New on the Horizon: Hedge accounting
Closer alignment of hedge accounting and risk management

The IASB published ED/2010/13 Hedge Accounting (the ED) in December 2010. This is the first instalment of the final phase to replace the existing standard on financial instruments, IAS 39 Financial Instruments: Recognition and Measurement. The ED proposes significant changes to the current general hedge accounting requirements. The proposals contained in the second instalment, expected during the second quarter of 2011, are intended to address portfolio or macro hedging.

We welcome this ED as a major milestone on the road to improving the financial instruments accounting model as called for by the G20. The changes proposed to the general hedge accounting model respond to significant criticisms of the complexity and burden of hedge accounting. The changes also aim to address the artificial mismatch in specific scenarios between risk management and hedge accounting strategies under the current requirements. In addition, we note the ED proposes changes that are different from those proposed for hedge accounting under US GAAP in the FASB’s comprehensive financial instrument accounting exposure draft published in May 2010.

The proposals in the ED alleviate some of the more operationally onerous requirements, such as the quantitative threshold and retrospective assessment for hedge effectiveness testing. An additional proposed simplification would allow entities to rebalance and continue certain existing hedging relationships that have fallen out of alignment instead of having to restart the hedge in a new relationship. However, voluntarily stopping hedging relationships in certain circumstances would be prohibited.

The changes regarding non-financial risks, which may make hedge accounting possible for some commodity components of operating exposures such as the oil component of jet fuel purchases, will be of particular importance to entities outside the financial sector. Other changes that would make the use of purchased options as hedging instruments more attractive and broaden the scope of eligible hedging instruments and hedged items will be equally important to financial and non-financial entities alike.

One key issue to financial institutions is the pending proposals on portfolio hedging as many institutions utilise this approach in their hedge accounting strategies. Portfolio hedging is also of particular importance in Europe as it is subject to the current “carve-out” in the European Union.

Although we are still waiting for the last piece of the puzzle, portfolio hedging, what we have seen so far proposes substantial changes. These changes aim to create an approach to integrate hedge accounting more closely with risk management policies and objectives and provide information that is more decision useful to users of financial statements. We urge all stakeholders in this important project to provide their feedback to the IASB by the end of the three-month consultation period.

Andrew Vials
KPMG’s global IFRS Financial Instruments leader
KPMG International Standards Group
1. Highlights

ED/2010/13 Hedge Accounting (the ED) proposes significant changes to the current general hedge accounting requirements, but also proposes to retain some of the existing guidance in IAS 39 Financial Instruments: Recognition and Measurement. However, it does not address a key issue for financial institutions: portfolio hedging. These proposals are expected during the second quarter of 2011.

This publication focuses on those requirements that would be changed and are expected to have an impact on the preparers and users of financial statements.

Key accounting changes proposed

- Hedge accounting would be more aligned with risk management.
- Non-derivative financial 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.
- Certain risk components of non-financial items, certain aggregate exposures that are combinations of exposures and derivatives, and certain layer components of defined nominal amounts would be eligible hedged items.
- Eligible hedged items also would include certain groups of items constituting gross or net positions.
- The quantitative threshold and retrospective assessment for hedge effectiveness testing would be eliminated.
- Fair value hedge mechanics would be adjusted to align closer with current cash flow hedge mechanics.
- Entities may rebalance certain existing hedge relationships that have fallen out of alignment instead of having to restart the hedge in a new relationship. However, voluntarily discontinuing certain hedge relationships would be prohibited.
- The relevant portion of the time value component of purchased options designated as hedging instruments would be accounted for in other comprehensive income.
### Other considerations

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<td>• linking of accounting and economics of derivative and hedging transactions;</td>
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<td>• forward-looking effectiveness assessment with no arbitrary effectiveness range;</td>
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<td>• rebalancing of a fair value hedging relationship that involves changing the volume of a hedged item that is a financial instrument;</td>
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<td>• tracking the component of the separate line item in the statement of financial position related to individual hedged items in fair value hedging relationships;</td>
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<td>• using basis adjustment in a hedge of a forecast transaction that results subsequently in the recognition of a non-financial item; and</td>
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<td>• hedging on a net position basis.</td>
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| **Transaction costs and choice of hedging instrument** | Considerations around the choice of hedging instruments that minimise ineffectiveness while adhering to risk management policies, balanced with the appropriate market conventions and transaction costs. |

| **Revision of risk management policies or hedging strategies** | Hedge accounting proposals may need to be applied at a different level of granularity from those an entity currently applies for its risk management strategies.  
Documentation or analysis of hedging strategies that use purchased options to determine whether based on transaction or time period.  
Considerations around the choice of hedging components of risks for non-financial items, including whether the components are separately identifiable and reliably measurable in the context of the particular market structure.  
Revision of hedging relationships that include voluntary terminations. |

| **Disclosure of information** | Disclosure proposals call for financial statements to provide more relevant detail. |
2. Introduction and background

2.1 Overview of the IAS 39-replacement project

The IASB is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard, IAS 39.

The IAS 39-replacement project, and in particular its timeline, is driven in part by requests for reform from the G20 and other constituents. Following the G20 summit in April 2009, the Leaders’ Statement called on accounting standard setters, including the IASB and the FASB, to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the international accounting standard setters to complete their convergence project by June 2011.

The IAS 39-replacement project has three main phases:

- Classification and measurement of financial instruments – the first chapters of IFRS 9 Financial Instruments (IFRS 9 (2009)) were published on 12 November 2009 and addressed financial assets. On 28 October 2010 the IASB updated IFRS 9 (IFRS 9 (2010)) to address, among other topics, financial liabilities.

- Amortised cost and impairment of financial assets – ED/2009/12 Financial Instruments: Amortised Cost and Impairment was published on 5 November 2009. See our publication New on the Horizon: ED/2009/12 Financial Instruments: Amortised Cost and Impairment for further information on that exposure draft. The IASB is currently deliberating the responses received and plans to re-expose proposals for impairment accounting early in the first quarter of 2011. The IASB plans to finalise this phase by June 2011.

- Hedge accounting – the ED was issued on 9 December 2010, which is the subject of this publication. The IASB’s proposals on portfolio or macro hedging are expected during the second quarter of 2011.

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process.
3. **Overview**

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<th><strong>Objective and scope</strong></th>
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<td>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 a particular risk that could affect profit or loss.</td>
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<th><strong>Hedging instruments</strong></th>
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<th><strong>Qualifying criteria for hedge accounting</strong></th>
<th><strong>Hedge effectiveness</strong></th>
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<td>The ED proposes that a qualifying hedging relationship would meet the hedge effectiveness requirements, tested prospectively, if it:</td>
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<td>meets the objective of the hedge effectiveness assessment, which is to produce an unbiased result that minimises expected hedge ineffectiveness; and</td>
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<td>is expected to achieve other than accidental offsetting, for example, a statistical correlation between two variables that have no substantive economic relationship would not meet this requirement.</td>
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### Fair value hedges

The proposed accounting for fair value hedges is more aligned with the current cash flow hedge accounting model under IAS 39. The proposed accounting would be as follows:

- The gain or loss from remeasuring the hedging instrument would be recognised in other comprehensive income.
- The hedging gain or loss on the hedged item would be recognised and presented as a separate line item in the statement of financial position with a corresponding gain or loss in other comprehensive income. Thus, the hedged item’s carrying amount would not be adjusted.
- The ineffective portion of the gain or loss of the hedging relationship would be transferred from other comprehensive income to profit or loss.

