

Hedge accounting under IFRS 9 – a closer look at the changes and challenges

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1. Introduction

The International Accounting Standards Board (IASB) issued an Exposure Draft *Hedge Accounting* (the ED) in December 2010, being the proposals for the third part of IFRS 9, the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. A summary of the highlights of the ED is contained in our *Supplement to IFRS Outlook* issue 91.

The high-level aim of the ED is to simplify hedge accounting. Specifically, it aims to provide a better link between an entity's risk management strategy, the rationale for hedging and the impact of hedging on the financial statements. The proposals represent a fundamental shift from the way entities have applied hedge accounting in the past. Potentially, financial reporting will reflect more accurately how an entity manages its risk and the extent to which hedging practices mitigate those risks, as a result of these proposals.

Snapshot of the proposed hedge accounting model

OVERALL: Align with risk management objectives

- ▶ Identify and measure risk components that are eligible as hedged items
- ▶ Designate hedges with qualifying hedging instruments and hedged items
- ▶ Perform prospective hedge effectiveness assessment
- ▶ Rebalance the hedge relationship, when necessary
- ▶ De-designate when risk management objective changes; voluntary de-designation is not permitted
- ▶ Provide additional disclosures

BOTTOM LINE: Measure ineffectiveness and recognise it in profit or loss

The most significant benefits are likely to be realised by non-financial services entities. For example, hedge accounting will now be permitted for components of non-financial items (such as certain commodities), provided certain criteria can be satisfied. While so-called 'macro hedging' has not yet been addressed, and will be the subject of a further ED later this year, banks and other financial institutions also stand to gain from the new proposals.

Under the ED, hedge effectiveness testing will be simpler as it will only be required on a prospective basis. Previously, it was necessary to perform retrospective and prospective tests. Qualitative testing will be possible where appropriate and there will be no arbitrary bright lines in the new model.

Ernst & Young welcomes the IASB's efforts to reduce the complexity of hedge accounting and to provide a principles-based approach that can be consistently applied for both financial services entities and other entities. We are supportive of the overall intent and direction of the proposals, although we do have concerns on a number of points of detail, mainly with respect to clarifying the wording of the ED.

We expect the insights in this publication to be particularly relevant for accountants, treasurers and all who are involved in hedging activities in both financial and non-financial services entities. The main changes proposed in the ED are summarised in Table 1. We have taken a closer look at the changes that have been proposed, and consider some of the potential benefits for entities in both the financial and non-financial services sectors. We also explore some of the challenges posed by the new proposals and how Ernst & Young's multi-disciplinary team can assist you in assessing the potential impact of the IASB's new proposals on your business.

The discussions in this publication are based on our preliminary assessments of the ED; it is likely that additional issues may be identified through continued analysis and when the new principles are applied in practice. We trust that this publication will be useful in evaluating these proposals and in responding to the IASB during the comment period which ends on 9 March 2011.

Table 1: Key differences between IAS 39 and the exposure draft

	IAS 39	The exposure draft
Risk management	<ul style="list-style-type: none"> ▶ Not necessarily linked to the objectives of hedge accounting 	<ul style="list-style-type: none"> ▶ Hedge accounting is expected to be more closely aligned
Hedged items	<ul style="list-style-type: none"> ▶ Several restrictions; non-financial items can only be hedged in their entirety or for foreign currency risk ▶ Derivatives are not permitted as hedged items 	<ul style="list-style-type: none"> ▶ Risk components that are separately identifiable and reliably measurable will be eligible, including those of non-financial items ▶ Layer components and combinations of derivatives and non-derivatives will also be eligible
Hedging instruments	<ul style="list-style-type: none"> ▶ Several restrictions apply to the types of hedging instruments that can be used in hedge relationships 	<ul style="list-style-type: none"> ▶ Some restrictions will be relaxed; any financial instrument measured at fair value through profit or loss will qualify ▶ Written options and internal derivatives will continue to be prohibited
Effectiveness assessment	<ul style="list-style-type: none"> ▶ Onerous requirements to perform retrospective and prospective testing ▶ Bright line test of 80-125% effectiveness for a hedge to remain highly effective ▶ Changes to hedge relationship would result in mandatory de-designation 	<ul style="list-style-type: none"> ▶ Testing is required only on a prospective basis ▶ No bright line tests ▶ Changes to hedge relationship may result in rebalancing of the hedge ratio rather than de-designation
Ineffectiveness	<ul style="list-style-type: none"> ▶ Measured on a retrospective basis and recognised in profit or loss 	<ul style="list-style-type: none"> ▶ No change proposed
Groups and net positions	<ul style="list-style-type: none"> ▶ Several restrictions for groups of gross positions, many difficulties in achieving hedge accounting ▶ Layer components of gross positions permitted only for forecast transactions ▶ Groups of net positions not permitted 	<ul style="list-style-type: none"> ▶ Items in gross positions must be individually eligible for hedge accounting and be managed on that basis for risk management ▶ Layer components now permitted for forecast as well as existing transactions, subject to some criteria ▶ Groups of net positions permitted subject to certain criteria
Fair value hedges	<ul style="list-style-type: none"> ▶ Hedge of the exposure to changes in fair value of a recognised asset or liability, or a previously unrecognised firm commitment, to buy or sell at a fixed price, or an identified portion that is attributable to a particular risk and could affect profit or loss. Mechanics involve: ▶ Hedged item being adjusted to reflect the offset achieved by the hedge relationship ▶ Changes in fair value of hedged item and hedging instrument being recorded in profit or loss 	<ul style="list-style-type: none"> ▶ No change proposed to definition; the mechanics would change as follows: ▶ Effect of hedge accounting will be reflected as a separate balance sheet line item ▶ Changes in fair value of both hedged item and hedging instrument will be recorded in OCI, and any ineffectiveness will be transferred to profit or loss immediately
Cash flow hedges	<ul style="list-style-type: none"> ▶ Hedge of the exposure to variability in cash flows attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction, which could affect profit or loss 	<ul style="list-style-type: none"> ▶ No change proposed
Hedges of net investments	<ul style="list-style-type: none"> ▶ Foreign currency exposure arising between the functional currencies of the foreign operation and the parent is permitted as a hedged item 	<ul style="list-style-type: none"> ▶ No change proposed



2. Risk management

IAS 39 does not provide an objective for hedge accounting, but instead presents various rules and restrictions as to the circumstances under which hedge accounting can be applied. By contrast, the ED introduces an objective for hedge accounting which is described as representing “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”. We believe this is a helpful step forward and facilitates a reduction in complexity by moving towards a less rules-based standard.

IAS 39 already requires that the ‘risk management objective’ is included within the hedge documentation required for hedge accounting. However, because there are so many rules concerning what can be a hedging instrument, what may be a hedged item and what sorts of relationships qualify for hedge accounting, the entity’s actual risk management strategy may be very different from that which is documented for accounting purposes. Consequently, the documented risk management objective is usually a generic description and interpreted to mean the hedge accounting objective (commonly, the avoidance of profit or loss volatility), rather than the economic strategy that led to hedging for risk management purposes. Although the ED uses the same term ‘risk management objective’ but does not define it, we believe that it is intended to refer to what is actually done for risk management purposes, rather than what is done to achieve an accounting outcome.

Would all risk management strategies qualify?

Although less so than IAS 39, the ED continues to constrain what can constitute a hedging instrument, a hedged item or a qualifying hedge relationship for accounting purposes. As a result, there will continue to be risk management strategies commonly undertaken (especially by financial institutions) that will not be possible to reflect in the entity’s hedge accounting. Consider the following examples where the risk management strategies are different from the entity’s objectives for applying hedge accounting.

- ▶ Banks typically pass on the interest rate risk on their banking book to the trading book by using internal derivatives; the internal derivatives form part of the trading book risk position that will be managed within their delegated risk limits. Therefore, it is possible that there will not be an external derivative that matches each internal derivative within the trading book. Since the ED precludes the use of internal derivatives as hedging instruments, there will be a disconnect between the bank’s combined risk management strategy and the permitted hedge accounting.
- ▶ An entity may have a risk management strategy to hedge the future foreign currency profits or dividend streams from its overseas subsidiaries. However, this is not an exposure eligible for hedge accounting under the new proposals. As a result, the entity may try to use net investment hedging to achieve hedge accounting instead.

Hence, entities whose risk management strategies will not qualify for hedge accounting are likely to continue to want to adjust their hedge designations for accounting purposes. Other examples could include:

- ▶ Hedges involving the use of foreign currency intercompany loans
- ▶ Fair value hedges of demand deposits (precluded since the IASB decreed that the fair value of a demand deposit cannot be less than its nominal value)
- ▶ Fair value hedges of a ‘bottom layer’ of prepayable assets (although this may be addressed by the Board’s deliberations on macro hedging)
- ▶ Cash flow hedges of a net position where hedged items impact profit or loss in different reporting periods
- ▶ Hedges of investments in equity instruments carried at fair value through OCI (under IFRS 9).

How we see it

Although the ED's less rule-based approach should allow hedge accounting to be much better aligned with risk management than under IAS 39, many entities will still not always be able to reflect their economic risk management objectives in their hedge accounting. We presume that the Board had intended the objectives of hedge accounting in the financial statements to be consistent with that of economic risk management, although this is not quite clear from the ED, as currently worded. We believe that the intent of the ED is to not to preclude entities from achieving hedge accounting in these instances, but to permit them to amend their designations so as to comply with the accounting rules. However, it is not clear how the entity's risk management objective should link to the hedge accounting strategy.

While we are supportive of what the ED is seeking to achieve, we consider that the linkage between an entity's economic risk management objective and its hedge accounting strategies needs to be better articulated.

Interaction with hedge effectiveness

Although entities are required to document their risk management strategy, the proposed qualifying criteria for hedge accounting do not specifically require that the objective will be met by the designated hedge relationship. Instead, the proposed objectives of the hedge effectiveness assessment are to ensure that:

- i) Changes in the value of the hedging instrument will not systematically either exceed or be less than the changes in the value of the hedged item, such that they will produce a 'biased' result

And

- ii) The expected offset between changes in the fair value of the hedging instrument and any hedged item's fair value or cash flows is not accidental

We discuss the use of the terms value and cash flows in more detail in Section 5.

This assessment is made on a prospective basis and there is no longer a need to examine whether the hedge has actually been effective in the period (although, as explained in more detail later, any actual ineffectiveness must always be reported in profit or loss). The assessment may be made qualitatively or quantitatively, depending on the expected level of effectiveness within the hedge itself.

