hedge ratio in accordance with IAS 39 as the starting point. Any gain or loss arising from the rebalancing would be recognised in profit or loss.

Entities will have to update their hedge accounting documentation to ensure that any continuing hedging relationships meet the proposed requirements on the date of initial application.
14. Due process

14.1 Project timeline

The review draft is made available for information purposes on the IASB’s website until early December 2012 to enable constituents to familiarise themselves with the document, after which the IASB intends to proceed to finalise the draft. There is no formal request for stakeholder comments; however, interested parties may provide comments to the IASB during this period.

- **9 December 2010:** Exposure draft published
- **9 March 2011:** Comment period ended
- **7 September 2012:** Review draft published
- **Early December 2012:** Review period concludes
- **Late 2012 / Early 2013 (IASB plan):**
  - Final standard on general hedge accounting
  - Discussion paper on macro hedging
15. FASB proposals and convergence

The FASB issued its comprehensive proposals on financial instrument accounting in May 2010. Late in 2010, the IASB and the FASB published a progress report acknowledging that they have diverged on some important technical issues. In February 2011, the FASB issued an invitation to comment, *Selected Issues about Hedge Accounting, to solicit input on the IASB Exposure Draft*, to improve, simplify and bring about convergence of the financial reporting requirements for hedging activities. In August 2011, the FASB discussed the feedback received on the invitation to comment, but reached no decisions. In November 2011, the IASB staff presented to the FASB an education session on the IASB hedge accounting model. The FASB will redeliberate hedge accounting in the future and will consider all input.

Significant differences between the two sets of proposals include:

<table>
<thead>
<tr>
<th>Differences between</th>
<th>IASB’s proposed model</th>
<th>FASB’s proposed model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach</strong></td>
<td>Comprehensive review led to fundamental change.</td>
<td>Review addressed specific issues. The proposed model would retain most of the current provisions of hedge accounting and would make only several key changes.</td>
</tr>
<tr>
<td><strong>Scope</strong></td>
<td>Does not address macro hedges and carries forward the guidance in IAS 39 for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities. (The IASB is discussing macro hedging as a separate project.)</td>
<td>Includes all hedging relationships.</td>
</tr>
<tr>
<td><strong>Non-derivative financial instruments designated as hedging instruments for foreign currency risk</strong></td>
<td>Would be permitted under all hedging models.</td>
<td>Would be permitted for a hedge of a net investment in a foreign operation and a fair value hedge of a firm commitment.</td>
</tr>
</tbody>
</table>
| **Non-derivative financial instruments measured at FVTPL (fair value through net income) designated as hedging instruments for risks other than foreign currency** | Would be permitted, unless the non-derivative is:  
• an equity instrument for which an entity has elected to present changes in fair value in OCI; or  
• a liability that has been designated under the fair value option for which the amount of changes in fair value attributable to changes in credit risk is presented in OCI. | Would be prohibited. |
<table>
<thead>
<tr>
<th>Differences between</th>
<th>IASB’s proposed model</th>
<th>FASB’s proposed model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowable hedged risk components for financial instruments</td>
<td>Risk component would need to be separately identifiable and reliably measureable. It could be either contractually or non-contractually specified, and could combine the risk components. There would be a rebuttable presumption that unless inflation risk is contractually specified, it would not be an allowable hedged risk component. Certain credit exposures would be permitted to be designated under the fair value option as a substitute for hedge accounting.</td>
<td>Benchmark interest rate risk, foreign currency risk and credit risk, as well as a combination of these risks, would be allowed.</td>
</tr>
<tr>
<td>Allowable hedged risk components for non-financial items</td>
<td>Would be the same as financial instruments.</td>
<td>The entire risk of the item would have to be hedged; foreign currency risk could also be hedged.</td>
</tr>
<tr>
<td>Fair value hedge of a layer component</td>
<td>Would be permitted if certain criteria are met.</td>
<td>Would be prohibited.</td>
</tr>
<tr>
<td>Effectiveness assessment requirement</td>
<td>Assessment would be based on the existence of an economic relationship, the lack of credit risk dominance and the existence of a proper hedge ratio.</td>
<td>A hedging relationship would need to be assessed as reasonably effective.</td>
</tr>
<tr>
<td>Frequency of effectiveness assessment</td>
<td>Effectiveness assessment would be required, at a minimum, each reporting period or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.</td>
<td>Re-assessment would be required only if circumstances suggest that the hedging relationship may no longer be reasonably effective.</td>
</tr>
<tr>
<td>Assumption of perfective effectiveness</td>
<td>Would be prohibited.</td>
<td>Would be prohibited.</td>
</tr>
<tr>
<td>Cash flow hedge accounting</td>
<td>The effective portion of the gain or loss on the hedging instrument would be recorded in AOCI; the effective portion would be the lower of the cumulative change in fair value of the hedging instrument and the cumulative change in fair value of the hedged item.</td>
<td>The effective portion of the gain or loss on the hedging instrument would be recorded in AOCI; the ineffective portion would be the difference between the cumulative change in fair value of the hedging instrument and the cumulative change in fair value of the hedged item.</td>
</tr>
</tbody>
</table>
### Differences between IASB’s proposed model and FASB’s proposed model