### Rebalancing the hedging relationship

Under the proposals, if a hedging relationship fails subsequently to meet the objective of the hedge effectiveness assessment but the entity’s risk management objective has not changed, then an entity would rebalance the relationship by adjusting the hedge ratio. If the entity expects the relationship to fail to meet the effectiveness assessment objective in the future, then it may rebalance the hedging relationship proactively.

Rebalancing of a hedging relationship would be accounted for as a continuation and any hedge ineffectiveness determined would be recognised immediately in profit or loss before adjusting the hedging relationship.

### Discontinuation of hedge accounting

The ED proposes that an entity would discontinue hedge accounting for all or a portion of a hedging relationship prospectively only when the hedging relationship either fails to meet the entity’s risk management objective or fails to meet the qualifying criteria after taking into consideration rebalancing of the hedging relationship, if applicable.

Voluntary discontinuation of hedge accounting would be prohibited.

### Accounting for time value of purchased options

Under the proposals, 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 the fair value of the time value of the option would be recognised in other comprehensive income to the extent that it relates to the hedged item. The method used to reclassify the amounts from equity to profit or loss would be determined by whether the hedged item is a transaction-related hedged item, e.g. the future purchase of a commodity, or a time period-related hedged item, such as commodity inventory.

### Hedges of a group of items

An entity may designate as a hedged item certain groups of individually eligible items representing a gross or net position. For cash flow hedges of net positions, any offsetting cash flows in the group would need to affect profit or loss in the same and only in that period, including interim periods.
### Disclosure
The ED proposes disclosures in addition to the requirements in IFRS 7 *Financial Instruments: Disclosures*; disclosures would include information about:

- an entity’s risk management strategy and how it is applied to manage risk;
- how the entity’s hedging activities may affect the amounts, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on the entity’s statement of financial position, statement of comprehensive income and statement of changes in equity.

### Effective date and transition
The effective date for the final standard resulting from the proposals is for annual periods beginning on or after 1 January 2013. The final standard would be applied prospectively and early application would be permitted. However, the hedge accounting requirements can be applied only if all existing IFRS 9 requirements are adopted at the same time or already have been applied.

### Accounting alternatives to hedge accounting

**Accounting for a contract to buy or sell a non-financial item as a derivative**

A net settleable contract that was entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item (commonly termed as “own use” contract) in accordance with the entity’s expected purchases, sales or usage requirements would be accounted for as a derivative financial instrument if that accounting is in accordance with the entity’s underlying business model and how the contracts are managed.

**Hedging credit risk using credit derivatives**

The IASB is asking for input on three alternative approaches to address situations in which credit risk is hedged by credit derivatives as achieving hedge accounting in these cases is often challenging.

### Alternative view
One of the IASB members dissented from the ED. The member does not believe that the ED would improve financial reporting as he believes that many of its provisions are not operational, lack rigour and would decrease comparability.

### FASB proposals and convergence
The IASB performed a comprehensive review of hedge accounting. It culminated in an exposure draft that proposes fundamental changes to current accounting. The FASB’s exposure draft keeps most US GAAP hedging provisions and proposes limited changes. The two exposure drafts have a number of significant differences.
4. **Objective and scope**

4.1 **Objective**

*ED 1, 2, BC12*

The objective of hedge accounting is 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 a particular risk that could affect profit or loss. Hedge accounting provides an exception to the normal recognition and measurement requirements in IFRSs as the information that results from the normal requirements without applying hedge accounting is not determined to be useful or complete.

*ED IN2*

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 proposals aim to address these criticisms by:

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

**Observations – Objective**

Currently, hedge accounting in accordance with IAS 39 does not make it an objective to reflect an entity’s risk management strategies in its financial statements. Many entities may welcome an opportunity to have their financial statements better reflect the economics of their derivative and hedging transactions. However, significant changes to accounting systems and procedures may be necessary to do so.

4.2 **Scope**

*ED 2, BC19, BC20*

The proposals address 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.

*ED 3, BC17, BC18, BC21*

An entity’s risk management strategy often assesses risk exposures on a continuous basis and at a portfolio level. As time passes, new exposures are continuously added to the hedged portfolio and other exposures are removed from it. Because of the level of complexity open portfolios introduce to hedge accounting, the IASB decided to address open portfolios or macro hedging as part of a subsequent exposure draft. Therefore, for a fair value hedge of interest rate exposure of a portfolio of prepayable financial assets or financial liabilities, the requirements of IAS 39 are retained until the second exposure draft is finalised.

**Observations – Scope**

The ED 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 concepts inherently have an element of an open portfolio.
Investments in equity instruments designated at fair value through other comprehensive income under IFRS 9 are not eligible hedged items as the objective of the hedge accounting model relates to risks that could affect profit or loss. The amounts recognised in other comprehensive income for such equity instruments are never reclassified to profit or loss.

However, dividends from investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from an equity investment measured at fair value through other comprehensive income could be an eligible hedged item.
5. Hedging instruments

5.1 Qualifying instruments and designation

**ED 5, B5**

Under the proposals, non-derivative financial assets and liabilities 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. For hedges other than hedges of foreign currency risk, the non-derivative financial instruments must be designated in their entirety.

**ED 6**

A non-derivative financial instrument that is not measured at fair value through profit or loss may be designated as the hedging instrument in a hedge of foreign currency risk provided that it is not designated at fair value through other comprehensive income.

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

The ED proposes that a non-derivative financial instrument that is measured at fair value through profit or loss could be designated as a hedging instrument. If such an instrument was designated in a cash flow hedge, then the change in its value that is determined to be effective would be recognised in other comprehensive income rather than profit or loss.
6. Hedged items

6.1 Qualifying items

Under the proposals, an entity may designate as the hedged item an aggregate exposure that consists of an exposure and a derivative if the combination creates a different exposure that is managed as a single exposure for a particular risk or risks.

Entities are sometimes required economically to enter into transactions that can result in multiple risk exposures. Under an entity’s risk management strategy these multiple exposures may be managed together or separately.

**Illustrative example – Hedged item as an aggregate exposure that contains a derivative**

An entity hedges the foreign currency risk for the entire term of a 10-year fixed rate foreign currency debt. However, the entity requires fixed rate exposure in its functional currency only for the short to medium term, e.g. two years, and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals, i.e. on a two-year rolling basis, the entity fixes the next two years’ interest rate exposure. In such a situation it is common for an entity to enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate domestic currency exposure. This is overlaid with a 2-year domestic interest rate swap that, on the basis of the domestic currency, swaps variable rate debt into fixed rate debt. In effect the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as domestic 10-year variable rate debt for risk management purposes. The synthetic domestic 10-year variable rate debt would be the hedged item in a cash flow hedge of interest rate risk for two years.