If the hedge effectiveness assessment objective ceases to be met, the ED requires that consideration be given to whether the risk management objective remains the same for the hedge relationship. If it does, the hedge relationship must be adjusted through rebalancing, and, if not, the hedge relationship must be terminated. Therefore, changes in the risk management objective will affect whether hedge relationships should be terminated or be permitted to continue.

How we see it

As currently worded in the ED, it is not clear whether risk management and hedge accounting need to be perfectly aligned and whether any degree of tolerance is permissible to accommodate any differences. Furthermore, the ED requires termination of a hedge relationship if there is a change in the risk management objective, although it is not clear whether entities are allowed to consider materiality in evaluating such changes.



3. Hedged items

Items that were eligible for hedge accounting under IAS 39 will continue to be eligible under the ED's proposals. This includes recognised financial assets or financial liabilities, unrecognised firm commitments, highly probable forecast transactions and net investments in a foreign operation. Consistent with IAS 39, the ED also permits a proportion of these items or one-sided risks to be hedged. Besides, designations may be made for the forward or spot elements of a forward contract.

In this section, we focus on the additional items permitted as eligible hedged items, namely:

- ▶ An aggregated exposure comprising a derivative and a non-derivative - see discussion below
- ▶ Risk components of non-financial items - see discussion below
- ▶ Portions or layer components of items within fair value hedges - see section 7

We also discuss some of the restrictions in IAS 39 that have been retained:

- ▶ The prohibition of credit risk as a risk component

And

- ▶ The requirement that a risk component must be less than the whole (the "sub-LIBOR issue").

Derivatives as hedged items

The ED states that "an aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item." IAS 39 precluded derivatives from being part of a hedged item, so this is a significant change. However, although this treatment is helpful, it will not result in derivatives being accounted for at amortised cost. The benefit of the proposed treatment in the ED is that derivatives can be included within the risk profile of the hedged item, hence, when the effectiveness assessment and measurement is performed, it will include the impact of the hedged derivative.

For example, Entity A (functional currency: EUR) may wish to lock in the USD price of its coal purchases for the following year. Entity A's coal purchase for the following year is highly probable and priced in USD. Entity A transacts a coal swap in USD fixing the USD coal price. This is designated as a cash flow hedged for coal price risk. Three months later, Entity A wishes to hedge the FX exposure on the fixed USD coal price. The ED would permit Entity A to designate the hedged item in the FX hedge to be a fixed USD price,

i.e., a combination of the actual variable USD coal price and the USD coal swap, locking in a fixed EUR price. The second hedge relationship would not change the accounting for the first hedge relationship, but the second relationship is enhanced as the hedged item is not impacted by coal price fluctuations.

Applying IAS 39 to the same scenario, Entity A would have two choices:

- ▶ De-designate the first hedge relationship and re-designate a second relationship combining the coal swap and the FX contract as the hedging instrument. This is likely to lead to some ineffectiveness as the coal swap will have a non-zero fair value on designation of the second relationship
- ▶ Designate the FX contract as a hedge of the variable USD coal price, leaving the first relationship untouched. If the coal price is volatile, the hedge may fail if it is possible that the coal price falls below the locked in USD price as there will not be sufficient hedged item in the second hedge relationship.

It is clear that the ED that permits derivatives to be included within the hedged item. Therefore, we assume that this would also apply to highly probable forecast derivatives. An example where this guidance would be helpful is when pre-hedging interest rate risk in a forecast foreign currency debt issue.

It may be highly probable that an entity will issue fixed rate foreign currency debt in six months' time. On issuance, it is also highly probable that the entity will transact a cross currency swap, converting the debt to functional currency floating rate. The entity may wish to hedge itself against increases in the interest rate between today and the day it will issue the debt and lock in the functional currency interest rate by transacting a forward starting interest rate swap (which will be closed out at the time the debt is issued). We believe that, under the ED, it would be possible to designate the hedged item as the combination of the highly probable forecast debt and the highly probable forecast cross currency swap, where the hedging instrument will be the interest rate swap.

How we see it

The ability to include a derivative within a hedged item should be beneficial as it makes hedge accounting possible for certain common risk management strategies.



Risk components as hedged items

Under IAS 39, a non-financial item can only be designated as the hedged item for accounting purposes for its foreign currency risk or all its risks in their entirety (while there is no such restriction for financial items). Therefore, the change introduced by the ED, to permit a broader range of risk components of non-financial items which are eligible for hedge accounting, will be a welcome relief for many entities, especially in the non-financial services sectors. The advantage of identifying and designating a risk component of a non-financial item is that the hedging instrument only needs to offset the variability of the identified risk component rather than the risks of the entire non-financial item. This is likely to enable many more hedge relationships to qualify for hedge accounting and will result in less ineffectiveness in profit or loss. The other general hedge accounting requirements within the ED would also apply to such hedges.

Under IAS 39 it is already possible to designate a component for a financial instrument, so this proposed change in the ED provides a more consistent treatment for components of financial and non-financial items.

The ED allows specific risk components to be designated if they are “separately identifiable and reliably measurable”, regardless of whether they are part of a financial or a non-financial item. To be identifiable, the risk component may be contractually specified or it may be implicit in the determination of fair value or the cash flows of the item to which the component belongs.

Risk components that are contractually specified

Consider the following example where an entity buys electric motors from a supplier. The supply contract for the electric motors is a variable price contract with a pricing formula that includes an indexation to the copper price and other costs. Specifically:

Electric motor price = copper price + (manufacturing costs + inflation index)

The indexation to copper reflects the fact that electric motors include a significant amount of copper. The other costs depend upon the costs of manufacturing and a specified inflation index. Under the proposals in the ED, the entity can apply hedge accounting for the copper component if it uses copper derivatives to hedge variations in the price from changes in the copper price under the contractual pricing formula. Indeed, inflation may also be an eligible risk component if the entity chooses to apply hedge accounting to that component.

In contrast, IAS 39 requires entities to compare the change in the fair value of the copper derivative with the entire price change of the supply contract, i.e., including the variable manufacturing costs. The result of this requirement, combined with the 80-125% effectiveness assessment test, is that hedge accounting is unlikely to be possible or there will be considerable ineffectiveness to report in profit or loss.

Other examples of contractual components are as follows:

- ▶ Gas supply contracts often include a price escalation clause based on the price of gas oil or fuel oil in addition to other components
- ▶ Electricity is sometimes sold based on the cost structure of a power plant. The contractually agreed prices may include for example, elements of coal prices and the cost of emission rights
- ▶ Many industries index the price of metals, agricultural produce, oil or chemical products to benchmark commodity prices in their purchase or sales contracts
- ▶ The interest rates on variable rate loans are commonly linked to a benchmark interest rate such as LIBOR
- ▶ A bond may have principal or coupons that are specifically linked to an inflation index

It is not sufficient for a component just to be contractually specified in order for it to be an eligible risk component, it must also be reliably measurable. Therefore, if there is not an active market in a particular component, and a price cannot be reliably derived, then hedge accounting for that component would still be precluded under the ED.

Although there is no requirement for the hedging instrument to be exactly the same as the hedged risk component, if the hedging instrument were actively traded and did match the risk component, then the hedged risk would clearly be reliably measurable, and could result in zero ineffectiveness. Where there are differences between the risk component and the hedging instrument, then an acceptable valuation method for the risk component must be determined.

It cannot be assumed that just because an entity has hedged a component from a risk management perspective that it must therefore be an eligible risk component without any ineffectiveness. If there is basis risk between the risk component and the hedging instrument then some ineffectiveness should still arise. For example, if the pricing formula for the hedged item is based on the monthly average price for copper, and the hedging instrument is priced based on the month-end closing copper price, then some ineffectiveness will occur.



The 'sub-LIBOR issue'

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 that asset or liability (the 'sub-LIBOR issue').

For example, some banks can raise funding at interest rates that are below a benchmark interest rate (e.g. LIBOR minus 50bps). They may enter into interest rate swaps to remove the variability in future cash flows caused by movements in benchmark interest rates. An entity can still achieve hedge accounting by designating the full contractual cash flow (e.g., LIBOR minus 50bps) and a LIBOR swap in a hedge relationship. However, it would not be acceptable to designate the LIBOR component as the hedged item.

The reason for this restriction is because, if benchmark interest rates decreased significantly such that the negative spread is actually greater than the benchmark, any further reduction in the benchmark would not be reflected in the hedged item as contractual interest rates would not be less than zero. Hence, offset would not be achieved.

Although the above guidance in the ED refers to financial instruments, the same issue may apply to a non-financial item. For example, a contract to deliver a commodity to a particular location which is cheaper than the price to deliver to the location referenced in a futures contract.

Risk components that are NOT contractually specified

The ED is clear that there is no need for a component to be contractually specified in order to be eligible for hedge accounting. However, it is clearly easier to determine that components are eligible if they are contractual. The often cited example where a non-contractual component exists is that crude oil is a component of jet fuel. As such, the ED would significantly increase the opportunity for airlines to achieve hedge accounting for their economic fuel hedges (see example below).

The ED explicitly retains the restriction in IAS 39 that inflation cannot be designated as a hedged item for financial instruments if it is not contractually specified. However, there may be instances where pricing of forecast sales (i.e., non-financial items) are driven by inflation, in which case, inflation may be an eligible risk component, for example, where it is common practice to amend a price list to reflect the effects of inflation.

The ED provides guidance that an entity's assessment of which risk components are eligible for designation as a hedged item is made "in the context of the particular market structure". We understand this to mean that the component must be a standard part of the pricing structure by market convention. This requires an evaluation of relevant facts and circumstances and there are no 'bright lines' to determine eligible risk components of non-financial items. Accordingly, judgment will need to be exercised.

Identifying risk components that are not contractually specified is not just an accounting exercise. There is a need to understand the pricing drivers and to be able to demonstrate that a component, by virtue either of manufacture or pricing, is a driver of the price of the whole item. While it is likely that the component should be a part of the make-up of the whole item, that alone is unlikely to be sufficient. As an example, while rubber is undoubtedly a component of the manufacture of rubber tyres, it is likely to be difficult to identify and measure the rubber component influence on the tyre price reliably.

For some fact patterns, we would expect a not insignificant amount of work to determine that a risk component exists. This would be likely to include some quantitative and qualitative analysis. Quantitative analysis may be able to derive an implicit pricing formula such that all changes in price can be determined by changes in the identified inputs to the formula. This evidence would be very persuasive, but will not be possible in all instances. We may find that, in some industries, we see a move to contractual pricing as a result of the proposals in the ED, if a pricing formula is already implicit.

