

December 2010

Exposure Draft ED/2010/13

153. DSR-Sitzung am 03.02.2011
153_03c_101209_ED_HedgeAccounting_152_02c

Hedge Accounting

Comments to be received by 9 March 2011

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HEDGE ACCOUNTING

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This exposure draft *Hedge Accounting* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IFRS 9 *Financial Instruments*. Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **9 March 2011**. Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

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ISBN for this part: 978-1-907026-96-6

ISBN for complete publication (set of two parts): 978-1-907026-95-9

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Introduction and invitation to comment

Reasons for publishing the exposure draft

- IN1 The exposure draft *Hedge Accounting* is the third phase of the International Accounting Standards Board's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The other phases are:
- (a) Phase 1: Classification and measurement of financial assets and financial liabilities. In November 2009 the Board issued the chapters of IFRS 9 *Financial Instruments* setting out the requirements for the classification and measurement of financial assets. In October 2010 the Board added to IFRS 9 the requirements for the classification and measurement of financial liabilities.
 - (b) Phase 2: Amortised cost and impairment. In June 2009 the Board published a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. The Board is redeliberating the proposals in the exposure draft to address the comments received from respondents and suggestions made by a panel of credit and risk experts that the Board set up to consider and advise it on the operational issues arising from an expected cash flow approach and views received through various outreach activities.
- IN2 The IASB has published this exposure draft to propose significant changes to the general hedge accounting requirements in IAS 39 in order to provide more useful hedge accounting information. Many users and preparers of financial statements describe hedge accounting today as complex and criticise it for not reflecting an entity's risk management activities nor to what extent those activities are successful in meeting the entity's risk management objectives. Many also find the requirements in IAS 39 excessively rule-based, resulting in arbitrary outcomes.
- IN3 The proposals in the exposure draft amount to a comprehensive review of hedge accounting requirements (apart from some portfolio hedge accounting requirements, see paragraph IN7), and the proposals in this exposure draft, if confirmed, would:
- (a) align hedge accounting more closely with risk management and hence result in more useful information.
 - (b) establish a more objective-based approach to hedge accounting.

- (c) address inconsistencies and weaknesses in the existing hedge accounting model.
- IN4 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. As the Board completes each subsequent phase of its project to replace IAS 39, it deletes the relevant portions of IAS 39 and creates chapters in IFRS 9 that replace the requirements in IAS 39.

Contents of this exposure draft

- IN5 This exposure draft proposes requirements in the following areas:
- (a) what financial instruments qualify for designation as hedging instruments;
 - (b) what items (existing or expected) qualify for designation as hedged items;
 - (c) an objective-based hedge effectiveness assessment;
 - (d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*); and
 - (e) hedge accounting presentation and disclosures.

It also proposes application guidance for the proposed hedge accounting model.

- IN6 The Board also proposes an objective for hedge accounting that relates to linking accounting with risk management.
- IN7 The Board decided not to address open portfolios or macro hedging as part of this exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross position or a net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship). The Board is continuing to discuss proposals for hedge accounting for open portfolios.

IN8 For the convenience of the reader, the proposals in this exposure draft are presented as a self-contained proposal rather than as an amendment to IFRS 9. However, any finalised requirements would be included in chapter 6 *Hedge accounting* of IFRS 9, apart from any finalised disclosure requirements, which would be included in IFRS 7 *Financial Instruments: Disclosures*.

Invitation to comment

IN9 The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Comments are most helpful if they:

- (a) respond to the questions as stated.
- (b) indicate the specific paragraph or paragraphs to which the comments relate.
- (c) contain a clear rationale.
- (d) describe any alternatives the Board should consider.

IN10 Respondents need not comment on all of the questions and are encouraged to comment on any additional matters. However, the Board is not seeking comments on aspects of IFRS 7, IAS 39 or IFRS 9 not addressed in this exposure draft.

IN11 The Board will consider all comments received in writing by 9 March 2011. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

Objective of hedge accounting (paragraphs 1 and BC11–BC16)

IN12 This exposure draft proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.

- IN13 The Board believes that an objective would be helpful in setting the scene for hedge accounting and to lay the foundation for a more principle-based approach. An objective also assists the understanding and interpretation of requirements.

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)

- IN14 The exposure draft proposes that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss may be eligible for designation as a hedging instrument.
- IN15 The Board believes that extending eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. However, the Board believes that extending eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety, would not give rise to the need to change the measurement basis of the financial instrument. The Board also believes that extending eligibility to these financial instruments would align more closely with the classification model of IFRS 9.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)

- IN16 The exposure draft proposes that an aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item.

- IN17 The Board believes that an entity is often economically required to enter into transactions that result in, for example, interest rate risk and foreign currency risk. Even though these two exposures can be managed together at the same time and for the entire term, the Board believes that entities often use different risk management strategies for the interest rate risk and foreign currency risk. The Board believes that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that aggregated exposure as a hedged item.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

**Designation of risk components as hedged items
(paragraphs 18, B13–B18 and BC52–BC60)**

- IN18 The exposure draft proposes that an entity may designate all changes in the cash flows or fair value of an item as the hedged item in a hedging relationship. An entity may also designate as the hedged item something other than the entire fair value change or cash flow variability of an item, ie a component. However, the exposure draft proposes that when an entity designates only changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component) that risk component must be separately identifiable and reliably measurable.
- IN19 The Board believes that it is not appropriate to limit the eligibility of risk components for designation as hedged items on the basis of whether the risk component is part of a financial or a non-financial item (as is the case in IAS 39). The Board believes that it is more appropriate to permit the designation of risk components as hedged items if they are separately identifiable and reliably measurable—irrespective of whether the item that includes the risk component is a financial or non-financial item. This would also more closely align hedge accounting with risk management. The determination of appropriate risk components requires an evaluation of the relevant facts and circumstances.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)

- IN20 The exposure draft proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.
- IN21 Hedging a layer of the nominal amount addresses the fact that there may be a level of uncertainty surrounding the hedged item. The Board believes that designating a percentage component of a nominal amount as the hedged item can give rise to an accounting outcome different from designating a layer component of a nominal amount as a hedged item. If the designation of the component of a nominal amount is not aligned with the risk management strategy of the entity, it might result in less useful information to users of financial statements. In the Board's view there might be circumstances in which it is appropriate to designate as a hedged item a layer component of the nominal amount.
- IN22 The Board believes that if the prepayment option's fair value changed in response to the hedged risk, a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured).

Question 5

- (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75–BC90)

- IN23 The exposure draft proposes that a hedging relationship should meet the hedge effectiveness requirements as one of the requirements to qualify for hedge accounting. Those qualifying criteria are set out in paragraph 19.
- IN24 IAS 39 permits hedge accounting only if a hedge is highly effective, both prospectively and retrospectively. IAS 39 regards a hedge as highly effective if the offset is within the range of 80–125 per cent. The Board proposes to eliminate the 80–125 per cent 'bright line' for testing whether a hedging relationship qualifies for hedge accounting. Instead, the Board believes that an objective-based assessment would enhance the link between hedge accounting and an entity's risk management activities. The proposed hedge effectiveness requirements are that a hedging relationship:
- (a) meets the objective of the hedge effectiveness assessment (ie to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and
 - (b) is expected to achieve other than accidental offsetting.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)

- IN25 The exposure draft proposes that when a hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity should rebalance the hedging relationship so that it meets the objective of the hedge effectiveness assessment again. When an entity expects that a hedging relationship might cease to meet the objective of the hedge effectiveness assessment in the future, it may proactively rebalance the hedging relationship.
- IN26 The Board believes that there are instances in which, although the risk management objective remains the same, adjustments are required to the existing hedging relationship to maintain the alignment to risk management policies. The adjustments to the hedged item or hedging instrument do not change the original risk management objective as stated in the documentation supporting the designation. The Board believes that in these circumstances the revised hedging relationship should be accounted for as a continuation of an existing hedge rather than as a discontinuation. The Board calls this adjustment rebalancing.