**Observations – Hedged item as an aggregate exposure that contains a derivative**

Although it is not clear, the ED seems to permit “synthetic accounting” for derivatives by allowing an aggregate exposure that contains a derivative to be a hedged item. In the example above, the fixed rate foreign currency denominated debt together with the cross-currency interest rate swap synthetically create a domestic currency variable rate instrument. This means that during the hedging relationship the cross-currency interest rate swap would be measured at amortised cost rather than having its changes in fair value recognised in profit or loss.

6.2 Designation of hedged items

6.2.1 Risk components

Under the proposals, an entity could hedge a risk component of a non-financial asset or liability. Currently foreign currency risk is the only risk component of a non-financial asset or liability that can be designated in a hedge. To be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or non-financial item and the changes in the cash flows or fair value of the item attributable to changes in that risk component must be reliably measurable.

When identifying what risk components, contractually or non-contractually specified, of both financial and non-financial items are eligible for designation as a hedged item, an entity would assess such components in the context of the particular market structure to which the risk(s) relate(s) and in which the hedging activity takes place.
The ED states that inflation is not separately identifiable and reliably measurable and could not be designated as a risk component unless it is contractually specified and other cash flows of the instrument are not affected by the inflation component.

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

IAS 39 treats financial and non-financial items differently as to the risk components that may be designated as hedged items. These provisions have caused an inconsistency between risk management strategies and accounting and were commonly noted as concerns during the IASB’s outreach activities. The ED applies the separately identifiable and reliably measurable criteria to both financial and non-financial items.

Manufacturers often may hedge their inventory with derivatives whose underlyings relate to the raw materials used to produce that inventory, e.g. a tire manufacturer may use a rubber forward contract to hedge its tire inventory. Under IAS 39, the manufacturer could hedge the entire price risk in the inventory, but not the rubber component only. Also, entities may use derivative contracts to hedge the forecasted sales or purchases of a commodity of a different grade, e.g. a manufacturer of premium chocolate may use an exchange grade quality cocoa forward contract to hedge its forecasted purchase of premium grade cocoa. Under IAS 39, the price risk of the entire purchase could be hedged, but not just the exchange grade quality component. Under the ED, such risk components may be eligible for hedge accounting, which would allow entities that use commodity derivatives greater flexibility in the application of hedge accounting.

**Illustrative example – Contractually specified risk component**

Company B has a long-term supply contract to purchase natural gas that 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 percent of its exposure to gas oil price risk and enters into gas oil forward contracts to hedge that price risk. The gas oil component is specified contractually. B determines that the gas oil price exposure is separately identifiable and that gas oil price exposure is reliably measurable, therefore, the gas oil price exposure is an eligible risk component for designation as a hedged item.

**Illustrative example – Non-contractually specified risk component**

Company C has a long-term supply contract to purchase 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 and increase the coverage volume as delivery gets nearer. C uses the following derivatives as hedging instruments during the different time horizons based on the liquidity of the derivatives’ markets:

- 12 months to 24 months – crude oil contracts
- 6 months to 12 months – gas oil contracts
- under 6 months – jet fuel contracts.

Although crude oil and gas oil are not contractually specified components of jet fuel prices, C has determined that based on analysis of the market structure for oil and oil products there is a relationship between crude oil and gas oil prices, and jet fuel prices. C has determined 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 two risk components, even though they are not specified contractually: crude oil prices and refining margins. 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.
6.2.2 Components of nominal amounts

Under the proposals, there are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a percentage component of a nominal amount or a layer component.

An example of a percentage component of a nominal amount is an entity designating 50 percent of the interest payments of a fixed rate bond as the hedged item in a fair value hedging relationship.

A layer component may be specified from a defined, but open, population or from a defined nominal amount. If the layer component is designated as the hedged item in a fair value hedging relationship, then an entity would specify it from a defined nominal amount. A layer component of a contract that includes a prepayment option would not be eligible to be designated as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk.

Observations – Layer component of a nominal amount

Designating a percentage component of a nominal amount as the hedged item can give rise to a different accounting outcome when compared with designating a layer component of a nominal amount.

For example, assume that a 5-year, 100 million debt instrument repays 20 million per year. If the hedged component is designated as 20 percent of the debt instrument, 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 percent. Alternatively, if the hedged component was the last 20 million of principal of the debt instrument, i.e. a bottom layer, the determination of the hedging gain or loss on the hedged component would consider only the last payment of 20 million. This may minimise ineffectiveness.
7. Qualifying criteria for hedge accounting

7.1 Hedge effectiveness

_Hedge effectiveness_ is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item. _Hedge ineffectiveness_ on the other hand is the extent to which there is no such offset or the changes in fair value or cash flows of the hedging instrument more than offset those on the hedged item.

When designating a hedging relationship and on an ongoing basis, an entity would analyse expected sources of ineffectiveness that are expected to affect the hedging relationship during its term. This analysis would serve as the basis for the entity’s expectation of hedge ineffectiveness for the hedging relationship. A qualifying hedging relationship would meet the hedge effectiveness requirements if it:

- meets the objective of the hedge effectiveness assessment; and
- is expected to achieve other than accidental offsetting.

7.1.1 Objective and extent of offset

The objective of the hedge effectiveness assessment under the proposals is to ensure that the hedging relationship would produce an unbiased result and minimise expected hedge ineffectiveness. This means that an entity, based on its expectations, cannot choose deliberately a hedge ratio that would result in the changes in value of the hedging instrument systematically either exceeding or being less than the changes in fair value of the hedged item for the hedged risk. However, this does not mean that perfect effectiveness would be a requirement to apply hedge accounting.

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

**Observations – Objective and extent of offset**

The effectiveness assessment proposed in the ED is forward looking only and does not prescribe an arbitrary effectiveness range. This will require changes to systems and procedures since currently they are focused on documenting that hedging relationships are prospectively and retrospectively effective within a range of 80 to 125 percent.

**Observations – An unbiased result and minimising expected ineffectiveness**

The requirement that a hedging relationship produce an unbiased result and minimise expected hedge ineffectiveness raises the question as to whether an entity must choose the hedging instrument that provides the best possible offset to the hedged item. It seems that this need not be the case. An entity would choose a hedging instrument that minimises ineffectiveness while adhering to its risk management policies, which may consider the appropriate market conventions and transaction costs. Thus, an entity may not need to use a hedging instrument that has high transaction costs just because in theory it provides a slightly better offset.
7.1.2 Other than accidental offset

**ED B31**

Under the proposals, as part of the hedge effectiveness assessment, an entity would analyse the economic relationship between the hedging instrument and hedged item to determine whether the expected offsetting is other than accidental. Two examples of accidental offsetting are:

- The changes in value of a hedging instrument and hedged item for the hedged risk are statistically correlated and achieve perfect offsetting but are not supported by a substantive economic relationship.

- The changes in value of a hedging instrument and hedged item continue to offset even though the relationship between them has broken down because the counterparty to the hedging instrument is experiencing a severe deterioration in its credit standing that is unrelated to the hedged item and only affects the hedging instrument.