As noted above, similar to the existence of contractual negative margins, it is not clear from the ED whether the 'sub-LIBOR' preclusion is applicable if an implied negative margin exists in a derived pricing formula. In particular, if the derived margin could vary over time such that it may be positive or negative.



Example: Jet fuel hedging

Background

It is common practice for many airlines to start hedging part of their forecast jet fuel purchases over the next 12 to 24 months and then increase the hedge coverage as the delivery date approaches. Airlines will typically use various contracts to manage their jet fuel price risk:

- ▶ For the time horizon from 24 months to about 12 months to delivery, only crude oil derivatives have the sufficient market liquidity
- ▶ For the time horizon between 12 months and six months to delivery, gas oil derivatives are sufficiently liquid

And

- ▶ Jet fuel derivatives are only sufficiently liquid within six months to delivery

Both gas oil and jet fuel are made from oil distillates, but they have different refining margins, also known as cracking spreads, i.e. the cost of converting crude oil into the respective distillate. Hence:

- ▶ Crude oil is unrefined and its price excludes any cracking spread
- ▶ Gas oil prices include the cracking spread for that distillate
- ▶ Jet fuel prices include a further refining margin compared with gas oil

Hence, by using crude oil derivatives, entities remain exposed to changes in the entire refining margin for jet fuel. As soon as gas oil derivatives are used, the variability of a part of the refining margin of jet fuel is hedged (up to the gas oil level). Once jet fuel derivatives are used, the variability of the entire refining margin is hedged.

As risk components for non-financial items are precluded under IAS 39, currently entities using crude oil derivatives would need to compare the change in the jet fuel price to the change in the price of crude oil. This often leads to high levels of ineffectiveness and can lead to hedges failing the 80% - 125% test.

The ED's proposals

Although jet oil pricing is not contractually based on crude plus various crack spreads, given the way in which the jet fuel market operates, we believe that the ED would permit an airline to designate crude oil as a component of their forecast jet fuel, based on the criteria discussed above. Indeed, crude oil as a component of jet fuel is also used as an example of a non-contractual eligible risk component in the ED. When hedging with crude oil derivatives, airlines would be able to achieve perhaps high levels of effectiveness, if crude oil were the designated component of the jet fuel purchase in the first year.

Over time, as the hedged jet fuel exposures become closer, airlines can improve the economic hedge and lock in the gas oil component of the jet fuel as crude vs. gas oil crack derivatives become available. For most airlines, the practice of improving the economic hedge of jet fuel, by transacting crack derivatives is part of a documented risk management strategy. However the guidance in the ED indicates that layering the crack derivative on the original hedge would not form part of rebalancing (see later discussion in section 5.4). Hence, it seems that the most appropriate treatment under the ED for this risk management strategy would be to designate a second hedge relationship as follows:

Hedged item	Highly probable forecast fuel purchases and crude oil derivative or synthetic forecast fuel purchases where price = fixed crude element + variable crude vs gas oil spread + variable gas oil vs jet fuel spread
Hedging derivative	Crude vs gas oil crack derivative
Hedged risk component	Crude vs gas oil crack spread



As jet fuel vs gas oil derivatives become available then a third hedge designation may be made as they are transacted, as follows:

Hedged item	Highly probable forecast jet fuel purchases plus crude oil and crude vs gas oil crack derivatives, or synthetic forecast fuel purchases where price = fixed gas oil element + variable gas oil vs jet fuel spread
Hedging derivative	Gas oil vs jet fuel crack derivative
Hedged risk component	Gas oil vs jet fuel crack spread

It is possible that the above crack derivative spreads may be negative at certain points in time, such that the price of crude oil exceeds the price of jet fuel. The ED prescribes that risk components must be less than the entire item, described previously in this publication as the 'sub-LIBOR' issue. However, it is not clear in the ED whether the possibility that a risk component might exceed the whole, at times, would preclude hedge accounting of the risk component.

How we see it

All three hedge relationships are likely to achieve high levels of effectiveness, which should be good news for the airlines. However, there will be a requirement to designate and operate three different hedge relationships which will have operational challenges.

Example: Partial term hedge

Given the guidance in the ED, it could also be argued that the 3-month forward FX risk is an eligible component of the 4-month forward FX risk, for the same currency pair. If this is the case then by designating the 3-month forward rate as the risk component, it would be possible to eliminate the majority of ineffectiveness from a change in timing of a hedged item, within a cash flow hedge. For example, as long as the hedged item was expected to occur sometime after three months, then no ineffectiveness would occur. This is not explicit in the ED, but we believe that it is what the Board intended, as long as it is consistent with the entity's risk management strategy.

How we see it

The ability to designate risk components for non-financial as well as financial items will, in our view, facilitate hedge accounting for many industries. In particular, given the typical volatility of commodity prices, we believe that this proposed amendment will make hedge accounting (and, as result, hedging for risk management purposes) more attractive to many entities exposed to commodity risks. However, there needs to be clarity on whether and when the component is ever allowed to be greater than the whole.

Credit risk

Many financial institutions use credit derivatives (such as Credit Default Swaps or CDSs) to manage the credit risk resulting from their lending activities. Portfolio managers typically manage credit risk depending on the circumstances and only for a portion of the loans and/or loan commitments. This flexible approach allows them to consider, for example, the expected pattern of drawdown and/or repayments and changes in credit quality.

Under IAS 39, most entities are unable to achieve hedge accounting for the credit risk component of financial assets carried at amortised cost when hedged by a CDS. This is due to the requirement in IAS 39 (which has been carried over into the ED) that hedged items (including risk components) must be reliably measurable in order to apply hedge accounting. The spread between the risk free interest rate and the market interest rate of a financial asset incorporates not only credit risk, but also other types of risk, such as liquidity risk. Hence, the Board considers that it is difficult to isolate and measure the changes in fair value that are attributable only to the change in credit risk. Therefore, credit risk would not be an eligible risk component under the ED.

The Board has requested feedback from respondents on four alternative approaches set out in the Basis for Conclusions (BC) section of the ED. The first alternative is simply to leave the issue unresolved. The remaining three alternatives propose the use of a modified fair value option (FVO) as set out in Appendix I to this publication.

4. Hedging instruments

IAS 39 places several restrictions on the types of instruments that can qualify as hedging instruments for hedge accounting purposes. The ED proposes to relax some of these restrictions.

As such, entities will be permitted to designate any financial asset or liability measured at fair value through profit or loss (FVTPL) as a hedging instrument. This means that, in addition to derivatives, cash instruments carried at FVTPL may be used as hedging instruments. For example, an entity wishing to hedge an exposure to interest rate risk arising from a commitment to make a loan will no longer be required to enter into a derivative, but can instead hedge that exposure by 'short selling' a bond. In such a fair value hedge, the changes in fair value of the short position will be recorded in OCI until the hedged risk affects profit or loss. The only limiting conditions under the proposals are that the entire hedging instrument (or a pro-rata portion thereof) must be designated in the hedging relationship and that the hedging instrument must be a contract with a party external to the reporting entity. Therefore, in the example above, the changes in the credit spread of the bond will result in ineffectiveness.

The ED proposes to continue the prohibition on designating written options as hedging instruments. For purchased option contracts, the ED proposes a methodology for recognising the time value that is different from the current practice (see section 8) and could significantly reduce profit or loss volatility arising from hedging with options.

How we see it

The ED helpfully permits a wider range of instruments to be designated as hedging instruments. However, the requirement to designate the entire non-derivative instrument (or a pro-rata portion) in the hedging relationship may reduce the desire to use them, as the ineffectiveness in the relationship may be significant.

5. Effectiveness assessment and rebalancing

An important distinction

For hedge accounting, the effectiveness assessment and the measurement of ineffectiveness have to be distinguished. The effectiveness assessment is performed to determine which hedging relationships qualify for hedge accounting and aims to identify accidental offsetting and prevents hedge accounting in those situations. Under the ED, hedge effectiveness will have to be assessed prospectively at inception and prospectively every reporting period on an ongoing basis. In contrast, IAS 39 requires an additional effectiveness assessment on a retrospective basis by applying the 'bright line' of 80-125 per cent in order to decide whether hedge accounting can be continued or not.

The measurement of ineffectiveness refers to the calculation of the 'non-offsetting' amounts in accounting for hedge relationships, i.e. the result in accounting terms. The measurement of ineffectiveness is performed only retrospectively and determines the amount to be recorded in profit or loss. The ED does not propose any change to this requirement currently in IAS 39.

A key qualifying criteria to achieve hedge accounting under the ED is that the hedge relationship meets the effectiveness requirements, i.e., the hedge relationship;

- ▶ Meets the objective of the hedge effectiveness assessment

And

- ▶ Is expected to achieve other than accidental offset

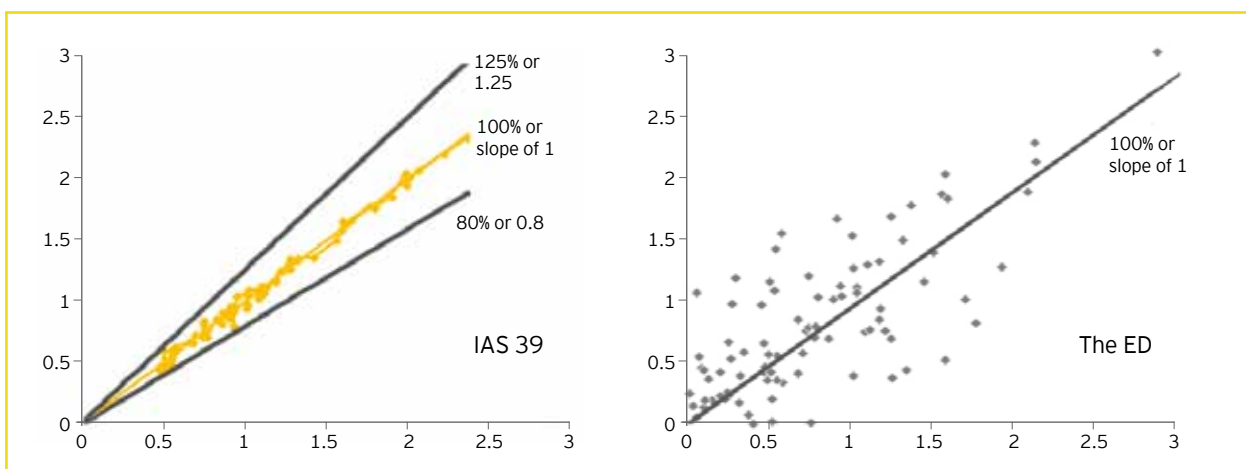
5.1 Objective of hedge effectiveness assessment

The objective of the hedge effectiveness assessment is to "ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness". This means that a hedging relationship may not contain a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would result in a biased outcome creating ineffectiveness. An unbiased outcome does not mean that the hedging relationship is expected to be perfectly effective at all times, however, the entity should have an expectation that changes in the value of the hedging instrument will not be systematically higher or lower than changes in value of the hedged item.