Question 7

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)

- IN27 The exposure draft proposes that an entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). This may affect the entire hedging relationship or a part of it.
- IN28 The Board believes that hedge accounting should reflect an entity's risk management activities. Therefore, an entity should only discontinue hedge accounting when it no longer reflects the risk management strategy. Consequently, the Board believes that it is inappropriate for an entity to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

Question 8

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)

- IN29 The exposure draft proposes that for fair value hedges, the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income. The ineffective portion of the gain or loss shall be transferred to profit or loss. In addition, the gain or loss on the hedged item shall be presented as a separate line item in the statement of financial position.
- IN30 The Board believes that the proposed accounting treatment:
- (a) eliminates the mixed measurement for the hedged item (eg an amount that is amortised cost with a partial fair value adjustment);
 - (b) avoids volatility in other comprehensive income and equity that some consider artificial;
 - (c) presents in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges); and
 - (d) provides information in the statement of comprehensive income about the extent of the offsetting achieved by fair value hedges.
- IN31 The Board also discussed linked presentation as an alternative for presenting information in the statement of financial position for fair value hedges. Linked presentation is a way to present information together in the statement of financial position to show how a particular asset and liability are related. Linked presentation is not the same as offsetting. This is because linked presentation displays the gross amounts together in the statement of financial position.
- IN32 The Board believes that although linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk that are covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and a liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (eg only currency risk but not credit risk or interest rate risk). Furthermore, the Board does not believe that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affects only one risk but not all risks. Instead, the Board believes

that disclosures about hedging would be a better alternative to provide information about the relationship between hedged items and hedging instruments that allows users of financial statements to assess the relevance of the information for their own analysis.

Question 9

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)

- IN33 In IAS 39 the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss. The Board believes that this accounting treatment is not aligned with an entity's risk management activities. The Board noted that the time value of an option is a cost of obtaining protection against unfavourable changes of prices or rates.
- IN34 The exposure draft proposes that an entity should distinguish the time value of options by the type of hedged item that the option hedges: a transaction related hedged item or a time period related hedged item.
- IN35 The exposure draft proposes specific accounting requirements for the time value of an option when an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in the intrinsic value.

Question 10

- (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)

Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)

IN36 The exposure draft proposes that a group of items is an eligible hedged item only if:

- (a) it consists of items (including components of items) that individually are eligible hedged items;
- (b) the items in the group are managed together on a group basis for risk management purposes; and
- (c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).

IN37 An individual hedging approach involves an entity entering into one or more hedging instruments to manage the risk exposure attributable to an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, in a group hedge approach an entity seeks to manage the residual risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument. An individual hedge approach and a group hedge approach are similar in concept, and so the Board believes that the requirements for qualifying for hedge accounting should also be similar. Consequently, the exposure draft proposes that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions are retained for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different reporting periods.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)

- IN38 The exposure draft proposes that for a hedge of a group of items with offsetting hedged risk positions that affect different line items in the statement of comprehensive income (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss shall be presented in a separate line from those affected by the hedged items.
- IN39 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items may affect different income statement line items. Consequently, a cash flow hedge of such a group creates a presentation problem when amounts are reclassified from other comprehensive income to profit or loss. This is because the reclassified amounts would need to be grossed up to offset the hedged items effectively. The Board concluded that if it proposed to adjust (gross up) all the affected line items in the income statement the result would be the recognition of gross (partially offsetting) gains or losses that do not exist. This is not consistent with basic accounting principles. Consequently, the exposure draft proposes that amounts that are reclassified from other

comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. The Board believes that this avoids the problem of distorting gains or losses with amounts that do not exist.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Disclosures (paragraphs 40–52 and BC183–BC208)

- IN40 The exposure draft proposes disclosure requirements that provide information about:
- (a) an entity's risk management strategy and how it is applied to manage risk;
 - (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
 - (c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.
- IN41 The exposure draft also proposes that in the reconciliation of accumulated other comprehensive income in accordance with IAS 1 *Financial Statement Presentation*, an entity should provide sufficient detail to allow users to identify related amounts disclosed as part of the information to explain the effects of hedge accounting on the statement of comprehensive income. Furthermore, in the reconciliation of accumulated other comprehensive income, an entity should differentiate amounts recognised regarding the time value of options between transaction related hedged items and time period related hedged items.
- IN42 The Board believes that the proposed disclosures provide relevant information that enhances the transparency regarding an entity's hedging activities.

Question 13

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

**Accounting alternatives to hedge accounting
(paragraphs BC208–BC246)**

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)

- IN43 The exposure draft proposes that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting shall apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.
- IN44 The Board believes that hedge accounting does not necessarily provide appropriate accounting for hedging relationships that include commodity contracts. Consequently, the Board proposes to amend the scope of IAS 39 to allow a commodity contract to be accounted for as a derivative in appropriate circumstances. The Board believes that this approach combines the purpose for a contract that can be settled net to buy or sell non-financial items (normally commodities) that are entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements and also how they are managed. This better reflects the contract's effect on the entity's financial performance and provides more useful information.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

**Accounting for credit risk using credit derivatives
(paragraphs BC219–BC246)**

- IN45 Many financial institutions use credit derivatives to manage credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer to a third party the risk of credit loss on a loan or a loan commitment. Hedges of credit risk might also reduce the regulatory capital requirement for the loan or loan commitment while allowing the financial institution to retain nominal ownership of the loan and the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's overall lending portfolio.
- IN46 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk component 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 changes in fair value that are attributable solely to credit risk for the purpose of hedge accounting.
- IN47 The Board considered three possible alternative approaches to hedge accounting when credit derivatives are used to hedge credit risk. Because of the complexities involved, the Board decided not to propose an alternative accounting treatment to account for hedges of credit risk using credit derivatives.

Question 15

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

**Effective date and transition
(paragraphs 53–55 and BC247–BC254)**

IN48 The Board proposes that the proposed requirements for hedge accounting be applied prospectively.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Proposals for hedge accounting

Hedge accounting

- 1 The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.
- 2 An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 5–18 and B1–B26. An entity shall account for the gain or loss on the hedging instrument and the hedged item in accordance with paragraphs 20–33. When the hedged item is a group of items an entity shall comply with the additional requirements in paragraphs 34–39.
- 3 For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities an entity shall apply the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114–AG132 of IAS 39) instead of this [draft] IFRS.
- 4 Hedge accounting shall not be applied to investments in equity instruments designated as at fair value through other comprehensive income.

Hedging instruments

Qualifying instruments

- 5 A financial asset or a financial liability measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options (see paragraph B4).
- 6 For a hedge of foreign currency risk, a financial asset or financial liability may be designated as a hedging instrument provided that it is not designated as at fair value through other comprehensive income (see paragraph 4).