**Observations – Effectiveness assessment**

The ED provides guidance on assessing effectiveness. However, this guidance is given in the context of an entity's risk management policies. Therefore, it will be up to entities to define clearly and apply consistently their effectiveness assessment policies.

7.1.3 Frequency of and methods for assessing hedge effectiveness requirements

**ED B32**

Under the proposals, an entity would assess hedge effectiveness at the inception of the hedging relationship and at a minimum each reporting period or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. As the assessment relates to expectations about hedge ineffectiveness and offsetting, the test would be only forward looking or prospective.

**ED B33**

The proposals do not specify a specific methodology, either quantitative or qualitative, for assessing whether a hedging relationship meets the hedge effectiveness requirements.

**ED B34**

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 the relationship would achieve systematic, unbiased and other than accidental offsetting; and

- calculate the optimal hedge ratio and support an expectation that the hedge ratio would minimise any hedge ineffectiveness.

**ED B36**

Conversely, if the critical terms were not closely aligned, then there would be an increased level of uncertainty relating to whether the relationship meets the hedge effectiveness requirements. Therefore, an entity may need to use a quantitative effectiveness assessment methodology to support its expectations. Similarly, the entity might also need a quantitative assessment to determine an appropriate hedge ratio and to support an expectation that the hedge ratio would minimise any hedge ineffectiveness.

**Observations – Qualitative or quantitative assessment**

If the critical terms of the hedging instrument and the hedged item match or are closely aligned, a qualitative effectiveness assessment may be appropriate. In other cases, a quantitative assessment may be more appropriate. The ED provides examples of critical terms but does not define the terms **critical terms** or **closely aligned**. Since these concepts are important in determining the type of effectiveness assessment that should be used, 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.
An entity would have to consider whether they need to change assessment methodologies if there are changes in circumstances that affect hedge effectiveness to ensure that all relevant characteristics of the hedging relationship including sources of hedge ineffectiveness are captured.

**7.2 Documentation**

At inception of the hedge there would be formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. In addition to the current hedge documentation requirements of IAS 39, an entity would document how it will assess whether the hedge relationship meets the revised hedge effectiveness requirements, including its analysis of the sources of ineffectiveness and how it determines the hedge ratio.

**Observations – Risk management and effectiveness assessment**

Risk management strategies may be set at various levels, e.g. entity-wide, business unit, geographic area, portfolios, or individual items. This can vary from entity to entity and within an entity as well. The hedge accounting provisions of the ED, which call for the hedging relationship to be aligned with the entity's risk management strategy, may need to be applied at a different level of granularity from those an entity currently applies for its risk management strategies. This could potentially create the need for an entity to re-write its current risk management policies and/or create ones if they do not exist.

**Observations – Hedge accounting required to be aligned with risk management**

The qualifying criteria for hedge accounting in the ED do not explicitly state that a hedging relationship needs to be aligned with the entity's risk management objectives. However, the discontinuation discussion in the ED 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, in order to qualify for hedge accounting, a hedging relationship must be aligned with an entity's risk management objectives at inception.
8. Accounting for qualifying hedges

8.1 Types of hedging relationships

The proposals retain the three types of hedging relationships in IAS 39: fair value hedges, cash flow hedges and hedges of the net investment in a foreign operation.

8.1.1 Fair value hedges

Under the proposals, accounting for fair value hedges would be more aligned with the current cash flow hedge accounting model. The gain or loss from remeasuring the hedging instrument would be recognised in other comprehensive income. The gain or loss on the hedged item, attributable to the hedged risk, would be recognised and presented as a separate line item in the statement of financial position with a corresponding gain or loss in other comprehensive income.

The separate line item would be presented in assets next to the line item that includes the hedged asset or presented in liabilities next to the line item that includes the hedged liability, until the hedged item is derecognised.

The ineffective portion of the gain or loss of the hedging relationship would be transferred from other comprehensive income to profit or loss.

Observations – Fair value hedge accounting

For a fair value hedge under IAS 39, the full change in fair value of the hedging instrument and the change in fair value of the hedged item that is attributable to the hedged risk are both recognised directly in profit or loss, which results in current period recognition of ineffectiveness in profit or loss. The accounting for a fair value hedge under the ED results in the same net effect on profit or loss even though the changes in the hedging instrument and hedged item are recognised first in other comprehensive income, offsetting each other.

If the hedged item is an unrecognised firm commitment, then the subsequent cumulative change in the fair value of the hedged item would be recognised as an asset or liability with a corresponding gain or loss recognised in other comprehensive income. If the unrecognised firm commitment is to acquire or assume a non-financial item, then upon settlement of the firm commitment the initial carrying amount of the resulting non-financial item would be adjusted to include the cumulative change recognised in the statement of financial position.

If the hedged item is a financial instrument, then the amortisation of the separate line item in the statement of financial position would follow the existing guidance in IAS 39 for amortisation of an adjustment to the carrying amount of a hedged item.

Observations – Separate line item for hedged item

Under IAS 39, the change in fair value of the hedged item that is attributable to the hedged risk is recognised as an adjustment to the hedged item; therefore, the hedged item is reported at an amount that is neither amortised cost nor fair value. Under the ED, this adjustment would be reported in a separate line item rather than as part of the actual hedged item; therefore, if the hedged item is measured at amortised cost, the amortised cost basis of the hedged item itself would be preserved. However, this separate line item, viewed in isolation and being a gain or loss, meets neither the definition of an asset or a liability. The line item has been created to preserve the amortised cost basis of the hedged item.
8.1.2 Cash flow hedges

Under the proposals, for a hedge of a forecast transaction resulting subsequently in the recognition of a non-financial item, the entity would remove the entire amount related to that transaction in the cash flow hedge reserve, accumulated in equity, and include it directly in the initial cost of the item, which is commonly called a basis adjustment. This is not a reclassification adjustment under IAS 1 Presentation of Financial Statements and therefore does not affect other comprehensive income. This accounting also would apply to a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied. For all other cash flow hedges, such as 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 as a reclassification adjustment in the same period or periods during which the hedged expected future 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 results subsequently 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 to 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 also would apply to a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied. The ED removes this accounting policy election.

8.2 Measurement of hedge ineffectiveness

Consistent with the current requirements under IAS 39, when measuring hedge ineffectiveness, an entity would consider the time value of money. Hence, the entity would determine the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also would include the effect of the time value of money.

One possible way of calculating the change in value of the hedged item for hedge effectiveness or ineffectiveness is to use a derivative that would have the critical terms of the hedged item and would be at the money at the time of designation, which is referred to commonly as a hypothetical derivative. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach. The change in value of the hedged item determined using a hypothetical derivative may also be used for the purposes of assessing whether a hedging relationship meets the hedge effectiveness requirements.

A hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods for example, statistical methods or dollar-offset, to assess the effectiveness of the hedging relationship or measure ineffectiveness.