The objective to minimise hedge ineffectiveness does not introduce a requirement to use the best possible hedging instrument. For example, an entity may have a hedging instrument that it considers will result in an acceptable degree of offset, even though other instruments are available in the market that would make the degree of offset higher. The entity may prefer to use the less effective instrument because it is cheaper or easier to transact. An example would be using a liquid currency forward contract as a hedge of an illiquid currency risk when the two currencies are expected to move in tandem. Alternatively, an entity may favour the use of exchange traded instruments rather than OTC derivatives that could be constructed as a perfect match. Or perhaps, an existing derivative could be used instead of transacting a new one. However, any hypothetical derivative used for effectiveness measurement or assessment would still need to be the perfect hedge, consistent with IAS 39.



The entity's chosen hedging instrument can be designated within a hedge relationship, but it must be designated such that it minimises the expected hedge ineffectiveness for the given hedging relationship and without bias.



The graph above explains the effectiveness assessment requirements in terms of a regression test. In IAS 39 the (population) slope of the regression line had to be between 0.80 and 1.25 and the dispersion of points around this line had to be fairly limited. Under the ED, however, the dispersion around the line can be much greater, but the (population) slope of the regression line should be equal to 1, which should be accomplished by changing the hedge ratio. In other words, when applying the ED, it does not matter how far the data points are away from the line of best fit, i.e. there are no restrictions on the level of correlation, as long as they are (on average) equally distributed around the line. If the data points are widely dispersed then this would likely affect the future measurement of ineffectiveness, but not the assessment.

The hedge effectiveness assessment is purely prospective. Although the ED requires that any retrospective ineffectiveness is measured for accounting purposes in the profit or loss, there is no obligation to pass a retrospective effectiveness test at the end of a reporting period. The hedge effectiveness assessment is required in order to achieve hedge accounting in subsequent periods. It should demonstrate whether the entity has any expectation of changes in the value of the hedging instrument that systematically would either exceed or be less than the change in value of the hedged item, such that they would produce a biased result.

The hedge ratio

The hedge ratio is not defined within the ED, but we assume it is the designated amount or notional of the hedged item compared with the designated amount or notional of the hedging instrument within the hedge relationship. Consistent with IAS 39, the ED requires a hedge ratio other than 1:1 if the sensitivity of the hedged item and hedging instrument differ. Indeed, at the start of a hedge relationship, the effectiveness assessment should provide evidence as to the most appropriate hedge ratio in order to achieve 'no expected bias' in the hedge relationship.

For example, the optimal amount of hedging derivative when hedging 100 tonnes of a particular grade of commodity in location A, might have an underlying of 90 tonnes of a different grade of the same commodity in location B, in which case, a hedge ratio of 1.11:1 would be appropriate. If subsequent effectiveness assessments indicate that there is bias, then the entity may be required to prospectively amend the hedge ratio as part of "rebalancing".

In many simple hedges, where the hedging instrument is a good match for the hedge item, we would expect the hedge ratio to remain to be 1:1.



If the relationship between the hedged item and the derivative underlying changes, so might the optimal hedge ratio if there is basis risk. Such an assessment would usually be made by considering historical and current market data for the hedged item and hedging instrument where possible, taking into account how they have performed relative to each other in the past.

5.2 Other than accidental offset

As part of the effectiveness assessment, there is a requirement within the ED that any offset between the hedged item and the hedging instrument is 'other than accidental'. We would expect this to be a qualitative assessment, perhaps based on the economics of the hedge relationship, but also using common sense. For example, the price of copper and apples may happen to be highly correlated from a statistical perspective over a year. But hedge accounting for apples using a copper derivative would not be allowed, as there is no economic linkage between apples and copper. This example is an extreme and unlikely case, but it illustrates the concept. We expect that this assessment should be relatively straight forward in most circumstances.

The ED notes that the assessment of whether an offset is 'other than accidental' may change over the life of the hedge relationship. It highlights credit risk within a derivative as a possible factor, whereby if the credit risk of the derivative counterparty deteriorates such that it is the major cause of changes in the fair value of the derivative, then any offset would be accidental.

5.3 Prospective hedge effectiveness assessment - how, and how often?

How: Effectiveness assessment methods

The ED does not prescribe a particular method for performing effectiveness assessments. However, the ED provides guidance that, when considering an appropriate method, an entity should use one that "captures the relevant characteristics of the hedging relationship including the sources of ineffectiveness". Management could also consider the following:

- ▶ Information that management uses for risk management purposes
- ▶ Whether the critical terms of the hedged item and hedging instrument are closely aligned
- ▶ The level of uncertainty of offset in the hedge relationship
- ▶ The complexity of the hedge and the materiality of any potential ineffectiveness

Under the ED, an entity is permitted to have different methods for assessing whether the hedge is expected to be unbiased and what is the appropriate hedge ratio. In reality, there may be few examples where different methods would be useful.

During the life of the hedge relationship, there may be a change in circumstances such that the chosen method for assessment is no longer appropriate. The ED gives as an example where a previously pegged currency pair becomes unpegged, in which case, the new FX risk will need to be incorporated into any effectiveness assessment. Under IAS 39, a change in the method for retrospective effectiveness assessment would result in the end of a hedge relationship. In contrast, the ED actually requires a change in method to include all sources of ineffectiveness, if the previous method is no longer appropriate.

The impact of time

As noted previously, the ED does not specify a particular method for assessing whether a hedge relationship meets the hedge effectiveness requirement. However, throughout the ED, there is reference to effectiveness being assessed by comparing the 'change in value or of fair value of the hedging instrument with the change in value or of fair value or cash flows of the hedged item'. In other instances, hedge effectiveness is referred to with regard to the change in fair value or cash flows of the hedging instrument.

As with IAS 39, it is not clear whether references to changes in 'cash flows' should be interpreted to mean the changes after discounting to their present values or not. (Some of the IAS 39 Interpretation Guidance implies that this is the case, but other parts of the standard are inconsistent). The ED specifically requires discounting for measuring ineffectiveness, but is silent on its use for the assessment of cash flow hedges.

How we see it

If it is the Board's intent that the impact of time value of money should be taken into account for effectiveness assessment, then the wording in the ED would need to be made clearer. Alternatively, if the effectiveness assessment should only follow the entity's risk management objective, then it would be useful to have that clarification.



Qualitative effectiveness assessment

The ED provides guidance that if the critical terms of the hedging instrument and the hedged item match or are closely aligned, then a qualitative assessment method might be acceptable. This qualitative assessment could be used to conclude that no bias exists as well as whether the hedge ratio is appropriate. It goes on to say that a qualitative assessment method might still be appropriate, even when the fair value of the hedging instrument is not zero on initial designation. However, the ED does indicate that a qualitative approach would not be appropriate where the hedging derivative had an initial non-zero fair value if “the hedge ineffectiveness arising from that fact could have a magnitude that a qualitative approach would not adequately capture”. Therefore, as discussed previously, it appears that ‘noise’ from a non-zero fair value derivative on designation within a fair value hedge is still considered to be hedge ineffectiveness for measurement purposes. Nevertheless, this may be ignored for effectiveness assessment based on its “magnitude”.

It is also important to note that while the ED does not require the critical terms to exactly match, they must as a minimum be “closely aligned”. This seems to permit management to use judgment as to whether a qualitative assessment is acceptable. Applying the guidance noted above, this judgment would need to be made in the context of the “magnitude” of any potential ineffectiveness where the critical terms do not exactly match.

How we see it

Under the ED we would expect many hedge relationships to be assessed qualitatively when there is a good match between the terms of the hedged item and hedging instrument. This would be a significant change to hedge accounting under IAS 39 and will reduce the operational costs of hedge accounting. However, whilst the effectiveness assessment may be qualitative, there would still be a requirement for actual ineffectiveness to be calculated and recorded in profit or loss.

Quantitative effectiveness assessment

When the critical terms of the hedging instrument and hedged item are not closely aligned, such that significant basis risk or other sources of ineffectiveness exist in a hedge relationship, we would expect that a quantitative hedge effectiveness assessment would be required by the ED.

Hypothetical derivatives

To calculate the change in the value of the hedged item for the purpose of assessing and measuring hedge ineffectiveness in cash flow hedges, entities typically use a hypothetical derivative with 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, i.e., the ‘perfect hedge’.

The ED seems to permit the use of hypothetical derivatives for hedge effectiveness assessment and measurement in both fair value hedges and cash flow hedges. However, the ED goes on to state that hypothetical derivatives can only be used where not using them would give the same result, i.e., the hypothetical derivative replicates the hedged item and, hence, results in the same outcome as if the change in value was determined by a different approach.

These two requirements seem inconsistent. On the one hand, it appears that it may not be possible to use hypothetical derivatives in fair value hedges, as, by doing so, no ineffectiveness would be recorded from the changes in the fair value of any floating leg of the hedging derivative where fixing has occurred. On the other hand, some ineffectiveness would be recognised if a hypothetical derivative had not been used as there would be no offset from the floating leg of the hedged item. We believe it would be helpful for the Board to clarify this point.

Use of risk management tools

In order to minimise the operational burden of hedge accounting, management may wish to consider the methods or tools used for risk management purposes and evaluate whether they would be appropriate for hedge-effectiveness assessment. Such an approach would be in line with the objective of hedge accounting as described in the ED, which is to reflect the entity’s risk



management activities. This might include VaR calculations, a volatility reduction method, DVO1 (i.e., the dollar value of a one basis point decrease in interest rates) or similar. However, as discussed previously, it is not clear from the ED whether using a change in variable cash flows or an index or spot price correlation assessment would be sufficient as such methods do not necessarily include the impact of discounting of cash flows.

Specifically for cash flow hedges, management may enter into a hedge for the purpose of swapping floating rate cash flows to fixed. For example, the risk management objective of hedging a floating rate financial asset with a receive-fixed pay-floating interest rate swap may be to achieve fixed rate interest coupons. Management may not consider any fair value changes in the swap due to the most recently fixed floating rate or from minor changes in the swap counterparty's credit risk to be relevant to their economic hedging strategy, even though these are sources of recorded hedge ineffectiveness. Furthermore, rebalancing does not mean these sources of hedge ineffectiveness will be resolved, since management cannot predict the direction of such ineffectiveness going forward. We consider this in more detail within the discussion on rebalancing in section 5.4.