<table>
<thead>
<tr>
<th>Forecast transaction that was the hedged item in a cash flow hedge that subsequently results in recognising a non-financial item (or a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied)</th>
<th>IASB’s proposed model</th>
<th>FASB’s proposed model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upon recognition of the non-financial item, the amount of the gain or loss that was accumulated in AOCI as part of the cash flow hedge accounting would be removed from AOCI and added to the original carrying amount of the non-financial item. The same accounting would apply upon the recognition of the forecast transaction for a non-financial item becoming a firm commitment for which fair value hedge accounting is applied.</td>
<td>The amount of the gain or loss that was accumulated in AOCI as part of the cash flow hedge accounting would remain in AOCI and would be reclassified to earnings when the non-financial item affects earnings.</td>
<td></td>
</tr>
</tbody>
</table>

| Mandatory rebalancing of a hedging relationship | An entity would be required to rebalance when the hedging relationship fails the effectiveness assessment but the entity’s risk management objective remains the same. Rebalancing would be treated as a continuation of hedging relationship. | Rebalancing would never be mandatory. Rebalancing would be treated as a new hedging relationship. |

| Voluntary discontinuation of hedge accounting | Would be prohibited. | Would be prohibited; however, an entity could effectively terminate a hedging derivative by meeting certain criteria. |

| Whether change in risk management objective triggers discontinuation of hedge accounting | Yes. | No. |

<p>| Accounting for the time value of a purchased option when the intrinsic value of the option is designated as a hedging instrument | Changes in fair value of the time value would be recognised in OCI based on the time value of a purchased option with critical terms that align with the hedged item. Amounts in equity would be reclassified to profit or loss, or recognised as basis adjustments, depending upon whether the hedged item is transaction-related or time period-related. This would apply to cash flow and fair value hedges. | The time value would be treated as a freestanding derivative; however, if total changes in the option’s cash flows are designated as the hedging instrument, then the changes in fair value of the time value would be recognised in OCI. These amounts would be reclassified from AOCI to earnings during the term of the hedge relationship. This applies only to certain cash flow hedges. |</p>
<table>
<thead>
<tr>
<th>Differences between</th>
<th>IASB’s proposed model</th>
<th>FASB’s proposed model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting for the forward element of a forward contract when the spot element of the forward contract is designated as a hedging instrument</td>
<td>Changes in fair value of the forward element would be recognised in OCI based on the forward element of a forward contract with critical terms that align with the hedged item. Amounts in equity would be reclassified to profit or loss. This applies to cash flow and fair value hedges.</td>
<td>The forward element would be treated as a freestanding derivative; however, if total changes in the forward contract’s cash flows are designated as the hedging instrument, then the changes in fair value of the forward would be recognised in OCI. These amounts would be reclassified from AOCI to earnings during the term of the hedge relationship. This applies only to certain cash flow foreign currency hedges.</td>
</tr>
<tr>
<td>Hedging gross positions</td>
<td>Would be permitted if certain criteria are met. The criteria would not include the criterion that the change in the fair value attributed to the hedged risk for each individual item in the group should be approximately proportional to the overall change in the fair value of the group for the hedged risk.</td>
<td>The individual items within the group should have similar risk characteristics, and the change in the fair value attributable to the hedged risk for each individual item in the group should be approximately proportional to the overall change in the fair value of the group for the hedged risk.</td>
</tr>
<tr>
<td>Hedging net positions</td>
<td>Would be permitted if certain criteria are met.</td>
<td>Would be prohibited.</td>
</tr>
<tr>
<td>Hedging nil net positions without a hedging derivative instrument</td>
<td>Would be permitted if certain criteria are met.</td>
<td>Would be prohibited.</td>
</tr>
<tr>
<td>Fair value option of own-use (normal purchase normal sale) contracts</td>
<td>Would be permitted if certain criteria are met.</td>
<td>Would be prohibited. However, use of the normal purchase normal sale exclusion is elective.</td>
</tr>
<tr>
<td>Aggregated exposure as the hedged item</td>
<td>Would be permitted if certain criteria are met.</td>
<td>Would be prohibited.</td>
</tr>
</tbody>
</table>
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our New on the Horizon publications are prepared on the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of New on the Horizon considers the proposed requirements of the IASB’s draft of its forthcoming IFRS on general hedge accounting (the review draft).