Although the proposals do not prescribe a specific methodology for assessing hedge effectiveness, because the measurement of hedge ineffectiveness would be based on the actual performance of the hedging instrument and the hedged item, the IASB proposed to retain that hedge ineffectiveness would be measured by comparing the change in their values (the dollar offset method).

8.3 Rebalancing the hedging relationship and changes to the hedge ratio

Under the proposals, if a hedging relationship subsequently fails to meet the objective of the hedge effectiveness assessment, i.e. the hedging relationship would not produce an unbiased
result or minimise hedge ineffectiveness, but the entity’s risk management objective has not changed and the relationship continues to achieve other than accidental offset, then an entity would be required to rebalance the relationship by adjusting the hedge ratio. If the entity expects the relationship to fail to meet the effectiveness assessment objective in the future, then it may proactively rebalance the hedging relationship.

ED B46

The following decision tree illustrates the rebalancing model:

Rebalancing of a hedging relationship would be accounted for as a continuation and any hedge ineffectiveness that has arisen to date would be recognised in profit or loss immediately before adjusting the hedging relationship.

ED B47

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.

ED B50

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

- fluctuations around the hedge ratio that remains valid; or
- an indication that the hedge ratio no longer reflects appropriately the relationship between the hedging instrument and the hedged item.

ED B49

**Illustrative example – Evaluating changes in offset**

**Background**

Company B hedges its price risk exposure to a forecast purchase of a commodity in Location C with exchanged 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 that 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. Therefore, the change in the extent of offset is a matter of measuring and recognising hedge ineffectiveness but not adjusting the hedge ratio.

**Hedge ratio is no longer appropriate – B should rebalance**

If there is a change in the relationship between the two commodities and therefore the statistical correlation between the price of the commodity in Location C and the price of the exchange traded commodity contracts in Location D is altered, then rebalancing the hedging ratio to reflect the new correlation would ensure that the relationship continues to meet the objective of the hedge effectiveness assessment. An example of such a change can be a new use for one of the commodities such that demand for it has been increased for the foreseeable future.

ED B60

If an entity rebalances a hedging relationship, then the entity would update its hedge documentation including the analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term.

ED B54

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

- weighting of the hedged item can be increased by either increasing the volume of the hedged item or decreasing the volume of the hedging instrument; or
- weighting of the hedging instrument can be increased by either increasing the volume of the hedging instrument or 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 but that they are not part of the hedging relationship.

ED B55

If an entity adjusts the hedge ratio by increasing the volume of the hedged item, then the remeasurement of the hedging instrument would be unaffected and the previously designated volume of the hedged item would be unaffected. However, subsequent to the rebalancing the change in value of the hedged item would include the change in value of the additional volume or additional layer. These changes would be measured starting from and by reference to the date of rebalancing rather than the
date on which the hedging relationship was originally designated. Therefore, the additional volume hedged may have different changes in value from those of the originally hedged volume.

**ED B56**

If an entity adjusts the hedge ratio by decreasing the volume of the hedging instrument, then the remeasurement of the hedged item would be unaffected and the previously designated hedging instrument that continues to be designated would be unaffected. However, subsequent to the rebalancing the volume by which the hedging instrument was decreased would no longer be part of the hedging relationship and would be marked to market through profit or loss unless it was designated in another hedging relationship.

**ED B57**

If an entity adjusts the hedge ratio by increasing the volume of the hedging instrument, then the remeasurement of the hedged item would be unaffected and the previously designated hedging instrument would be unaffected. However, subsequent to rebalancing the changes in value of the hedging instrument would include the changes in value of the additional volume of hedging instrument. It is likely that the derivatives have different critical terms as they were entered into at different times. Therefore, subsequent changes in value of the derivatives would be different.

**ED B58**

An entity may rebalance proactively a hedging relationship if it aims to ensure that the hedging relationship would continue to meet the objective of the hedge effectiveness assessment. For example, if an entity observes changes in the extent of offset in the hedging relationship that follow an unusual pattern, the entity would have to determine that although the relationship still meets the objective of the hedge effectiveness assessment, adjusting the hedge ratio would reduce the likelihood of ceasing to meet the objective in the future.

### Observations – Beginning amortisation after rebalancing

When rebalancing a fair value hedging relationship involves decreasing the volume of a hedged item that is a financial instrument, the entity would begin amortising the amount within the separate line item in the statement of financial position 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 related to the individual hedged items.

### 8.4 Discontinuation of hedge accounting

**ED 24**

Under the proposals, an entity would discontinue hedge accounting prospectively only when the hedging relationship fails to meet the qualifying criteria after taking into consideration rebalancing of the hedging relationship, if applicable. They would prohibit voluntary discontinuation when the qualifying criteria are met. Examples of when discontinuation would be required include when the risk management objective for the hedging relationship has changed or when the hedging instrument expires or is sold, terminated or exercised, excluding scenarios where the expiration or termination is part of a documented replacement or rollover hedging strategy.

**ED B66**

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

**ED B65**

If an entity fails to predict its volume of highly probable forecast transactions accurately with the result that the expected volume is lower than the originally designated volume, then 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 hedged items.

8.5 Accounting for the time value of purchased options

Under the proposals, when using a purchased option, an entity can separate the intrinsic value and the time value of the option contract and designate only the change in intrinsic value of the option 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 would be recognised in other comprehensive income to the extent that it relates to the hedged item. The method used to reclassify the amounts from equity to profit or loss would be determined by whether the hedged item is a transaction-related hedged item or a time period-related hedged item.

8.5.1 Determining the type of hedged item

An entity would determine the type of hedged item on the basis of the nature of the hedged item regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge.

The time value of a purchased option would relate to a transaction-related hedged item if the nature of the hedged item is that of transaction costs. An example of a transaction-related hedged item is an entity hedging 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 an option would relate to a time period-related hedged item if the nature of the hedged item is that of the cost for obtaining protection against a risk over a specific period of time. However, 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.

8.5.2 Accounting for the time value

Transaction-related hedged items

Under the proposals, the change in fair value of the time value of an option that hedges a transaction-related hedged item would be recognised in other comprehensive income.

If the hedged item results in recognition of a non-financial asset or liability, or a firm commitment for which fair value hedge accounting is applied, then the entity would be required to remove the amount from the separate component of equity and would include it directly in the initial cost or other carrying amount of the item. This would not be a reclassification adjustment under IAS 1 and therefore would not affect other comprehensive income. In other cases, the entity would be required to reclassify the amount from the separate component of equity to profit or loss as a reclassification adjustment in the same period or periods when the hedged future cash flows affect profit or loss.

Any portion of the time value of an option recognised in other comprehensive income that is not expected to be recovered in future periods would be required to be reclassified into profit or loss as a reclassification adjustment.

Time period-related hedged items

The change in fair value of the time value of an option that hedges a time period-related hedged item would be recognised in other comprehensive income. The original time value paid to the option writer would be amortised on a rational basis over the term of the hedging relationship. Hence, in each period the amortisation amount would be required to be reclassified from the separate component of equity to profit or loss as a reclassification adjustment.