How often: frequency of hedge effectiveness assessment

An effectiveness assessment must be performed, as a minimum, at each reporting date or upon a significant change in circumstances, whichever comes first. Having said that, the ED does not prevent an entity from assessing effectiveness more frequently, say, on a monthly basis when it only reports every six months, in particular, if its risk management practices operate monthly.

In addition, the ED introduces an additional administrative burden on an entity to constantly monitor whether the hedge effectiveness assessment should be performed outside the normal reporting cycle, which will require management judgment. If such assessments are not performed in a timely matter, then appropriate action cannot have been taken. In such circumstances, the ED would determine that the hedge accounting criteria have not been met and that hedge accounting would be precluded from the time rebalancing should have occurred.

How we see it

Within the ED there are a number of instances where management judgment can/will need to be applied. These include whether there is a need to rebalance and if an effectiveness assessment needs to be performed between two reporting dates. This could mean that two entities with the same risk management strategy could report different hedge accounting results.

5.4 Rebalancing

Under IAS 39, a change in the hedge relationship often results in the need to de-designate the existing relationship and re-designate a new relationship. Examples of where this can happen include a reduction in the expected 'highly probable' cash flows, change in the basis between hedging instrument and hedged item such that the hedge is no longer 'highly effective', etc. If the hedge relationship is de-designated and re-designated, then it is likely that the hedging instrument will have a non-zero fair value, whereas the hedged item would be represented by a 'hypothetical derivative' that would have a fair value of zero at the time of re-designation. This will result in some level of ineffectiveness in the new hedge relationship and will result in volatility in profit or loss. In extreme cases, this could cause hedge accounting to fail.

The ED introduces a concept of "rebalancing" a hedge relationship. The need to consider rebalancing arises when the objectives of hedge effectiveness assessment are no longer met, e.g., there is bias or an expectation that ineffectiveness will not be minimised by the current hedge designation. Rebalancing is treated as a continuation of the existing hedge relationship and the impact of rebalancing is recognised on a prospective basis. The effect of rebalancing is that the same hypothetical derivative can continue to be used rather than having to reset the hypothetical derivative with a fair value of zero.

In order for any changes to the hedge relationship to be considered a rebalancing, an additional assessment must be undertaken, to confirm that the risk management objective is still consistent with the hedge relationship. If not, then the relationship must be terminated, i.e., a mandatory discontinuation.

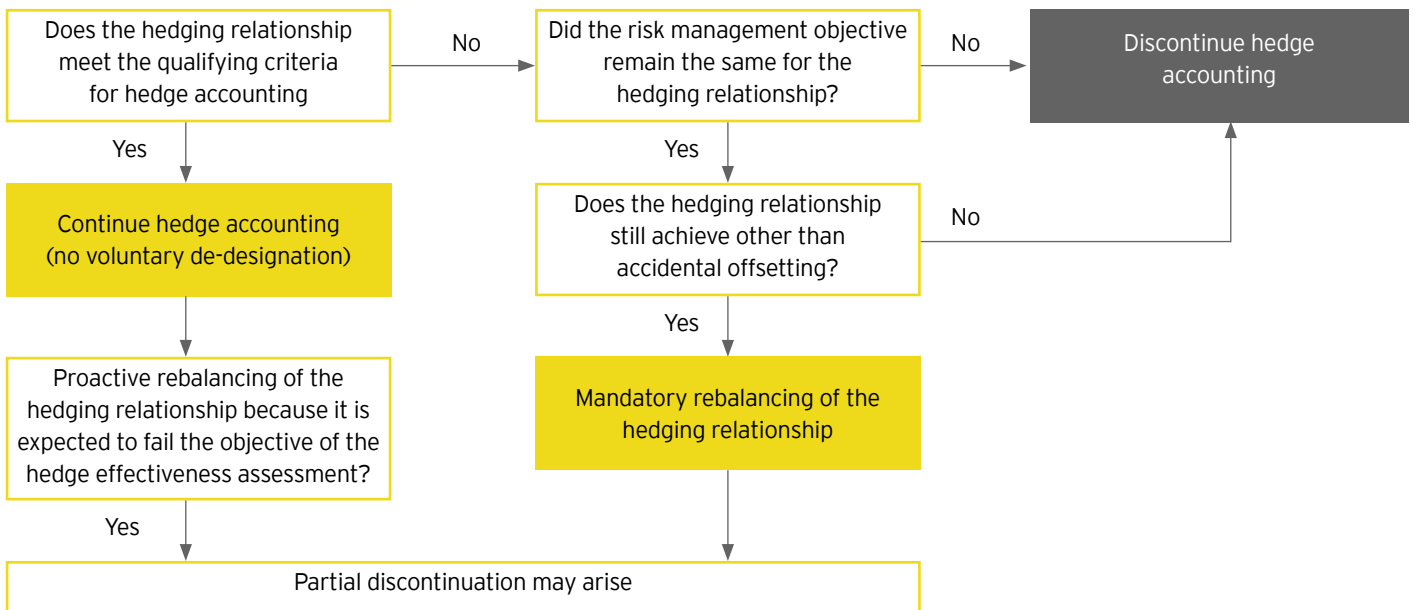


A significant change from IAS 39 is that hedge relationships can no longer be de-designated voluntarily if the original risk management objective of a hedge relationship remains unchanged and the qualifying criteria are still met. The flow chart below assists in explaining the required steps for rebalancing.

How we see it

Ineffectiveness is determined and recognised in profit or loss prior to any rebalancing. The prospective effectiveness assessment is then performed after the impact of rebalancing, but without the need to restart the hedge relationship. This is helpful as, going forward, there is no additional ineffectiveness from introducing a new hypothetical derivative. Consequently, it is important to understand whether any amendments to hedging strategies will be treated as a de-designation or rebalancing of hedge relationships under the ED.

Flowchart: Rebalancing the hedge relationship subsequent to initial designation





Why is rebalancing needed?

A key criterion in order to achieve hedge accounting is that the hedge relationship will give an unbiased result and minimise ineffectiveness. If the effectiveness assessment indicates that bias exists (so that changes in the fair value of the hedging instrument and the fair value or cash flows of the hedged item will no longer offset) then the ED requires that consideration is given to adjusting or rebalancing the hedge relationship, such that the bias is eliminated.

If bias is shown to exist, the ED requires the entity to consider the following:

- ▶ The sources of ineffectiveness causing the bias
- ▶ Management's ability to eliminate the bias within its risk management strategy
- ▶ Whether the bias is temporary or indicative of a trend away from the designated hedge ratio
- ▶ Any changes to the hedged item, such as whether it is still highly probable.

Management must then decide whether or not it is appropriate to rebalance the hedge. The ED recognises that judgment must be applied, but decisions would need to be justified, without the benefit of hindsight. Any rebalancing will need to be assessed on a case by case basis to determine whether a hedge relationship should continue.

The ED indicates that it will not always be possible to minimise ineffectiveness to zero. As part of management's decision as to whether there is a need to rebalance a hedge relationship, we expect that it would be acceptable for management to consider materiality. For example, if the effectiveness assessment indicated that the optimal hedge ratio is 1.0001:1 and the designated hedge ratio is 1:1, would the ED require the designation to be adjusted? Economically management is unlikely to amend the hedging instrument in this instance, and also would be reluctant to amend the designation for accounting purposes as it would add to the complexity of accounting for the hedge.

How we see it

The ED recognises that ineffectiveness will not always be minimised such that it is expected to be zero. However, the requirement to "eliminate any bias" indicates an expectation that no bias is acceptable. We believe that the ED should be clearer that judgment is permitted in deciding whether to rebalance, not solely based on the sources of ineffectiveness and whether the additional ineffectiveness is a trend, but also on the level of bias that is acceptable over the life of the hedge.

Proportional de-designations / Partial discontinuation

Where bias is shown to exist in a hedge relationship, one solution which is discussed extensively in the ED is to increase or decrease the volume of the hedged item or hedging instrument.

Developing on our example in the discussion on the hedge ratio, an entity determines, based on historical data, that in order to hedge 100 tonnes of the future purchase of commodity A it should transact 90 tonnes of notional value of derivatives on benchmark commodity B. The entity designates this as a cash flow hedge relationship.

On the next reporting date, the effectiveness assessment demonstrates that the basis for benchmark commodity B has changed such that only 80 tonnes are required to hedge 100 tonnes of commodity A. If the entity believes this is part of a trend leading away from the hedge ratio rather than just a temporary fluctuation, then under the ED, it has at least two choices:

- ▶ De-designate 10 tonnes of the hedging derivative

Or

- ▶ Designate an additional 12.5 tonnes of the hedged item, if highly probable of occurring.

De-designating a proportion of the hedging instrument, such as 10 tonnes of commodity B, is permissible under the ED. Proportional de-designations were not permitted under IAS 39, and we believe this is a beneficial change, particularly for cash flow hedges.



De-designating a proportion of the hedging instrument for accounting purposes under the ED does not necessarily require closing out that proportion of the instrument, i.e., there is no need to perform an actual transaction. For example, a change in volume of the hedging instrument may be required for accounting purposes to ensure the designated hedge relationship is unbiased. However, if the cost of closing out a proportion of the derivative were expensive, say where there is a standard contract or if transaction costs are high, then the de-designated proportion could remain and be recorded at fair value through profit or loss, with no further impact on hedge accounting going forward. This protects the hedge accounting for the proportion of the hedging instrument required for the hedge relationship.

Interaction with the risk management objective

Management may not be concerned about some sources of accounting ineffectiveness recognised as a result of their risk management strategy. This may include the impact of derivative counterparty credit risk (as long as the counterparty is still expected to meet its obligations), derivatives designated with non-zero fair values or the effect of the fixed nature of current floating legs.

The ED is not clear whether this small degree of bias must be eliminated upon hedge designation or as part of rebalancing. As already mentioned in section 2, we believe it would be helpful for the ED to permit a degree of tolerance in expected bias in order to avoid the need for adjustments of the hedge ratio in these circumstances.