- 7 For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.

Designation of hedging instruments

- 8 A hedging instrument must be designated in its entirety in a hedging relationship. The only exceptions permitted are:
- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value (see paragraph 33); and
 - (b) separating the interest element and the spot price of a forward contract and designating as the hedging instrument only the change in the spot element of a forward contract and not the interest element.
- 9 A percentage of the nominal amount of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
- 10 An entity may view in combination and jointly designate as the hedging instrument any combination of the following (including those circumstances when the risk or risks arising from some hedging instruments offset those arising from others):
- (a) derivatives or a percentage of their nominal amounts.
 - (b) non-derivatives or a percentage of their nominal amounts.
- 11 However, a derivative instrument that combines a written option and a purchased option (eg an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option. Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged items

Qualifying items

- 12 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be:
- (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, or
 - (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations (subject to paragraphs 34–39).
- A hedged item can also be a component of these items (see paragraph 18).
- 13 The hedged item must be reliably measurable.
- 14 If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.
- 15 An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item (see paragraph B9).
- 16 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the entity can be designated as hedged items. Hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group.
- 17 However, as an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. In accordance with IAS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in

consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of hedged items

- 18 An entity may designate all changes in the cash flows or fair value of an item as the hedged item in a hedging relationship. An entity may also designate as the hedged item something other than the entire fair value change or cash flow variability of an item, ie a component. An entity may designate the following types of components (including combinations) as hedged items:
- (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that the risk component is separately identifiable and reliably measurable (see paragraphs B13–B18); risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or specified rate (ie a ‘one-sided’ risk).
 - (b) one or more selected contractual cash flows.
 - (c) nominal components, ie a specified part of the amount of an item (as set out in paragraphs B19–B23).

Qualifying criteria for hedge accounting

- 19 A hedging relationship qualifies for hedge accounting only if all the following criteria are met:
- (a) The hedging relationship consists only of eligible hedging instruments and hedged items.
 - (b) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge. That documentation includes identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

- (c) The hedging relationship meets the hedge effectiveness requirements (see paragraphs B27–B39). A hedging relationship meets the hedge effectiveness requirements if it:
- (i) meets the objective of the hedge effectiveness assessment; and
 - (ii) is expected to achieve other than accidental offsetting.

Accounting for qualifying hedges

- 20 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 19 (which include the entity's decision to designate the hedging relationship).
- 21 There are three types of hedging relationships:
- (a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.
 - (b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and could affect profit or loss.
 - (c) *hedge of a net investment in a foreign operation* as defined in IAS 21.
- 22 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
- 23 If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity shall rebalance the hedging relationship so that it meets the qualifying criteria again (see paragraphs B46–B60). When an entity expects that a hedging relationship might cease to meet the qualifying criteria of hedge accounting in the future, it may proactively rebalance the hedging relationship.
- 24 An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging

instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). This might affect the entire hedging relationship or a part of it.

25 An entity shall apply:

- (a) paragraph 28 when it discontinues hedge accounting for a fair value hedge for which the hedged item is (or is a component of) a financial instrument measured at amortised cost; and
- (b) paragraph 30 when it discontinues hedge accounting for cash flow hedges.

Fair value hedges

26 While a fair value hedge meets the qualifying criteria in paragraph 19 during the hedged period, the hedge relationship shall be accounted for as follows:

- (a) The gain or loss from remeasuring the hedging instrument shall be recognised in other comprehensive income.
- (b) The hedging gain or loss on the hedged item shall be recognised and presented as a separate line item in the statement of financial position, and be recognised in other comprehensive income. The separate line item shall be presented next to the line item that includes the hedged asset or liability. The separate line item is presented within assets for those reporting periods for which the hedged item is an asset and within liabilities for those reporting periods for which the hedged item is a liability. Amounts included in these line items shall not remain in the statement of financial position when the assets or liabilities to which they relate are derecognised. When a hedged item is an unrecognised firm commitment (or a component thereof), the subsequent cumulative change in the fair value of the hedged item is recognised as an asset or liability with a corresponding gain or loss recognised in other comprehensive income.
- (c) The ineffective portion of the gain or loss from remeasuring the hedging instrument and the hedged item shall be transferred from other comprehensive income to profit or loss.

- 27 When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire a non-financial asset or assume a non-financial liability, the initial carrying amount of the non-financial asset or non-financial liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position.
- 28 The separate line item in the statement of financial position described in paragraph 26(b) shall be amortised to profit or loss if the hedged item is a financial instrument (or a component thereof) measured at amortised cost. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the separate line item ceases to be adjusted for changes in the fair value of the hedged item. The amortisation is based on a recalculated effective interest rate at the date amortisation begins (taking into account the carrying amounts of the separate line item and the financial instrument that it relates to).

Cash flow hedges

- 29 While a cash flow hedge meets the qualifying criteria in paragraph 19, it shall be accounted for as follows:
- (a) The separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):
 - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the change in the hedged expected future cash flows) from inception of the hedge.
 - (b) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.
 - (c) Any remaining gain or loss (ie hedge ineffectiveness) is recognised in profit or loss.
 - (d) The amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

- (i) If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is not a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence it does not affect other comprehensive income.
- (ii) For cash flow hedges other than those covered by (i) that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).
- (iii) However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment (see IAS 1) the amount that is not expected to be recovered.

30 When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 24 and 25) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 29(a) as follows:

- (a) If the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur. When the future cash flows occur, paragraph 29(d) applies.
- (b) If the hedged future cash flows are no longer expected to occur, that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1). A hedged future cash flow that is no longer highly probable of occurring may still be expected to occur.

Hedges of a net investment in a foreign operation

- 31 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IAS 21), shall be accounted for similarly to cash flow hedges:
- (a) The portion of the gain or loss on the hedging instrument that is determined an effective hedge (see paragraph 29) shall be recognised in other comprehensive income.
 - (b) The ineffective portion shall be recognised in profit or loss.
- 32 The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the cash flow hedge reserve shall be reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1) in accordance with paragraphs 48–49 of IAS 21 on the disposal or partial disposal of the foreign operation.

Accounting for the time value of options

- 33 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option (see paragraph 8(a)), it shall account for the time value of the option as follows (see paragraphs B67–B69):
- (a) An entity shall distinguish the time value of options by the type of hedged item that the option hedges:
 - (i) a transaction related hedged item; or
 - (ii) a time period related hedged item.
 - (b) The change in fair value of the time value of an option that hedges a transaction related hedged item shall be recognised in other comprehensive income to the extent that it relates to the hedged item. The cumulative change in fair value arising from the time value of the option that has been accumulated in a separate component of equity (the amount) shall be accounted for as follows:
 - (i) If the hedged item subsequently results in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied, the entity shall remove the amount from the separate component of equity and include it directly in the initial cost or other carrying amount of the asset or liability.

This is not a reclassification adjustment (see IAS 1) and hence does not affect other comprehensive income.