However, if the hedging relationship that includes the intrinsic value of the option is discontinued, then the net amount that has been accumulated in the separate component of equity, net of cumulative amortisation, would be required to be reclassified immediately into profit or loss as a reclassification adjustment.
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 is related to a transaction or time period. Entities will need to analyse their hedging strategies that use options in order to make this determination, as they may not have previously documented their option strategies in this manner.

8.5.3

Aligned time value vs actual time value

Under the proposals, the specific accounting guidance for the time value of purchased options described above would apply only to the extent that the time value relates to the hedged item. This is referred to as the aligned time value. An entity would determine the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

Observations – Aligned time value vs actual time value

The aligned time value would be the time value of an option that would have 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 use of judgement, which should be applied consistently.

ED B68, B69

If the actual time value of the option, i.e. the time value included in the premium paid, differs from the aligned time value, then the method that the entity would use to account for the difference during the hedging relationship would be as follows:

• If, at inception of the hedging relationship, the actual time value is higher than the aligned time value, then the entity:
  – would determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
  – would account for the differences in the fair value changes between the two time values in profit or loss.

• If, at inception of the hedging relationship, the actual time value is lower than the aligned time value, then the entity:
  – would determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of the actual time value and the aligned time value; and
  – would recognise in profit or loss any remainder of the change in fair value of the actual time value.
9. Hedges of a group of items

9.1 Eligibility of a group of items as the hedged item

Under the proposals, 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 individually would be eligible hedged items as noted in Section 6 of this publication;
- the items in the group are managed together on a group basis for risk management purposes; and
- for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items that is exposed to the hedged risk, would affect profit or loss in the same and only in that reporting period including interim periods as defined in IAS 34 Interim Financial Reporting.

Observations – Hedges of gross positions

Under IAS 39, in order for a group of items to qualify for hedge accounting, additional criteria must be met. More specifically, the individual items within the group must have similar risk characteristics and the change in the fair value attributable to the hedged risk for each individual item in the group must be approximately proportional to the overall change in the fair value of the group for the hedged risk. These restrictions are not consistent with the way that many entities manage risk. The ED does not require such criteria to be met to hedge a gross position. Therefore, the ED 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 these risks to one central business unit within the entity through the use of 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 as 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 ED better aligns hedge accounting and such a risk management strategy.

Entities will need to give consideration in order to determine what information system and internal procedures will need to be made to operationalise hedge accounting on a net position basis.
A group that is a nil net position, i.e. the hedged items fully offset the risk that is managed on a group basis, would be an eligible hedged item 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 as the accounting would not recognise the offsetting risk position 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.

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

Under the proposals, an entity can only designate groups of items that constitute a net position with offsetting risks that affect profit or loss in different reporting periods in a fair value hedging relationship. A cash flow hedging relationship would not be eligible as the gross items that constitute the net position will not naturally offset in net profit or loss as they affect profit or loss in different reporting periods. Therefore an entity cannot gross up net hedging instrument gains or losses for recognition in different periods, nor can an entity defer value changes from one hedged item to match the later recognition of another hedged item.

**9.3 Designation of a component of a nominal amount**

Under the proposals, an entity could designate a percentage component 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 items in the group do not contain prepayment options other than those whose fair value is not affected by the hedged risk.

A hedging relationship can include layers from multiple different groups of items. For example, in a net position hedge of a group of assets and a group of liabilities, the hedging relationship can comprise, in combination, a layer component of the group of assets and a layer component of the group of liabilities.
9.4  

**Presentation**

ED 37, B81, B82  
For a group of items in a fair value or cash flow hedge that has offsetting risk positions that affect different line items in the statement of comprehensive income, the recognition of any hedging instrument gains or losses in profit or loss would be presented in a separate line from those affected by the hedged items. This is to avoid the grossing up of 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. For some fair value hedges, the objective of the hedge is not primarily to offset the fair value changes of the hedged item but rather to transform the cash flows, for example transforming the fixed interest cash flows of a fixed rate note into floating interest cash flows using an interest rate swap. For this type of hedge the net interest accrual on the interest rate swap would be accrued in profit or loss.

If the group of items does not have any offsetting risk positions, in a cash flow hedge or a fair value hedge, then the hedging instrument gains or losses would be apportioned to the line items in the statement of comprehensive income affected by the hedged items on a rational basis, without grossing up the net gains or losses arising from a single hedging instrument.

ED 38  
For groups of items in a fair value hedging relationship either with or without offsetting risks, the gains or losses on the assets or liabilities would be recognised in the statement of financial position as it would be for one-for-one hedging relationships and presented on a gross basis next to each line item that includes the related asset or liability. This is consistent with the designation of the hedged item being the overall group of items, not a non-specific abstract net position amount.
10. Disclosures

10.1 General

ED 40

Under the proposals, in the ED, an entity would disclose, in addition to the requirements in IFRS 7, the following:

- an entity’s risk management strategy and how it is applied to manage risk;
- how the entity’s hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on the entity’s primary financial statements.

Observations – Disclosure

Financial statement users have expressed to the IASB that they do not find current hedge accounting disclosures helpful. The IASB has designed the above disclosure requirements to address that concern. Financial statement preparers will need to give thoughtful consideration and exercise judgment in providing information that is relevant.

ED 41

An entity would present the required disclosures in a single note or separate section in its financial statements. However, an entity would not need to duplicate information that is already presented elsewhere, provided that information is incorporated by cross-reference and is available for users of the financial statements.

ED 42

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

ED 43, BC200

Although an entity would be allowed to determine the extent of aggregation or disaggregation of the disclosures, an entity should consider the level of aggregation it uses for other disclosure requirements in IFRS 7.

10.2 Risk management strategy

ED 44

One of the concepts included in the proposals is that an entity would explain its risk management strategy for each category of risk exposure 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 risk components of an item; and
- the extent of risk exposure that the entity manages.

10.3 Amount, timing and uncertainty of future cash flows

ED 45

Under the proposals, an entity would disclose, for each category of risk exposure, quantitative information to enable users of its financial statements to evaluate the types of risk exposures being managed in each risk category, the extent to which each type of risk exposure is hedged and the effect of the hedging strategy on each type of risk exposure.
An entity would provide a breakdown for each subsequent period that the hedging relationship is expected to affect profit or loss, including:

- the monetary amount or other quantity to which the entity is exposed for each particular risk; for hedges of groups of items, an entity would explain the risk exposure in the context of a group or net position;
- the amount or quantity of the risk exposure being hedged; and
- in quantitative terms, how hedging changes the exposure.

For each category of risk, an entity would disclose 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 would disclose those sources and explain the resulting hedge ineffectiveness.

10.4 Effect of hedge accounting on the primary financial statements

10.4.1 Hedging instrument

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

- the carrying amount of the hedging instruments, separating financial assets from financial liabilities; and
- the notional amounts or other quantity related to the hedging instruments.