For instance, a derivative designated in a cash flow hedge may have a non-zero fair value upon original designation. But, if management were to amend the hedge ratio (e.g., by increasing or reducing the notional amount of the hedging instrument) in an attempt to eliminate some of the ineffectiveness caused by the non-zero fair value, it may be that it no longer meets their risk management objective to offset their designated floating cash flows. This may also be the case for a fair value hedge if the risk management objective is to manage floating rate cash flows, i.e., without a focus on fair values. It would seem strange if the rebalancing requirements in the ED forced a change to the hedge accounting designation such that it was inconsistent with the risk management objective, given the stated objective of hedge accounting in the ED.

How we see it

We do not think the Board would expect rebalancing to be a frequent occurrence for hedge relationships where the existing designation does not require amending for risk management purposes, even where some ineffectiveness may occur. However, given the requirement to eliminate bias, this is not obvious from the ED.

The focus of rebalancing within the ED is almost exclusively where the elimination of bias can be achieved via a change in volume of either the hedged item or hedging instrument. We believe there will be other situations where alternative action, such as transacting additional derivatives that change the risk profile of hedging derivative in line with the existing risk management strategy may be appropriate. For example, consider the following situations:

- ▶ On original designation, a highly probable forecast foreign currency cash flow is expected to occur in 12 months' time. Hence, a forward FX contract for delivery in 12 months' time is transacted and designated within a cash flow hedge relationship. The hedged risk is forward FX risk. It becomes apparent three months later, that the forecast flow will occur in 13 months, i.e., four months later than originally expected. In order to minimise ineffectiveness from this difference in timing, the entity may transact a forward starting FX swap (near leg nine months, far leg 13 months), creating a synthetic 13-month forward FX contract matching the revised timing of the forecast cash flow and maintaining the risk management strategy to lock in an FX rate for the forecast cash flow.

Question: Under the ED could the forward starting FX swap be included in the hedge relationship as part of rebalancing?

- ▶ A lender had provided a loan facility to a borrower such that the borrower could draw funding at 1-month LIBOR or 3-month LIBOR. Historically, the borrower has always drawn down at 1-month LIBOR. The lender wishes to lock in a fixed rate for the loan hence it transacts a receive fixed, pay 1-month LIBOR interest rate swap. The swap and forecast drawdowns on the facility are designated within a cash flow hedge, with an expectation of zero ineffectiveness. Sometime later, the borrower switches its funding from a 1-month to 3-month LIBOR basis, under the terms of its facility. Unexpected



ineffectiveness now exists and the lender may wish to transact a 1-month vs 3-month basis swap to eliminate that source of ineffectiveness.

Question: Under the ED, could the basis swap be designated in combination with the existing fixed v 1m swap to eliminate effectiveness from the basis risk as part of rebalancing?

The above examples are not uncommon and they allow the entity to improve the effectiveness of a hedge without any change to the risk management strategy. Indeed, an economic risk management strategy may require such action and not to do so may indicate a change in risk management strategy forcing a hedge termination.

The ED says that “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.”

This would indicate that, perhaps, the above scenarios would be considered rebalancing. However, given the almost exclusive focus in the ED on rebalancing by changing the hedge ratio, i.e., rebalancing volume, it is by no means clear that rebalancing other than by volume changes are permitted. This will be an important distinction for financial institutions and corporates alike.

How we see it

It is helpful that changes to hedge relationships can now be dealt with through a ‘rebalancing’ exercise. The requirement under IAS 39 to de-designate the existing relationship and re-designate a new relationship was onerous and created volatility in profit or loss through future ineffectiveness. However, the focus of rebalancing within the ED is on the elimination of bias solely through a change in volume of either the hedged item or the hedging instrument. As outlined above, there seem to be other methods of rebalancing that may be appropriate. It would be helpful if the Board provided clarity.

6. Recording hedge effectiveness

Measurement

Hedge ineffectiveness is typically determined using a dollar-offset basis, i.e., by comparing the cumulative change in fair value of the hedging instrument with that of the hedged item. Therefore, any part of the change in fair value of the hedging instrument that does not offset a corresponding change in the fair value of the hedged item is treated as ineffectiveness. The ED does not propose significant changes to the rules for measurement of ineffectiveness in profit or loss, as currently required by IAS 39. Therefore, entities must continue to measure ineffectiveness by considering the effect of credit risk and the time value of money (due to differences in the timing of cash flows) on the value of the hedged item and the hedging instrument.

Recognition

Recognition of ineffectiveness will differ based on whether the hedge is a cash flow hedge or a fair value hedge:

- ▶ For cash flow hedges, the 'lower of' test will continue to apply. There will be no ineffectiveness for under-hedges, i.e., where the cumulative change in fair value of the hedging instrument is less than the cumulative change in fair value of the hedged item.
- ▶ For fair value hedges, any difference between the change in the fair value of the hedging instrument and that of the designated hedged component is ineffectiveness which must be transferred from OCI (see commentary in section 8.2 *Fair value hedge mechanics*).

Under IAS 39, entities would, on occasion, include 'more' of the hedged item in their cash flow hedges to avoid recognising ineffectiveness. However, entities may not be able to continue with this practice under the proposed ED because of the requirement to designate a hedge relationship that will produce an unbiased result and minimise ineffectiveness.

How we see it

The requirement to recognise all ineffectiveness combined with the proposals to: (i) align hedge accounting to risk management activities; and (ii) relax the stringent rules around hedge effectiveness testing will be seen as an improvement by many preparers. Therefore, while entities will have some flexibility in assessing hedge effectiveness, the income statement will still reflect the actual performance of the hedging instrument and the hedged item.

7. Groups and net positions

The hedge accounting rules in IAS 39 were designed, primarily, from a single instrument view point. A typical hedging relationship would involve a single hedging instrument (e.g., an interest rate swap) hedging a single item (e.g., a loan).

IAS 39 allows multiple items to be hedged together as a group. However, the restrictions are so narrow that the types of groups that are eligible as hedged items under IAS 39 are generally those that would also qualify for hedge accounting in individual hedge relationships.

In an effort to address the issues raised by these restrictions, the ED proposes new criteria for multiple items to be hedged together as a group. These new criteria address three different situations:

- ▶ Groups of gross positions (with no offsetting risk positions within the group)
- ▶ Groups of gross positions where only a bottom layer is hedged
- ▶ Groups of net positions (where the hedged items among themselves offset part of the risk that is managed on a group basis)

We consider each of these in detail in the discussion that follows.

7.1 Hedges of groups of gross positions

Current requirements

Under IAS 39, a group of gross positions is eligible as a hedged item only if (i) the individual items within the group share the risk exposure that is designated as being hedged, and (ii) the change in the fair value attributable to the hedged risk for each individual item in the group is 'approximately proportional' to the overall change in the fair value of the group for the hedged risk.

For example, consider an entity that acquires a portfolio of shares to replicate a stock index, records it as available for sale and enters into a put option on the index to protect itself from fair value losses. IAS 39 does not permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares. This is because the change in the fair value attributable to the hedged risk for each individual item in the group (the individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

However, items in the portfolio do not necessarily have to have the same overall exposure to all risks. Therefore, a portfolio of loans with different credit exposures could be hedged as a group if the risk-free rate is designated as the hedged risk component.

The ED's proposals

The ED proposes that a group of gross positions may be an eligible hedged item if:

- ▶ It consists of items (including components of items) that are individually eligible as hedged items i.e., the qualification criteria must be satisfied by each individual item within the group
- ▶ The items in the group are managed together on a group basis for risk management purposes

The individual items in the group no longer need to move proportionately with the group to allow a hedge of the group.

The ED adds that, where a group of items does not have offsetting hedged risk positions, the hedging gains or losses shall be apportioned to the line items affected by the hedged items on a rational basis i.e., the apportionment should not result in the grossing up of the net gains or losses arising from a single hedging instrument.

7.2 Hedges of layers of groups of gross positions

Current requirements

The designation of layers in a group of forecast cash flows is currently allowed under IAS 39 in identifying the hedged item within a cash flow hedge (e.g., the sale of the first 15,000 units of a specific product during a specified three-month period). Such a designation accommodates the fact that there may be a level of uncertainty surrounding the hedged item and that uncertainty does not form part of the hedge relationship.

However, IAS 39 does not allow designation of layers for fair value hedges. Consequently, an entity that wants to hedge part of a group of items within a fair value hedge must identify specific items within the group or designate a percentage of the total as the hedged item. In particular, IAS 39 clearly prohibits a "bottom-layer approach" to designate the hedged item in a portfolio hedge of prepayable fixed-rate loans. The premise of the IAS 39 model is to replicate, on a portfolio basis, the hedge accounting result that would arise on an individual hedged item basis. For this reason, when less than the entire portfolio is hedged, the hedged amount is typically defined as a proportion (as opposed to a portion or layer component) of the total portfolio.



For example if a £50m interest rate swap was designated as hedging the benchmark rate of £50m of a £100m fixed rate bond as part of a fair value hedge, this would be deemed to be a 50% hedge of the £100m fixed rate bond. Hence, if £30m (or 30%) of the bond was sold, then the hedged item would be calculated as $£100m \times 70\% \times 50\% = £35m$, which would lead to ineffectiveness when compared to the £50m interest rate swap.

The ED's proposals

The ED proposes to permit the designation of a layer component of a nominal amount as the hedged item for anticipated as well as existing transactions.

Under the proposals, an entity can designate a layer component of an existing item in a fair value hedge under the following conditions:

- ▶ It must specify the layer component designated from a defined nominal amount (e.g., the last CU80m of a CU100m firm commitment or the top layer of CU20m of a CU100m fixed rate bond)

And

- ▶ It must track the nominal amount from which the layer component is defined, in order to determine when the layer component must be recognised in profit or loss

The ED extends this guidance to layers of an overall group of items (e.g., a bottom layer), based on similar conditions. In particular:

- ▶ The risk management objective must be to hedge a layer component
- ▶ The items in the overall group are separately identifiable and reliably measurable
- ▶ The items must be 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
- ▶ The entity must be able to identify and track the overall group of items from which the hedged layer is defined

And

- ▶ The items in the group do not contain prepayment options other than those whose fair value is not affected by the hedged risk for fair value hedges

How we see it

The ability to designate layers of hedged item within a fair value hedge will, in most instances, be more aligned with risk management strategies than the required proportional approach under IAS 39.

The guidance in the ED adds that a layer component may be specified from a defined, but **open**, population or from a defined nominal amount. This does seem confusing since the introduction to the ED states that the Board decided 'not to address open portfolios or macro hedging as part of this ED' and that the proposals for groups of gross/net positions in the ED are in the context of closed portfolios.