- (ii) For hedging relationships other than those covered by (i), the amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, when a forecast sale occurs).
 - (iii) However, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered shall be reclassified into profit or loss as a reclassification adjustment (see IAS 1).
- (c) The change in fair value of the time value of an option that hedges a time period related hedged item shall be recognised in other comprehensive income to the extent that it relates to the hedged item and be accumulated in a separate component of equity. The original time value paid to the option writer or seller, to the extent that it relates to the hedged item, shall be amortised on a rational basis over the term of the hedging relationship. Hence, in each period the amortisation amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see IAS 1). However, if hedge accounting is discontinued for the hedging relationship that includes the change in intrinsic value of the option as the hedging instrument, the net amount (ie including cumulative amortisation) that has been accumulated in the separate component of equity shall be immediately reclassified into profit or loss as a reclassification adjustment (see IAS 1).

Hedges of a group of items

Eligibility of a group of items as the hedged item

- 34 A group of items (including a group of items that constitute a net position, see paragraphs B70–B76) is an eligible hedged item only if:
- (a) it consists of items (including components of items) that individually are eligible hedged items;
 - (b) the items in the group are managed together on a group basis for risk management purposes; and

- (c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, affect profit or loss in the same and only in that reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).

Designation of a component of a nominal amount

- 35 A percentage component of an eligible group of items is an eligible hedged item provided that designation is consistent with the entity's risk management objective.
- 36 A layer component of an overall group of items (eg a bottom layer) is eligible for hedge accounting only if:
- (a) it is separately identifiable and reliably measurable;
 - (b) the risk management objective is to hedge a layer component;
 - (c) the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not dependent on which items from the overall group form part of the hedged layer);
 - (d) for a hedge of existing items (eg an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements regarding the accounting for qualifying hedges); and
 - (e) the items in the group do not contain prepayment options other than those whose fair value is not affected by the hedged risk.

Presentation

- 37 For a hedge of a group of items with offsetting hedged risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss shall be presented in a separate line from those affected by the hedged items.
- 38 For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss on the assets and liabilities shall be recognised in the statement of financial position in accordance with paragraph 26(b). The gain or loss shall be presented on a gross basis next to each line item that includes the related asset or liability.

Nil net positions

- 39 When the hedged item is a group that is a nil net position (ie the hedged items among themselves fully offset the risk that is managed on a group basis) an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument provided that:
- (a) the hedge is part of a rolling net risk hedge strategy for a hedged position that changes in size over time;
 - (b) over the life of the rolling net risk hedge strategy eligible hedging instruments will be used to hedge the net risk (ie when the net position is not nil);
 - (c) hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and
 - (d) not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes as the accounting would not recognise the offsetting risk position that would otherwise be recognised in a hedge of a net position.

Disclosures

- 40 Hedge accounting disclosures shall provide information about:
- (a) an entity's risk management strategy and how it is applied to manage risk;
 - (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
 - (c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.
- 41 An entity shall present the required disclosures in a single note or separate section in its financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

- 42 When paragraphs 44–52 require the entity to separate by risk category the information disclosed, the entity shall determine each category of risk on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. An entity shall determine risk categories consistently for all hedge accounting disclosures.
- 43 To meet the objectives in paragraph 40, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need any additional information to evaluate the quantitative information disclosed. However, when an entity determines the level of aggregation or disaggregation, it shall consider the level of aggregation or disaggregation it uses for other disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.

The risk management strategy

- 44 An entity shall explain its risk management strategy for each category of risk exposure that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate (for example):
- (a) how each risk arises.
 - (b) how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item.
 - (c) the extent of risk exposures that the entity manages.

The amount, timing and uncertainty of future cash flows

- 45 For each category of risk exposure, an entity shall disclose 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.
- 46 An entity shall provide a breakdown that discloses, for each subsequent period that the hedging relationship is expected to affect profit or loss, the following:

- (a) the monetary amount or other quantity (eg tonnes, cubic metres) to which the entity is exposed for each particular risk (for hedges of groups of items, an entity shall explain the risk exposure in the context of a group or net position);
 - (b) the amount or quantity of the risk exposure being hedged; and
 - (c) in quantitative terms, how hedging changes the exposure (ie the exposure profile after hedging such as the average rate at which the entity has hedged that exposure).
- 47 For each category of risk, an entity shall disclose a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.
- 48 If other sources of hedge ineffectiveness emerge in a hedging relationship, an entity shall disclose those sources and explain the resulting hedge ineffectiveness.

The effects of hedge accounting on the primary financial statements

- 49 An entity shall 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 (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):
- (a) the carrying amount of the hedging instruments (financial assets separately from financial liabilities); and
 - (b) the notional amounts or other quantity (eg tonnes or cubic metres) related to the hedging instruments.
- 50 An entity shall disclose, in a tabular format, the following amounts related to hedged items separately by category of risk for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):
- (a) for fair value hedges:
 - (i) the carrying amount of the accumulated gains or losses on the hedged item presented in a separate line item in the statement of financial position, separating assets from liabilities; and

- (ii) the balance remaining in the statement of financial position of any hedges for which hedge accounting has been discontinued.
 - (b) for cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) the balance in the cash flow hedge reserve for continuing hedges that will be reclassified when the hedged item affects profit or loss; and
 - (ii) the balance remaining in the cash flow hedge reserve from any hedges for which hedge accounting has been discontinued.
- 51 An entity shall disclose, in tabular format, the following amounts separately by category of risk for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):
- (a) for fair value, cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) changes in the value of the hedging instrument recognised in other comprehensive income;
 - (ii) hedge ineffectiveness recognised in profit or loss;
 - (iii) a description of the line item(s) in the income statement in which hedge ineffectiveness is included.
 - (b) for fair value hedges, the change in the value of the hedged item.
 - (c) for cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) for hedges of net positions, the hedging gains or losses recognised in a separate line item in the income statement (see paragraph 37);
 - (ii) the amount reclassified from the cash flow hedge reserve into profit or loss as a reclassification adjustment (see IAS 1) (differentiating between amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss); and
 - (iii) a description of the line item in the income statement affected by the reclassification adjustment (see IAS 1).

- 52 An entity shall provide a reconciliation of accumulated other comprehensive income in accordance with IAS 1, either in the statement of changes in equity or in the notes to the financial statements, that:
- (a) allows users of its financial statements to identify the amounts that relate to the disclosures in paragraph 51(a)(i), (c)(i) and (c)(ii);
 - (b) differentiates between amounts associated with the time value of options that hedge transaction related hedged items and amounts associated with the time value of options that hedge time period related hedged items when an entity accounts for the time value of an option in accordance with paragraph 33 (see paragraphs B67–B69).

Effective date and transition

- 53 An entity shall apply this [draft] IFRS prospectively for annual periods beginning on or after 1 January 2013 with earlier application permitted. The disclosure requirements of this [draft] IFRS need not be applied in comparative information provided for periods before initial application of the [draft] IFRS. However, the hedge accounting requirements in this [draft] IFRS can be applied only if all existing IFRS 9 requirements are adopted at the same time or have already been adopted.
- 54 To apply hedge accounting from the date of adoption of this [draft] IFRS, all qualifying criteria must be met as at that date.
- 55 Hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the criteria of this [draft] IFRS (see paragraph 19) shall be regarded as continuing hedging relationships.

Appendix A

Defined terms

This appendix is an integral part of the IFRS.

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

- (a) derivative
- (b) effective interest method
- (c) equity instrument
- (d) fair value
- (e) financial asset
- (f) financial instrument
- (g) financial liability

firm commitment

A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

forecast transaction

An uncommitted future transaction that is expected.