10.4.2 Hedged item

An entity would disclose, in tabular format, the following amounts related to hedged items separately by category of risk for each type of hedge:

| Fair value hedges | • the carrying amounts of the accumulated gains or losses on the hedged items presented in a separate line item in the statement of financial position, separating assets from liabilities; and
| | • the balance remaining in the statement of financial position of any hedges for which hedge accounting has been discontinued. |
| Cash flow hedges and hedges of a net investment in a foreign operation | • the balance in the cash flow hedge reserve for continuing hedges that will be reclassified when the hedged item affects profit or loss; and
| | • the balance remaining in the cash flow hedge reserve from any hedges for which hedge accounting has been discontinued. |

10.4.3 Changes during the reporting period

An entity would disclose, in tabular format, the following amounts separately by category of risk for each type of hedge:

| All hedge types | • changes in the value of hedging instruments recognised in other comprehensive income;
| | • hedge ineffectiveness recognised in profit or loss; and
| | • a description of the line item(s) in the statement of comprehensive income in which hedge ineffectiveness is included. |
Fair value hedges

- the change in value of the hedged item.

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

- for hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive income;
- the amount reclassified from the cash flow hedge reserve into profit or loss as a reclassification adjustment differentiating between amounts for which hedge accounting had previously been used, but the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss; and
- the line item in the statement of comprehensive income affected by the reclassification adjustment.

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. Rather, users want to understand how an entity manages its risks and the results after hedging. However, to provide effectively information on the effects of hedge accounting on the financial statements, the information should reflect the applied accounting treatment, e.g. cash flow hedge accounting or fair value hedge accounting. The IASB believes that a table prepared by risk category and by type of hedge would provide sufficient links between the accounting and risk management information.

Reconciliation

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

- would allow users of the financial statements to identify the amounts that relate to the disclosures in 10.4.3 for changes in the value of the hedging instrument recognised in other comprehensive income, the hedging gains or losses recognised in the statement of comprehensive income for hedges of net positions and the amount reclassified from the cash flow hedge reserve into profit or loss; and
- would differentiate between amounts associated with the time value of purchased options that hedge transaction-related hedged items and amounts associated with the time value of options that hedge time period-related hedged items when an entity designates as the hedging instrument only the change in intrinsic value of the option.

Under the proposals, the reconciliation required by IAS 1 would have the same level of detail as the information that identifies the effects of hedge accounting on the statement of comprehensive income.
11. Effective date and transition

**ED 53**

The effective date for the final standard resulting from the proposals is for annual periods beginning on or after 1 January 2013. The final standard would be applied prospectively and early application would be permitted.

**Observations – IASB request for views on effective dates and transition methods**

The IASB published in October 2010 a request for views on effective dates and transition methods for IFRSs expected to be issued in 2011 as well as other new IFRSs. The objective of this request is to develop an implementation plan to manage the pace and cost of changes to new IFRSs. The result of this request may impact the effective date and transition method of the ED.

An entity would not be required to present the disclosure requirements in comparative information provided for periods before initial application of the final standard.

Like the other phases of IFRS 9, the hedge accounting requirements in IFRS 9 may be applied only if all existing IFRS 9 requirements are adopted at the same time or have already been adopted.

**ED 55**

Existing hedging relationships that qualify for hedge accounting under IAS 39 would be subject to the proposed requirements from the adoption date. Hedging relationships that qualify for hedge accounting in accordance with IAS 39 that also qualify under the final standard would be regarded as continuing hedging instruments.

**Observations – Transition**

In addition to applying the proposed requirements to new hedging relationships, entities will have to apply the proposals to all existing hedging relationships in order for them to be regarded as continuing hedging relationships. This means that at the time of transition to the new hedge accounting provisions of IFRS 9, a hedging relationship that met the hedging requirements under IAS 39 would also have to be aligned with the reporting entity’s risk management objectives, produce an unbiased result and minimise ineffectiveness and provide other than an accidental offset. 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.
12. Accounting alternatives to hedge accounting

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

12.1 Accounting for a contract to buy or sell a non-financial item as a derivative

ED BC209, BC210
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, which is referred to commonly as the own-use scope exception in IAS 39, which mostly applies to commodity purchases or sales.

ED BC211
Frequently, if a commodity contract does not meet the own-use scope exception it will be accounted for as a derivative contract and marked to market 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 will also be marked to market through profit or loss and therefore the entity does not need to apply hedge accounting to achieve accounting offset.

ED BC212, BC213
If the contract meets the own-use scope exception, then it is accounted for as a normal purchase or sales contract, i.e. executory contract. Therefore if an entity enters into a derivative contract to 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 often are entered into in large volumes and managed typically on a net basis. In addition, hedge accounting often produces a less meaningful result than fair value accounting.

ED App C
In order 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. The amendment would change the scope for a contract that was entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchases, sales or usage requirements. An entity would account for such a contract that can be settled net in cash or other financial instruments (including a contract for a commodity that is readily convertible to cash) as a derivative financial instrument if that accounting is in accordance with the entity’s underlying business model and how the contracts are managed. That would be the case for a fair value-based risk management strategy, i.e. the entire business is managed on a fair value basis and the net exposure is maintained close to nil.

12.2 Hedging credit risk using credit derivatives

ED BC219
Many financial institutions use frequently 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 also might reduce the regulatory capital requirement for the loan or loan commitment, but at the same time allow the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers use frequently 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.
However, financial institutions that manage credit risk using credit derivatives often do not achieve hedge accounting because it is operationally difficult to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk.

However, when the requirements for hedge accounting are not met, IFRS 9 and IAS 39 permit an entity to designate as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of the standard if doing so eliminates or reduces significantly an accounting mismatch. However, the fair value option has a number of restrictions and limitations. Consequently, most financial institutions do not and often cannot elect to apply the fair value option.

As a result, financial institutions that use credit default swaps to hedge credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments. The changes in fair value of the credit default swaps are recognised in profit or loss every period, as for a trading book. The accounting outcome is a mismatch of gains and losses of the loans and loan commitments vs those of the credit default swaps, which creates volatility in profit or loss.

The IASB requests input on three alternative approaches to address situations in which credit risk is hedged by credit derivatives. These alternatives represent three variations on the fair value option model that include allowing certain loan commitments that ordinarily would not qualify for the fair value option to do so, allowing an entity flexibility in starting and stopping the fair value option, and allowing an entity to designate a portion of certain items under the fair value option.
13. **Alternative view**

**ED AV1**
One of the IASB members dissented from the ED. The member does not believe that the ED would improve financial reporting. He believes that many of its provisions are not operational, lack rigour and would decrease comparability.

**ED AV2-AV11**
The member is concerned that the ED would allow hedge accounting to become the norm rather than an exception. The ED relies on risk management as the basis for hedge accounting. The member does not support relying on risk management as a basis for hedge accounting because it is not defined well or applied uniformly. He is concerned that policies can be written to permit an entity to move freely in and out of hedge accounting to manipulate accounting results. He also believes that the effectiveness assessment proposed in the ED may set the bar for achieving hedge accounting too low and is not rigorous enough to ensure any level of precision. Further, he is opposed to certain of the proposals that would expand the current application of hedge accounting, e.g. the method to identify certain risk components in non-financial items, hedging aggregate exposures that include derivatives, net position hedging and allowing non-derivatives that are measured at fair value through profit or loss as hedging instruments. The member believes that these changes would expand unjustifiably hedge accounting, resulting in free choice to change the normal IFRS recognition and measurement requirements. Also, he is concerned that accounting for the time value of options when the intrinsic value is designated as a hedged item is too complex.