Under the proposals, an entity can designate a nominal amount from a group of items to be hedged, instead of arbitrarily identifying specific items within the group or a percentage of the total. This will be particularly useful for fair value hedges of existing transactions subject to non-performance risk as illustrated in the following examples:

- ▶ An entity has eight firm commitments to buy items from a supplier, where each contract is for EUR10m. There is some risk that the supplier will only be able to deliver six of the contracts, although it is not known which six contracts. The entity may sensibly only wish to hedge the FX risk of EUR60m. The ED would permit designation of the first EUR60m to be purchased from the group of eight firm commitments. Hence, as long as at least six contracts are delivered then any non-performance of the remaining two contracts would not impact the hedge relationship.
- ▶ An entity has ten non-prepayable traded fixed rate bond assets of USD10m principal each. It wishes to hedge USD40m for interest rate risk. If this is consistent with its risk management objective, the entity may designate a bottom layer of USD40m from a defined group of the ten bonds. As a result of this, up to USD60m of bonds could be sold without affecting the hedge relationship, because the hedged USD40m will remain. On the other hand, the top USD60m of bonds could be designated within a fair value hedge under the ED, if their disposal was expected and the risk management strategy was to protect the fair value of the portion to be sold.



Layer approach in a portfolio fair value hedge accounting for interest rate risk ('macro-hedging')

The ability to designate layers of an overall group is helpful in the above examples. However, the restriction regarding items that contain prepayment options (as mentioned earlier) would preclude a "bottom-layer approach" in a fair value hedge of a portfolio of mortgage loans prepayable at par or at a fixed redemption penalty.

The ED does not address open portfolios or macro hedging, but the Board has recently commenced its discussions on a fair value macro hedge accounting model for open portfolios. It should be noted that at the December 2010 meeting the Board tentatively decided to consider further the concept of defining the hedged item as a bottom layer of the overall portfolio of prepayable debt instruments. During the Board's outreach activities, it was noted that banks tend to hedge on a portfolio basis, to intentionally derive a different hedging result to that which would arise on an individual basis. The Board, therefore, discussed whether the new model that is being developed could accommodate hedging on a portfolio basis, where the accounting outcome is different to hedge accounting on an individual basis. Such an approach would characterise hedged cash flows of the portfolio in the bottom layer as less susceptible to prepayment risk, than the unhedged cash flows in the top layer.

7.3 Hedges of net positions

Current requirements

A hedge of an overall net position does not qualify for hedge accounting under IAS 39. When entities hedge net exposures for risk management purposes, IAS 39 specifies that the hedging instrument should be designated as a hedge of a proportion of the gross position that forms part of the net position. Hedge accounting based on such designation does not represent the natural risk offset within the group of items.

Consider an entity that hedges foreign currency risk on a net basis. It has a forecast foreign currency sale of FC100 and purchase of FC80 in month A, both of which are eligible hedged items. It hedges the net exposure using a single forward foreign exchange contract for FC20 for delivery in month A.

In this example, the entity has the following choices under IAS 39:

(a) Designate a partial hedge of the gross sales

Hedge accounting could be applied by designating the FC20 of forward exchange contract as hedging FC20 of the FC100 forecast sales. As designated, hedge accounting only partially protects the functional currency recorded sales and offers no protection for cost of sales. The offsetting sale and purchase transactions will be reflected at the spot rate when they occur. If both the sale and purchase transactions occur in the same period, the effect of the hedge will be reflected in net profit or loss. However, if the transactions affect profit or loss in different periods (for instance, because items purchased are stored), then net profit or loss will be distorted.

(b) Do not apply hedge accounting

The hedging derivative is at FVTPL, resulting in profit or loss volatility and with no recognition of the economic hedging strategy.

The entity could also decide to transact gross forward exchange contracts (a forward sale of FC100 and a partially offsetting forward purchase of FC80). The impact of hedge accounting could then be reflected in both sales and costs of sales. However, there may be additional costs and counterparty risk to transacting gross derivatives in order to achieve the desired accounting treatment. Also it does not seem desirable that risk management objectives and strategies be driven by the desired hedge accounting result.

The ED's proposals – fair value hedge of a group of net positions

The ED allows a group of net positions to be an eligible hedged item in a fair value hedge based on the same criteria mentioned above for groups of gross positions:

- ▶ The items in the group must be individually eligible hedged items – i.e., the qualification criteria must be satisfied by each individual item within the group.
- ▶ The items in the group must be managed together on a group basis for risk management purposes.

The ED states that, whether an entity hedges on a net basis for risk management purposes is a matter of fact, rather than just an assertion or documentation. Net position hedging must form part of an established risk management objective and strategy that would normally be approved by key management personnel.

When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the gross amounts of the offsetting positions that together give rise to the hedged net position.



Presentation of eligible fair value hedge net positions

The hedged risk components of all the items in the overall net position must be recognised on the balance sheet on a gross basis (next to each line item that includes the related asset or liability¹). Changes in the fair value of both the hedged item (attributable to changes in the hedged risk), and the hedging instrument are recognised in other comprehensive income with any ineffectiveness transferred to profit or loss (see section 8.2 on fair value hedge mechanics). Also, if the group of items with offsetting hedged risk positions affect different line items in profit or loss, then the hedging gains or losses are to be presented in a separate line in the income statement as illustrated in the following example.

Consider a net position of a FC100 fixed-rate loan and a FC80 fixed-rate debt instrument hedged on a group basis for risk management purposes with a FC20 receive fixed swap. The net position is an eligible hedged item in a fair value hedge. Therefore the changes in fair value of the risk-free rate components of both the loan and the debt are separately recognised on the balance sheet on a gross basis (next to the line items that include the hedged loan and the hedged debt instrument) with corresponding gains or losses recognised in other comprehensive income. Since the two offsetting items affect two different line items in the income statement (interest income and interest expense), the gains or losses recognised in profit or loss on the swap will be presented in a separate line.

Income statement	The ED CU	IAS 39 CU
Interest income (fixed rate of the loan)	x	x
Interest expense (fixed rate of the debt)	(x)	(x)
Hedging (gain/loss)	x/(x)	–
Net interest income/(expense)	x/(x)	x/(x)

¹ If the net position is in respect of off balance sheet exposures such as firm commitments, then the amount is presented in a separate line (as is current practice) although there is no asset or liability pertaining to the hedging gain or loss.

Nil net positions

The ED also considers the situation where the net position hedged as a group for risk management purposes results in a nil net position at a given point in time. In this situation, the hedged items fully offset among themselves and no hedging instrument is therefore included in the hedging relationship.

The ED proposes that hedge accounting be still permitted if the following conditions are met:

- ▶ The hedge is part of a rolling net risk hedge strategy for a hedged position that changes in size over time.
- ▶ Over the life of the rolling net risk hedge strategy eligible hedging instruments will be used.
- ▶ Hedge accounting is normally applied when the net position is not nil.
- ▶ Not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes.

The ED's proposals – cash flow hedge of a group of net positions

For the purpose of cash flow hedge accounting, the ED specifies an additional criterion to allow a group of net positions as a hedged item. That is, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, must affect profit or loss in the same reporting period (including interim reporting periods).

For example, an entity with a net position of FC100 forecast sales in 12 months and FC150 purchases in 20 months hedges its net position for 12 months with a forward contract of FC50. When the sale is recognised in profit or loss, it will be measured at the spot exchange rate in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. 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.



Another example is where an entity anticipates the purchase of a fixed asset for FC200m in six months' time and FC100m of sales also in six months' time. The ED would preclude this net hedge as the FC100m of sales will impact profit or loss in six months' time, whereas the fixed asset will impact profit or loss over a number of years through depreciation. Therefore, even though the hedged cash flows might occur on the same day, hedge accounting of the net amount is not permitted because recognition in profit or loss is over different reporting periods.

How we see it

The criterion that the offsetting cash flows in a group of net positions must affect profit or loss in the same reporting period may be a significant constraint for many entities. This may be because risk management is based on the timing of cash flows rather than the timing of profit or loss impact. Forecast sales and purchases with the same payment dates often do not affect profit or loss in the same period (since there is, typically, a stock turnover period on the items purchased). Also, this restriction will have greater effect for entities that report on a quarterly or half-yearly basis.

Entities hedging on a net basis may have an additional concern. If the risk management objective and strategy is to hedge on a net basis, but not all hedged items impact profit or loss in the same reporting period, hedge accounting consistent with the risk management objective and strategy is not permitted. In this scenario, it is unclear whether designating the hedging instrument as a proportion of a gross amount would be acceptable given that it is inconsistent with the actual net risk management objective and strategy.

Presentation of eligible cash flow hedge net positions

Even when a group of net positions is an eligible hedged item in a cash flow hedge, the ED specifies that, any hedging instrument gains or losses recognised in profit or loss shall be presented in a separate line, if the items in the net position affect different line items in the income statement. Therefore, when forecast sales and purchases are an eligible hedged net position (say, because they affect profit or loss in the same period), their corresponding line items in the profit or loss ("sales" and "cost of goods sold") will still be recorded at spot rate and will not reflect the effect of the hedge (which is to be shown on a separate line). This may not be the desired outcome for many entities, as volatility will still occur in gross line items in profit or loss.

Income statement	The ED CU	IAS 39 CU
Sales (recorded at spot rate)	X	X
Cost of sales (recorded at spot rate)	(x)	(x)
Hedging (gain/loss)	x/(x)	-
Gross profit (reflected at hedged rate)	X	X

The rationale for this presentation is that the reclassified amounts would need to be grossed up to offset the hedged items effectively. Such grossed-up adjustments of all the affected line items in the income statement would result in the recognition of gross (partially offsetting) gains or losses that do not exist.

As a further example, consider a firm sales commitment of FC100 and firm purchase commitment of FC80 (both denominated in the same foreign currency) that are hedged on a net basis with a forward contract for FC20. The net position is designated as a hedged group in a fair value hedge. The foreign-currency risk components of both the FC100 firm sale commitment and the FC80 firm purchase commitment are recognised as two separate balance sheet items (an asset if the foreign currency component is a gain and a liability if it represents a loss). The foreign-currency risk component recorded on the firm sale commitment will be transferred to profit or loss when the sale occurs (the "sale" line item being reflected at hedged rate). The foreign-currency risk component recorded on the firm purchase commitment will be transferred to the carrying amount of the non-financial asset purchased or directly to profit or loss if the item purchased is directly expensed.