The text of this publication is referenced to the review draft and to selected other current IFRSs in issue at 31 August 2012. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed for an entity to consider the potential impact of this review draft in light of the entity’s own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change.

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Visit www.kpmg.com/ifrs to keep up to date with the latest developments in IFRS and browse our suite of publications. Whether you are new to IFRS or a current user of IFRS, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative financial statements and checklists. For a local perspective, follow the links to the IFRS resources available from KPMG member firms around the world.

All of these publications are relevant for those involved in external IFRS reporting. The In the Headlines series and Insights into IFRS: An overview provide a high level briefing for audit committees and boards.

<table>
<thead>
<tr>
<th>Your need</th>
<th>Publication series</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Briefing</td>
<td>In the Headlines</td>
<td>Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.</td>
</tr>
<tr>
<td></td>
<td>IFRS Newsletters</td>
<td>Highlights recent IASB and FASB discussions on the financial instruments, insurance, leases and revenue projects. Includes an overview, an analysis of the potential impact of decisions, current status and anticipated timeline for completion.</td>
</tr>
<tr>
<td></td>
<td>The Balancing Items</td>
<td>Focuses on narrow-scope amendments to IFRS.</td>
</tr>
<tr>
<td></td>
<td>New on the Horizon</td>
<td>Considers the requirements of due process documents such as exposure drafts and provides KPMG’s insight. Also available for specific sectors.</td>
</tr>
<tr>
<td></td>
<td>First Impressions</td>
<td>Considers the requirements of new pronouncements and highlights the areas that may result in a change in practice. Also available for specific sectors.</td>
</tr>
<tr>
<td>Your need</td>
<td>Publication series</td>
<td>Purpose</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Application issues</td>
<td>Insights into IFRS</td>
<td>Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretative issues.</td>
</tr>
<tr>
<td></td>
<td>Insights into IFRS: An overview</td>
<td>Provides a structured guide to the key issues arising from the standards.</td>
</tr>
<tr>
<td></td>
<td>IFRS Practice Issues</td>
<td>Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.</td>
</tr>
<tr>
<td></td>
<td>IFRS Handbooks</td>
<td>Includes extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard.</td>
</tr>
<tr>
<td>Interim and annual reporting</td>
<td>Illustrative financial statements</td>
<td>Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors.</td>
</tr>
<tr>
<td></td>
<td>Disclosure checklist</td>
<td>Identifies the disclosures required for currently effective requirements for both annual and interim periods.</td>
</tr>
<tr>
<td>GAAP comparison</td>
<td>IFRS compared to US GAAP</td>
<td>Highlights significant differences between IFRS and US GAAP. The focus is on recognition, measurement and presentation; therefore, disclosure differences are generally not discussed.</td>
</tr>
<tr>
<td>Sector-specific issues</td>
<td>IFRS Sector Newsletters</td>
<td>Provides a regular update on accounting and regulatory developments that directly impact specific sectors.</td>
</tr>
<tr>
<td></td>
<td>Application of IFRS</td>
<td>Illustrates how entities account for and disclose sector-specific issues in their financial statements.</td>
</tr>
<tr>
<td></td>
<td>Accounting under IFRS</td>
<td>Focuses on the practical application issues faced by entities in specific sectors and explores how they are addressed in practice.</td>
</tr>
<tr>
<td></td>
<td>Impact of IFRS</td>
<td>Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.</td>
</tr>
</tbody>
</table>

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