**ED AV12**
The member does not support presenting changes in the value of hedged items in a separate line in the statement of financial position since they do not constitute assets or liabilities in their own right. He is concerned particularly that the ED does not provide any guidance to require the items constituting the separate line item to be tracked with and linked specifically to the hedged items to which they relate.

**ED AV12-AV16**
The member does not believe that financial statements users are served well by the ED due to the reasons stated above. Additionally, he is concerned that little consideration was given to the resulting operational issues created by the changes required by the ED and that there may be significant unintended consequences.
14. FASB proposals and convergence

The FASB issued its comprehensive proposals on financial instrument accounting in May 2010 with a comment period that ended in September 2010. In the quarterly progress report published by the IASB and the FASB (the Boards) on 29 November 2010, the Boards acknowledge that they have diverged on some important technical issues and that addressing those differences in ways that foster convergence could affect the envisaged timetables. The FASB will not begin redeliberating hedge accounting until the second quarter of 2011 and will consider input received on the IASB’s exposure draft during its discussions.

Significant differences between the two sets of proposals include:

<table>
<thead>
<tr>
<th>IASB proposed model</th>
<th>FASB proposed model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach</strong></td>
<td>Comprehensive review led to fundamental change.</td>
</tr>
<tr>
<td><strong>Scope</strong></td>
<td>Does not address hedges of open portfolios or fair value hedges of a portfolio for interest rate risk (macro hedge).</td>
</tr>
<tr>
<td><strong>Non-derivative financial instruments designated as hedging instruments for foreign currency risk</strong></td>
<td>Permitted under all hedging models.</td>
</tr>
<tr>
<td><strong>Non-derivative financial instruments measured at fair value through profit or loss (fair value through net income) designated as hedging instruments for risks other than foreign currency</strong></td>
<td>Permitted.</td>
</tr>
<tr>
<td><strong>Allowable hedged risk components for financial instruments</strong></td>
<td>Risk component must be separately identifiable and reliably measureable; and can be either contractually or non-contractually specified, as well as a combination of such risk components.</td>
</tr>
<tr>
<td><strong>Allowable hedged risk components for non-financial items</strong></td>
<td>Same as those for financial instruments above.</td>
</tr>
<tr>
<td><strong>Fair value hedge of a layer component</strong></td>
<td>Permitted if certain criteria are met.</td>
</tr>
<tr>
<td><strong>Effectiveness assessment requirement</strong></td>
<td>Must produce an unbiased result, minimise expected ineffectiveness and be expected to achieve other than accidental offsetting.</td>
</tr>
<tr>
<td><strong>Frequency of effectiveness assessment</strong></td>
<td><strong>IASB proposed model</strong></td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>At a minimum each reporting period or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.</td>
<td>Reassessment would be required only if circumstances suggest that the hedging relationship may no longer be reasonably effective.</td>
</tr>
<tr>
<td><strong>Assumption of perfective effectiveness</strong></td>
<td><strong>Prohibited.</strong></td>
</tr>
<tr>
<td><strong>Fair value hedge accounting</strong></td>
<td>Change in full fair value of the hedging instrument and change in value of hedged item attributable to the hedged risk would be recognised and offset in other comprehensive income with any ineffectiveness transferred to profit or loss.</td>
</tr>
<tr>
<td><strong>Fair value hedge – hedged item value changes</strong></td>
<td>The change in fair value of hedged item attributable to the hedged risk would be recognised in a separate line item in the statement of financial position rather than adjusting the hedged item.</td>
</tr>
<tr>
<td><strong>Cash flow hedge accounting</strong></td>
<td>The effective portion of the gain or loss on the hedging instrument would accumulate in other comprehensive income; 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>
</tr>
<tr>
<td><strong>Forecasted transaction that was the hedged item in a cash flow hedge that subsequently results in recognising a non-financial asset/liability (or a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied)</strong></td>
<td>Upon recognition of the non-financial asset/liability (or the forecast transaction for a non-financial item becoming a firm commitment for which fair value hedge accounting is applied), the amount of the gain or loss that was accumulated in other comprehensive income as part of the cash flow hedge accounting would be removed from other comprehensive income and added to the original carrying amount of the non-financial asset/liability.</td>
</tr>
<tr>
<td></td>
<td>IASB proposed model</td>
</tr>
<tr>
<td>------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Rebalancing a hedging relationship voluntarily with continuation of relationship</td>
<td>An entity may rebalance proactively based on expectations.</td>
</tr>
<tr>
<td>Mandatory rebalancing of a hedging relationship with continuation of relationship</td>
<td>An entity would be required to rebalance when the hedging relationship fails the effectiveness assessment but the entity’s risk management strategy remains the same.</td>
</tr>
<tr>
<td>Voluntarily discontinuing hedge accounting</td>
<td>Prohibited.</td>
</tr>
<tr>
<td>Change in risk management strategy triggers discontinuing hedge accounting</td>
<td>Yes.</td>
</tr>
<tr>
<td>Accounting for the time value of an option when the intrinsic value of the option is designated as a hedging instrument</td>
<td>Changes in fair value of the time value would be recognised in other comprehensive income based on the time value of an 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, but the manner would depend upon whether the hedged item is transaction related or period related.</td>
</tr>
<tr>
<td>Hedging gross positions</td>
<td>Permitted if certain criteria are met. They do not include approximately proportional criteria.</td>
</tr>
<tr>
<td>Hedging net positions</td>
<td>Permitted if certain criteria are met.</td>
</tr>
<tr>
<td>Hedging nil net positions without a hedging derivative instrument</td>
<td>Permitted if certain criteria are met.</td>
</tr>
<tr>
<td>Synthetic position being the hedged item, e.g. a foreign currency denominated fixed rate debt and a fixed to floating cross-currency interest rate swap designated as a synthetic domestic currency denominated floating rate debt</td>
<td>IASB proposed model</td>
</tr>
<tr>
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</tr>
<tr>
<td>Permitted if certain criteria are met.</td>
<td>Prohibited.</td>
</tr>
</tbody>
</table>
15. Project timeline

The IASB has invited comments on the proposals contained in the ED by 9 March 2011. The final standard currently is scheduled to be published in the second quarter of 2011.

The IASB will continue to deliberate the portfolio hedging model and an exposure draft currently is expected to be published in the second quarter of 2011; with a final standard in the fourth quarter of 2011.

The FASB published an exposure draft containing its comprehensive proposals on financial instruments accounting in May 2010.
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 upon 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 ED/2010/13 Hedge Accounting (the ED).

The text of this publication is referenced to the ED and to selected other current IFRSs in issue at 9 December 2010. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED 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.

Abbreviations

IASB: International Accounting Standards Board
FASB: US Financial Accounting Standards Board
G20: Group of Twenty

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A more detailed discussion of the general accounting issues that arise from the application of IFRSs can be found in our publication Insights into IFRS.

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