Appendix B

Application guidance

This appendix is an integral part of the [draft] IFRS.

Hedging instruments

Qualifying instruments

- B1 Derivatives that are embedded in hybrid contracts but are not separately accounted for cannot be designated as hedging instruments.
- B2 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.
- B3 For hedges of foreign currency risk, an entity may designate as the hedging instrument a foreign currency risk component of a non-derivative financial instrument determined in accordance with IAS 21.

Written options

- B4 This [draft] IFRS does not restrict the circumstances in which a derivative may be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

Designation of hedging instruments

- B5 For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument, it shall designate the non-derivative financial instrument in its entirety.
- B6 A single hedging instrument may be designated as a hedging instrument of more than one type of risk provided that the different risk positions are designated as hedged items.

Hedged items

Qualifying items

- B7 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.
- B8 An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge. This is because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.
- B9 Paragraph 15 permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative. When designating such a hedged item an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks). In that case the entity may designate the hedged item on the basis of the aggregated exposure. For example:
- (a) An entity may hedge a given quantity of expected coffee purchases in two years against price risk (based on US dollars) using a two-year futures contract for coffee. The expected coffee purchases and the futures contract for coffee in combination can be viewed as a two-year fixed amount US dollar foreign currency risk exposure for risk management purposes (ie like any fixed amount US dollar cash outflow in two years' time).
 - (b) An entity may hedge the foreign currency risk for the entire term of a 10-year fixed rate debt denominated in a foreign currency. However, the entity requires fixed rate exposure in its functional currency only for a short to medium term (say two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years' interest rate exposure (if the interest level is such that the entity wants to fix

interest rates). In such a situation it is common for an entity to enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate domestic currency exposure. This is overlaid with a two-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.

- B10 Paragraph 17 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.
- B11 If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive income in accordance with paragraph 29 shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Designation of hedged items

- B12 A component is a hedged item that is something less than the entire item. Therefore, a component reflects only some of the risks of the item of which it is a part or reflects the risks only to some extent (eg when designating a percentage of an item).

Risk components

- B13 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.
- B14 When identifying what risk components are eligible for designation as a hedged item, an entity assesses such risk components in the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market.
- B15 When designating risk components as hedged items, an entity considers whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or cash flows of an item of which they are a part (non-contractually specified risk components). Non-contractually specified risk components can relate to items that are not a contract (eg forecast transactions) or contracts that do not explicitly specify the component (eg a firm commitment that includes only one single price instead of a pricing formula that references different underlyings). For example:
- (a) Entity A has a long-term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (eg gas oil, fuel oil, and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Hence, because of the type of pricing formula, Entity A concludes that the gas oil price exposure is separately identifiable. At the same time there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable. Therefore, the gas oil price exposure in the

supply contract is a risk component that is eligible for designation as a hedged item.

- (b) Entity B hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the coverage volume over time. Entity B hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity B uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity B uses gas oil derivatives because they are sufficiently liquid. For time horizons up to 6 months Entity B uses jet fuel contracts. On the basis of its analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances, Entity B concludes that although crude oil and gas oil are not specified in any contractual arrangement there is a relationship between their prices and the jet fuel prices. This relationship results from different refining margins (also known as cracking spreads) that allow the entity to look at the hedging relationship as a ‘building block’. Therefore, Entity B is exposed to two different risks: the crude oil price and the refining margins for different types of distillates. Entity B concludes that these are two risk components that are separately identifiable and reliably measurable even though they are not contractually specified. Therefore, Entity B may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil).

- B16 When designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. For example, the hedging relationship must meet the hedge effectiveness requirements, including determining a hedge ratio so that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness, and any hedge ineffectiveness must be measured and recognised.
- B17 An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast

commodity purchase. In such a situation, the entity designates only cash flow losses that result from an increase in the price above the specified level. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss.

- B18 Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified. A contractually specified inflation component of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation component.

Components of a nominal amount

- B19 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. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.
- B20 An example of a percentage component of a nominal amount is 50 per cent of the contractual cash flows of a loan.
- B21 A layer component may be specified from a defined, but open, population or from a defined nominal amount. Examples include:
- (a) a part of a monetary transaction volume, eg the next FC10* cash flows from sales denominated in a foreign currency after the first CU20* in March 201X;
 - (b) a part of a physical volume, eg 50,000 cubic metres of the natural gas stored in location XYZ;
 - (c) a part of a physical or other transaction volume, eg the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or
 - (d) a layer of the nominal amount of the hedged item, eg the last CU80 million of a CU100 million firm commitment or the bottom layer

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

of CU20 million of a CU100 million fixed rate bond (the defined nominal amount is CU100 million).

- B22 If a layer component is designated in a fair value hedge, an entity shall specify it from a defined nominal amount. To comply with the requirements for qualifying fair value hedges, an entity shall remeasure the hedged item for fair value changes (ie remeasure the item for fair value changes attributable to the hedged risk). The change in fair value of the hedged item is recognised as a separate asset or liability. It must be recognised in profit or loss no later than when the item ceases to exist or is transferred and derecognised. Therefore, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal component from which it is defined. For example in paragraph B21(d), the total fixed rate bond must be tracked in order to track the bottom layer of CU20 million.
- B23 A layer component of a contract that includes a prepayment option is not 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.

Relationship between components and the total cash flows of an item

- B24 If a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or equal to the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate
- (a) a component of the liability equal to the principal amount plus interest at LIBOR; and
 - (b) a negative residual component.
- B25 However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the change in the value of the cash flows of that entire liability (ie principal plus interest at LIBOR minus 100 basis points) that is attributable to changes in LIBOR. The entity would choose a hedge ratio that meets the objective of the hedge effectiveness assessment (see paragraph B29).

- B26 If a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. For example, assume that an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates the related LIBOR interest rate risk as the hedged item, the effective yield of the asset based on its then fair value of CU90 would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR component of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie CU90) and the amount repayable on maturity (ie CU100).

Qualifying criteria for hedge accounting

Hedge effectiveness

- B27 Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item (eg when the hedged item is a risk component the change in fair value or cash flows of an item attributable to the hedged risk). Hedge ineffectiveness is the extent to which there is no such offset or the changes in the fair value or cash flows of the hedging instrument more than offset those on the hedged item.
- B28 When designating a hedging relationship and on an ongoing basis, an entity shall analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates in accordance with paragraph B60 arising from rebalancing a hedging relationship) is the basis for the entity's expectations of hedge ineffectiveness for the hedging relationship.

Objective and extent of offset

- B29 The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness. This means an entity has no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result. However, this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting.
- B30 An entity considers the relationship between the weightings of the hedging instrument and the hedged item (the hedge ratio) when assessing whether the hedging relationship will 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 A and that commodity usually trades at about 90 per cent of the price for the exchange-traded benchmark grade of the same commodity in Location B. 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 benchmark grade of the commodity in Location B 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 effectiveness.
- B31 An entity also assesses whether the expected offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is other than accidental by analysing the economic relationship between the hedged item and the hedging instrument. This includes an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. Hence, for example, a statistical correlation between two variables that have no substantive economic relationship would not support a valid expectation of other than accidental offsetting. Another example of a lack of a valid expectation of other than accidental offsetting is when the relationship between the changes in the value of the hedging instrument and the hedged item breaks down. For example, an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, any offsetting between the change in the fair value of the

hedging instrument and the hedged item's fair value or cash flows might become accidental. This is because the effect of the changes in the credit standing of the counterparty is unrelated to the hedged commodity price risk and affects only the hedging instrument. Hence, that effect might outweigh the effect of changes in the commodity price, which affects both the hedging instrument and the hedged item.

Frequency of assessing whether the hedge effectiveness requirements are met

- B32 An entity shall assess at the inception of the hedging relationship and on an ongoing basis whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge ineffectiveness and offsetting and therefore is only forward-looking.

Methods for assessing whether the hedge effectiveness requirements are met

- B33 This [draft] IFRS does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements, including determining the hedge ratio. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors the method can be a qualitative or a quantitative assessment.
- B34 For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging relationship will probably achieve systematic offset and that the hedge ineffectiveness, if any, would not be expected to produce a biased result. This qualitative assessment might also allow the entity to determine an appropriate hedge ratio (eg 1:1 or as determined by simple ratio calculation) and also support an expectation that that hedge ratio would minimise any hedge ineffectiveness.

- B35 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether the hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.
- B36 Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty regarding the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that the hedging relationship is likely to achieve systematic offset and that the hedge ineffectiveness would not be expected to produce a biased result. Similarly, the entity might also need a quantitative assessment to determine an appropriate hedge ratio (eg determined by regression analysis or on the basis of a long-term average ratio between variables) and to support an expectation that that hedge ratio would minimise any hedge ineffectiveness. An entity can use the same or different methods for the different purposes (eg to determine the hedge ratio and to ascertain whether the hedging relationship is expected to achieve other than accidental offsetting).
- B37 If there are changes in circumstances that affect hedge effectiveness, an entity might have to change the method for assessing whether a hedging relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness are still captured.
- B38 An entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets the hedge effectiveness requirements. This means management information (or analysis) used for decision-making purposes can be used as a basis to assess whether a hedging relationship meets the hedge effectiveness requirements.
- B39 An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements including the method or methods used.

Accounting for qualifying hedges

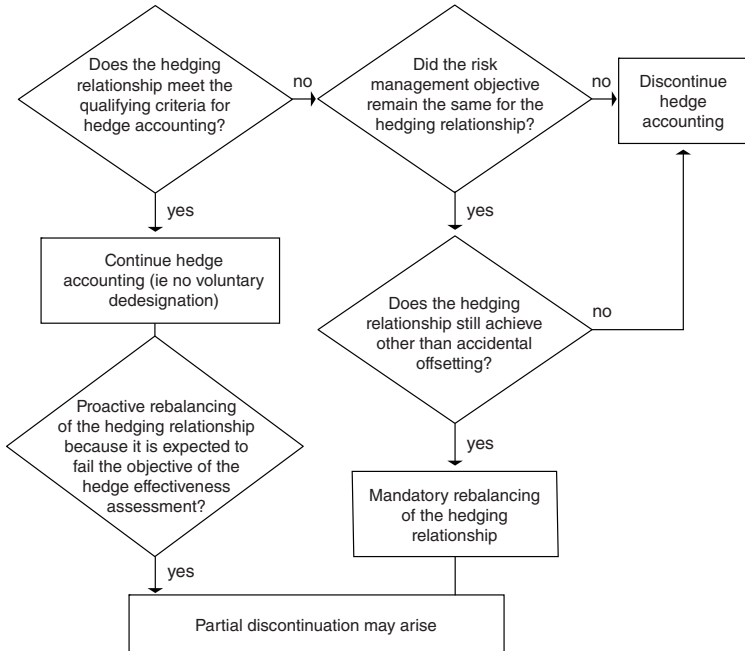
- B40 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument arising from changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.
- B41 An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction in which the future cash flows being hedged are the future interest payments).
- B42 A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, in accordance with paragraph 22 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Measurement of hedge ineffectiveness

- B43 When measuring hedge ineffectiveness, an entity shall consider the time value of money. Hence, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.
- B44 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item and would be at the money at the time of designation of the hedging relationship (this is commonly referred to as a 'hypothetical derivative'). This is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach.
- B45 The change in the value of the hedged item determined using a hypothetical derivative may also be used for the purpose of assessing whether a hedging relationship meets the hedge effectiveness requirements.

Rebalancing the hedging relationship and changes to the hedge ratio

B46 The following flow chart illustrates the evaluation when a hedging relationship is rebalanced.



- B47 If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so, an entity determines whether the risk management objective for that hedging relationship remains unaltered. If so, the hedging relationship is adjusted so that the new hedge ratio again meets, or is no longer expected to cease to meet, the objective of the hedge effectiveness assessment (rebalancing). Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B48–B60. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship.
- B48 Adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item arising from their underlyings or risk variables. For example, a hedging relationship in which the hedging instrument and the hedged item have different but related underlyings changes in response to a change in basis risk that affects the relationship between these two underlyings (eg different but related reference indices, rates or prices). Hence, rebalancing allows continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.
- B49 For example, an entity hedges an exposure to foreign currency A using a currency derivative that references foreign currency B and currencies A and B are pegged (ie their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the exchange rate between currencies A and B were changed (ie a new band or rate was set) rebalancing the hedging relationship to reflect the new exchange rate would ensure that the hedging relationship meets the objective of the hedge effectiveness assessment in the new circumstances. In contrast, if there were a default on the currency derivative changing the hedge ratio could not ensure that the hedging relationship meets the objective of the hedge effectiveness assessment. Hence, rebalancing does not facilitate continuing a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.

- B50 Not every change in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows constitutes a change in the relationship between the hedging instrument and the hedged item. An entity analyses the sources of hedge ineffectiveness that it expected to affect the hedging relationship during its term and evaluates whether changes in the extent of offset are:
- (a) fluctuations around the hedge ratio that remains valid (ie continues to appropriately reflect the relationship between the hedging instrument and the hedged item); or
 - (b) an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

An entity performs this evaluation against the objective of the hedge effectiveness assessment, ie whether the hedge ratio still ensures that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Hence, this evaluation requires judgement.

- B51 Fluctuation around a constant hedge ratio (and hence the related hedge ineffectiveness) cannot be minimised by adjusting the hedge ratio in response to each particular outcome. Hence, in such circumstances, the change in the extent of offset is a matter of measuring and recognising hedge ineffectiveness but not of adjusting the hedge ratio, ie it does not result in rebalancing.
- B52 Conversely, if changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio, hedge ineffectiveness can be minimised by adjusting the hedge ratio whereas retaining the hedge ratio would increasingly produce a biased result and hedge ineffectiveness. Hence, in such circumstances, the change in the extent of offset is a matter of adjusting the hedge ratio and therefore requires rebalancing the hedging relationship. In addition, it is also a matter of measuring and recognising hedge ineffectiveness because, on rebalancing, the hedge ineffectiveness of the hedging relationship must be determined and recognised in profit or loss immediately before adjusting the hedging relationship in accordance with paragraph B47.

- B53 If the risk management objective for a hedging relationship has changed rebalancing does not apply. Instead, hedge accounting for that hedging relationship shall be discontinued (notwithstanding that an entity might designate a new hedging relationship that involves the hedging instrument or hedged item of the previous hedging relationship as described in paragraph B66).
- B54 If a hedging relationship is rebalanced the adjustment of the hedge ratio can be effected in different ways:
- (a) The weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:
 - (i) increasing the volume of the hedged item; or
 - (ii) decreasing the volume of the hedging instrument.
 - (b) The weighting of the hedging instrument can be increased (which at the same time reduces the weighting of the hedged item) by:
 - (i) increasing the volume of the hedging instrument; or
 - (ii) decreasing the volume of the hedged item.

Changes in volume refer to the quantities that are part of the hedging relationship. Hence, decreases in volumes do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur but that they are not part of the hedging relationship. For example, decreasing the volume of the hedging instrument can result in the entity retaining a derivative but only part of it might remain a hedging instrument of the hedging relationship. This could occur if the rebalancing could be effected only by reducing the volume of the hedging instrument in the hedging relationship, but the change in the volume is such that it does not allow the entity to unwind the part of the hedging instrument that is no longer needed (eg because of the minimum lot size of a standardised derivative contract). In that case the undesignated part of the derivative would be accounted for at fair value through profit or loss (unless it was designated as a hedging instrument in a different hedging relationship).

- B55 Adjusting the hedge ratio by increasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedged item also include the change in the value of the additional volume of the hedged item. These changes are measured

starting from and by reference to the date of rebalancing rather than the date on which the hedging relationship was designated. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 (the forward price at inception of the hedging relationship) and added a volume of 10 tonnes on rebalancing when the forward price was CU90, the hedged item after rebalancing would comprise two layers: 100 tonnes hedged at CU80 and 10 tonnes hedged at CU90.

- B56 Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and reduces that volume by 10 tonnes on rebalancing, a notional amount of 90 tonnes of the hedging instrument volume would remain (see paragraph B54 regarding the consequences for decreasing the derivative volume (ie the 10 tonnes) that is no longer a part of the hedging relationship).
- B57 Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the fair value of the hedged item are measured. The measurement of the changes in the value of the hedging instrument regarding the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedging instrument also include the change in the value of the additional volume of the hedging instrument. The changes are measured starting from and by reference to the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and added a volume of 10 tonnes on rebalancing, the hedging instrument after rebalancing would comprise a total derivative volume of 110 tonnes. The change in the fair value of the hedging instrument is the total change in fair value of the derivatives that make up the total volume of 110 tonnes. These derivatives could (and probably would) have different critical terms, such as their forward rates, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition).

- B58 Adjusting the hedge ratio by decreasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item regarding the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price CU80 and reduces that volume by 10 tonnes on rebalancing, the hedged item after rebalancing would be 90 tonnes hedged at CU80. The 10 tonnes of the hedged item that are no longer part of the hedging relationship would be accounted for in accordance with the requirements for discontinuation of hedge accounting (see paragraphs 23, 24, 30 and B61–B66).
- B59 An entity may rebalance a hedging relationship if it aims to ensure that the hedging relationship will continue to meet the objective of the hedge effectiveness assessment (ie the adjustment aims at reducing the likelihood of ceasing to meet the objective in the future). For example, an entity might expect that a hedging relationship will cease to meet the objective of the hedge effectiveness assessment at a future date. The entity observes changes in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows that follow an unusual pattern. The entity considers that the pattern might still reflect fluctuations around the currently used hedge ratio but that it might also signal that a trend is emerging that leads away from the currently used hedge ratio. The entity uses its judgement and decides that although the hedging 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 medium term. Hence, the entity is permitted to rebalance the hedging relationship.
- B60 When rebalancing a hedging relationship, an entity shall update its analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its (remaining) term (see paragraph B28). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of hedge accounting

- B61 Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.

- B62 An entity shall not de-designate and thereby discontinue a hedging relationship that:
- (a) still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (ie the entity still pursues that risk management objective and strategy); and
 - (b) continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).
- B63 The discontinuation of hedge accounting can affect:
- (a) a hedging relationship in its entirety; or
 - (b) a part of a hedging relationship (which means hedge accounting continues for the remainder of the hedging relationship).
- B64 A hedging relationship is discontinued in its entirety when as a whole it ceases to meet the qualifying criteria. For example:
- (a) The hedging relationship no longer meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective and strategy).
 - (b) The hedging instrument or instruments have been sold or terminated (regarding the entire volume that was part of the hedging relationship).
 - (c) The offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is no longer expected to be other than accidental (eg when the hedging instrument experiences a severe credit deterioration).
- B65 A part of a hedging relationship is discontinued (and hedge accounting continues for its remainder) when only a part of the hedging relationship ceases to meet the qualifying criteria. For example:
- (a) On rebalancing of the hedging relationship, the hedge ratio might be adjusted such that some of the volume of the hedged item is no longer part of the hedging relationship (see paragraph B58); hence, hedge accounting is discontinued only for the volume of the hedged item that is no longer part of the hedging relationship.
 - (b) When the occurrence of some of the volume of the hedged item that is (or is a component of) a forecast transaction is no longer highly probable, hedge accounting is discontinued only for the volume of the hedged item whose occurrence is no longer highly

probable. However, if an entity has a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur, the entity's ability to predict forecast transactions accurately is called into question when predicting similar forecast transactions. This affects the assessment whether similar forecast transactions are highly probable (see paragraph 14) and hence whether they are eligible as hedged items.

B66 An entity can designate a new hedging relationship that involves the hedging instrument or hedged item of a previous hedging relationship for which hedge accounting was (in part or in its entirety) discontinued. This does not constitute a continuation of a hedging relationship but is a restart. For example:

- (a) A hedging instrument experiences such a severe credit deterioration that the entity replaces it with a new hedging instrument. This means the original hedging relationship failed to achieve the risk management objective and is hence discontinued in its entirety. The new hedging instrument is designated as the hedge of the same exposure that was hedged previously and forms a new hedging relationship. Hence, the changes in the fair value or cash flows of the hedged item are measured starting from and by reference to the date of designation of the new hedging relationship instead of the date on which the original hedging relationship was designated.
- (b) A hedging relationship is discontinued before the end of its term. The item that was the hedging instrument in that hedging relationship can be designated as the hedging instrument in another hedging relationship (eg when adjusting the hedge ratio on rebalancing by increasing the volume of the hedging instrument or when designating a whole new hedging relationship).

Accounting for the time value of options

B67 An entity shall assess the type of hedged item (see paragraph 33(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

- (a) The time value of an option relates to a transaction related hedged item if the nature of the hedged item is that of transaction costs. An example is when the time value of an option relates to a hedged item that results in the recognition of an item whose initial

measurement includes transaction costs (eg an entity hedges a commodity purchase, whether it is a forecast transaction or a firm commitment, against commodity price risk and includes the transaction costs in the initial measurement of the inventory). Similarly, an entity that hedges a sale of a commodity, whether it is a forecast transaction or a firm commitment, would include the time value of the option as part of the cost related to that sale (hence, the time value would be recognised in profit or loss in the same period as the revenue from the hedged sale).

- (b) The time value of an option relates to a time period related hedged item if the nature of the hedged item is that of the cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of transaction cost in accordance with (a)). For example, if a commodity inventory is hedged for six months using a commodity option with a corresponding life, the time value of the option would be allocated to profit or loss (ie amortised on a rational basis) over that six-month period.
- B68 The accounting for the time value of options in accordance with paragraph 33 applies only to the extent that the time value relates to the hedged item (aligned time value). The time value of an option relates to the hedged item if the critical terms of the option (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the option and the hedged item are not fully aligned an entity shall determine the aligned time value, ie how much of the time value included in the premium paid (actual time value) relates to the hedged item (and therefore should be treated in accordance with paragraph 33). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.
- B69 If the actual time value and the aligned time value differ an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 33 as follows:
- (a) If, at inception of the hedging relationship, the actual time value is higher than the aligned time value the entity shall:
- (i) determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
 - (ii) account for the differences in the fair value changes between the two time values in profit or loss.

- (b) If, at inception of the hedging relationship, the actual time value is lower than the aligned time value the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
- (i) the actual time value; and
 - (ii) the aligned time value.

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

Hedge of a group of items

- B70 A net position is eligible for hedge accounting only if an entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact (not only of assertion or documentation). Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy. Normally this would be approved by key management personnel as defined in IAS 24 *Related Party Disclosures*.
- B71 For example, Entity A, whose functional currency is its local currency has a firm commitment to pay FC150,000 for advertising expenses in nine months' time and a firm commitment to sell finished goods for FC150,000 in 15 months' time. Entity A enters into a foreign currency derivative that settles in nine months' time under which it receives FC100 and pays CU70. Entity A has no other exposures to FC. Entity A does not manage foreign currency risk on a net basis. Hence, Entity A cannot apply hedge accounting for a hedging relationship between the foreign currency derivative and a net position of FC100 (consisting of FC150,000 of the firm purchase commitment—ie advertising services—and FC149,900 (of the FC150,000) of the firm sale commitment) for a nine-month period.
- B72 If Entity A did manage foreign currency risk on a net basis and did not enter into the foreign currency derivative (because it increases its foreign currency risk exposure instead of reducing it) then the entity would be in a natural hedged position for nine months. Normally this hedged position would not be reflected in the financial statements because the transactions are recognised in different reporting periods in the future. The nil net position would be eligible for hedge accounting only if the conditions in paragraph 39 are met.

- B73 When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. The entity cannot designate an abstract amount of a net position up to FC20. Instead, it must designate a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position. An entity shall designate gross positions that give rise to the net position so that the entity is able to comply with the requirements for the accounting for qualifying hedges.

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

- B74 When an entity hedges a group of items with offsetting risks (eg a net position) that affect profit or loss in *different* reporting periods, the eligibility for hedge accounting depends on the type of hedge. If the hedge is a fair value hedge then the net position may be eligible as a hedged item. If, however, the hedge is a cash flow hedge then the net position is not eligible as a hedged item.
- B75 Offsetting value changes in a group of hedged items in a cash flow hedge will naturally offset in net profit or loss if they are recognised in the same reporting period. If, however, the offsetting risk positions affect profit or loss in different reporting periods, then this natural offset is not achieved. An entity cannot gross up net hedging instrument gains or losses for recognition in different periods, nor can it defer value changes from one hedged item to match the later recognition of another hedged item. As a result, cash flow hedge accounting is not permitted for groups of items with offsetting cash flows that affect profit or loss in different reporting periods.
- B76 For example, an entity has a net position of FC50 consisting of forecast sales of FC100 in 12 months' time and forecast purchases of FC150 in 20 months' time. This could be hedged for 12 months using a forward foreign exchange contract under which the entity receives FC50 and pays CU25 (ie a 2:1 forward exchange rate). When the sale is recognised in profit or loss it will be measured at the spot exchange rate in accordance with IAS 21. Reclassifying, into profit or loss when the sale is recognised, any amount of the gain or loss deferred in other comprehensive income from the hedging instrument would exaggerate any variability in profit or loss arising from changes in the exchange rate over the 12-month period. This

is because the entity receives foreign currency in accordance with both the sale and the forward foreign exchange contract. To mitigate the variability arising in profit or loss from the sale, it would be necessary to defer some of the value change on the sale in other comprehensive income to match the later recognition of the purchase. This deferral of value changes is not permitted.

Layers of groups of items designated as the hedged item

- B77 For the same reasons noted in paragraph B22, designating layer components of groups of existing items requires the specific identification of the nominal amount of the group of items from which the hedged layer component is defined.
- B78 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.

Presentation of hedging instrument gains or losses

- B79 If items are hedged together as a group in a cash flow hedge, the items might affect different line items in the income statement. The presentation in the income statement of the hedging instrument gains or losses reclassified from other comprehensive income will depend on the group of items.
- B80 If the group of items does not have any offsetting hedged risk positions (eg a group of foreign currency expenses that affect different line items in the income statement, hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment should be done on a rational basis and should not result in the grossing up of the net gains or losses arising from a single hedging instrument.
- B81 If the group of items does have offsetting risk positions (eg a group of sales and expenses denominated in a foreign currency hedged together for foreign currency risk) then an entity shall present the reclassified hedging instrument gains or losses in a separate line item in the income statement. For example, consider a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency

expenses of FC80 using a forward exchange contract for FC20. The gain or loss reclassified from other comprehensive income to profit or loss (when the net position affects profit or loss) shall be presented in a separate line item.

- B82 For some types of fair value hedges the objective of the hedge is not primarily to offset the fair value change of the hedged item but rather to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in profit or loss. In case of a net position hedge (eg a net position of a fixed rate asset and a fixed rate liability), this net interest accrual must be presented in a separate line item in the income statement. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising them in different line items (eg this avoids grossing up a net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense).

Appendix C

[Draft] Amendments to other IFRSs

The amendments [outlined] in this [draft] appendix shall be applied for annual periods beginning on or after January 2013. If an entity applies the [draft] amendments for an earlier period, it shall apply the amendments in this [draft] appendix for that earlier period.

Standard	Description of amendment
<ul style="list-style-type: none"> • IAS 32 <i>Financial Instruments: Presentation</i> 	<ul style="list-style-type: none"> • Amend paragraph 8 of the scope of IAS 32. 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 purchase, sale or usage requirements. An entity would account for such a contract 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, ie the entire business is managed on a fair value basis and the net exposure is maintained close to nil.
<ul style="list-style-type: none"> • IAS 39 <i>Financial Instruments: Recognition and Measurement</i> 	<ul style="list-style-type: none"> • Retain the hedge requirements in IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk. • Amend paragraph 5 of the scope of IAS 39. This would be similar to the amendment proposed for paragraph 8 of IAS 32.
<ul style="list-style-type: none"> • IFRS 7 <i>Financial Instruments: Disclosures</i> 	<ul style="list-style-type: none"> • Delete the disclosure requirements in paragraphs 22, 23(a), 23(c)–(e) and 24.
<ul style="list-style-type: none"> • IFRS 9 <i>Financial Instruments</i> 	<ul style="list-style-type: none"> • Amend references to hedge accounting in IFRS 9 in chapters other than chapter 6 <i>Hedge accounting</i> (for example paragraph 5.4.1).

Approval by the Board of *Hedge Accounting* published in December 2010

The exposure draft *Hedge Accounting* was approved for publication by fourteen of the fifteen members of the International Accounting Standards Board. Mr Smith voted against its publication. His alternative view is set out after the Basis for Conclusions.

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