How we see it

Although the ability to designate groups of net positions as hedged items represents significant progress in aligning risk management and hedge accounting, there remain some significant restrictions for hedges of forecast transactions. These restrictions may significantly limit the scope of risk management strategies that are eligible under the proposals in the ED, in particular, for hedges of foreign-currency risk. The separate presentation in the income statement of the hedging instruments' gains or losses will also probably not meet the accounting outcome that may be desired by preparers who would expect that the hedged transactions that form part of the net position can all be reflected at the hedged rate.

Open portfolio or macro hedging

Banks and financial institutions typically manage their interest rate risk exposures on a net basis at a portfolio (or macro) level, giving rise to fundamental differences between the requirements in IAS39 and actual hedging practices. IAS39 portfolio hedging is a contentious topic and has been debated at length and over many years by the IASB and the banking industry. Although some of the banks' concerns were dealt with in previous revisions to IAS 39, many were not dealt with fully and led to the existing EU carve-out of IAS 39.

The proposals of the ED deliberately exclude open portfolios since the Board's deliberations on the macro hedging model are ongoing and a separate exposure draft on macro hedging is expected later in 2011. The Board decided to expose the general model for hedge accounting (the ED) so that it can consider the feedback received when developing the portfolio hedge accounting model. Conversely, the Board has also not ruled out the possibility of adjusting the general model as a result of its deliberations on the macro hedging model.

How we see it

Banks and financial institutions may find it difficult to comment on the general model without fully understanding the impact of the proposed changes on their existing hedge accounting issues. As already mentioned earlier, the Board has tentatively decided in December 2010 to consider further the bottom layer approach for portfolios of prepayable debt instruments. The eligibility of groups of net positions for closed portfolios in the ED may also be considered as a promising step in the current debate. However, there remain significant issues to be solved, such as the designation of dynamic hedging relationships in an open portfolio, the eligibility of demand deposits in a fair value hedge and the eligibility of sub-LIBOR components.



8. Other changes

8.1 Time value of options

The use of options as hedging instruments has been problematic under IAS 39. For hedges involving financial options, both IAS 39 and the ED give entities the choice:

- (a) To designate the option as a hedging instrument in its entirety
- Or
- (b) To separate the time value of the option and only designate (the change in) its intrinsic value as the hedging instrument

In practice, under IAS 39, it is common to apply choice (b), in which case, the time value of the option has to be recorded at FVTPL. Consequently, there can be significant volatility in the recorded profit or loss, even if hedge accounting is applied.

The Board has acknowledged that this accounting treatment is disconnected from risk management and that, for risk management purposes, entities typically consider the premium paid on an option (which, on inception, is often only time value) as a cost of hedging rather than a held-for-trading position. From this perspective, the time value of an option could be considered as a premium for protection against risk (an “insurance premium” view). To illustrate that approach, the Board refers to the accounting treatment of the cost of insuring risk under other IFRSs. For example, insurance premiums could be treated either as transaction costs that are capitalised into the cost of the insured asset (e.g., freight insurance paid by the buyer in accordance with IAS 2 or IAS 16) or as expenses over the period for which the entity is insured (e.g., fire insurance for a building).

Consequently, the ED proposes to account for the time value of options in a hedge accounting relationship by making a distinction between two types of hedged items:

- ▶ Transaction related (e.g., the forecast purchase of a commodity)

And

- ▶ Time period related (e.g., hedging price changes affecting commodity inventory)

For both transaction-related and time-period-related hedged items, the cumulative change in fair value of the option's time value would initially be accumulated in Other Comprehensive Income (OCI). In the former case, the amount is removed from OCI and included in the initial cost or other carrying amount of the hedged item. In the latter case, the amount is recycled from OCI to profit or loss, in order to amortise the original time value of the option over the term of the hedging relationship. Even though the ED does not prescribe the amortisation method to be used, the examples provided on the IASB website are based on straight-line amortisation.

When the option used contains critical terms (such as the notional amount, life and underlying) that do not match the hedged item, an additional assessment has to be made to “align” the option's time value to the insured risk. This may occur if the timing of the hedged item changes, or if the underlying is not exactly the same as the hedged item (i.e. there is basis risk). For that purpose, the actual time value has to be compared with that of a hypothetical option that perfectly matches the hedged item (e.g., with the same notional amount, life and underlying). Such an assessment is required, for example:

- ▶ If an entity hedges the commodity price risk of a commodity A purchase for delivery in 12 months' time using a 12-month option for commodity B which is more widely traded than commodity A (transaction-related)

Or

- ▶ When hedging the fair value of a fixed rate bond with respect to interest rates for a period of 24 months using a 25-month call option that would be sold after twenty 24 months (time-period-related).

In the first example, the option's aligned fair value is derived based on a similar option contract for commodity A for a 12-month period, in the second example, it is based on a similar option contract for a 24-month period.



Accounting for time value of options

	Transaction related	Time period related
Cumulative FV change of option's time value	<ul style="list-style-type: none"> ▶ Recognised in OCI based on the 'lower of' the cumulative FV change of: <ul style="list-style-type: none"> ▶ The actual time value (the initial time value of the purchased option) And ▶ The aligned time value (the time value that would have been paid for an option that perfectly matched the hedged item) ▶ If the actual change in time value > the change in aligned time value, difference goes to profit or loss 	
Recycle/transfer out to P&L	<ul style="list-style-type: none"> ▶ Recycle when the hedged item affects P&L ▶ Capitalise into carrying value as 'basis adjustment' (for non- financial hedged item) ▶ Recognised in profit or loss immediately if hedged item no longer expected to occur 	Amortisation of OCI into profit or loss as an expense over the period of protection on a 'rational basis'
Discontinuation of hedge	Follow general requirements above	Unamortised OCI amount will be recognised in profit or loss immediately

How we see it

Many constituents have asked the IASB in the past to allow a treatment for options as hedging instruments similar to that allowed by US GAAP Derivatives Implementation Group (DIG) G20. The proposals in the ED reflect the IASB's positive response to those requests, although it should be noted that the US GAAP guidance is only applicable in respect of a sub-set of cash flow hedges, whereas the proposals in the ED extend the requirement to all fair value and cash flow hedges.

The new accounting requirements for the time value component of options will introduce additional complexity. Entities that use options as part of their hedging strategy will need a valuation model and they will need to obtain detailed information to calculate 'aligned time value'. Besides this, additional disclosures will have to be made in the financial statements. Nevertheless, the overall impact will be beneficial for entities to reduce the volatility that results from the current requirements under IAS 39.



8.2 Changes to fair value hedge accounting

The ED proposes to change the method of accounting for fair value hedges so that it is more in line with that for cash flow hedging. Thus, changes in the fair value of both the hedging instrument and the hedged item will be recognised in OCI and any difference (ineffectiveness) will be recognised in profit or loss immediately. This will not result in any net movement in OCI. Nevertheless, the Board expects that users will benefit from the fact that all the effects of hedge accounting are presented gross “in one place” in a primary statement.

The proposals in the ED will also result in changes in presentation to the face of the balance sheet in that the cumulative gain or loss on the hedged item attributable to the hedged risk will be presented as a separate line item in the balance sheet, rather than being included as an adjustment to the carrying amount of the hedged item as currently required under IAS 39.

As noted earlier in Section 6, the ‘lower of’ test used for cash flow hedges is not applied to fair value hedges. Thus, ineffectiveness will continue to be recognised in profit or loss if the cumulative change in the fair value of the hedging instrument is greater than that of the hedged item. This is illustrated in the examples below.

How we see it

We appreciate that the ED’s proposals on fair value hedge mechanics are aimed at reflecting the impact of the hedging activity in one place in the primary financial statements. However, we believe the proposals increase the operational burden on entities using fair value hedges.

Moreover, we do not prefer the ED’s proposal 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, for several reasons:

- ▶ The primary financial statements will be cluttered, depending on the number of hedge relationships entered into by an entity
- ▶ The resulting assets and liabilities would not meet the definitions of such items in the framework.

The ED states that the separate line item must be presented next to the line item that includes the asset or the liability. Applying this requirement, it is likely that there will be hedge adjustments that are negative figures on the asset/liability sides of the balance sheet and this might seem counter-intuitive.

Scenario 1 - FV of hedged item > FV of hedging instrument		Scenario 2 - FV of hedging instrument > FV of hedged item	
FV change of hedged item	100	FV change of hedged item	80
FV change of hedging instrument	(80)	FV change of hedging instrument	(100)
Accounting for the hedged item		Accounting for the hedged item	
Dr Cumulative FVH adjustment (BS)	100	Dr Cumulative FVH reserve (BS)	80
Cr OCI	(80)	Cr OCI	(80)
Cr Hedge ineffectiveness (P&L)	(20)		
Accounting for the hedging instrument		Accounting for the hedging instrument	
Dr OCI	80	Dr OCI	80
Cr Hedging instrument (BS)	(80)	Dr Hedge ineffectiveness (P&L)	20
		Cr Hedging instrument (BS)	(100)
<ul style="list-style-type: none"> ▶ No net impact on OCI ▶ Ineffectiveness of (20) taken to P&L ▶ Under cash flow hedge rules, no ineffectiveness would be recognised in P&L 		<ul style="list-style-type: none"> ▶ No net impact on OCI ▶ Ineffectiveness of 20 taken to P&L ▶ Same treatment of ineffectiveness as cash flow hedges 	

8.3 Own use contracts

Current requirements

Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell non-financial items that can be settled net in cash, as if they were financial instruments. Many commodity purchase and sale contracts meet the criteria for net settlement in cash because certain commodities are readily convertible to cash. However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39.

In these situations, contracts are accounted for as normal sales or purchase contracts. Consequently, if an entity enters into a derivative contract to hedge changes in the fair value or cash flow exposures arising from such contracts, it creates an accounting mismatch because the change in the fair value of the derivative is recognised in profit or loss, while the change in the fair value of the commodity supply contract is not recognised.

To eliminate the accounting mismatch, an entity could apply hedge accounting. It could designate commodity supply contracts (if they meet the definition of a firm commitment) as hedged items in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the changes would offset the changes in fair value of the derivative instruments. However, hedge accounting in these circumstances is administratively burdensome. Furthermore, entities enter into large volumes of commodity contracts and, within the large volume of contracts, some positions may offset each other. An entity would therefore typically hedge on a net basis where the net position is maintained at nil or close to nil by monitoring, managing and adjusting the position almost on a daily basis.

The ED's proposals

The Board proposes that derivative accounting would apply to contracts (that would otherwise meet the 'own use' scope exception), if an entity's risk management strategy is fair value-based. The Board believes that this approach would faithfully represent the financial position and performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements and be less onerous for entities than applying hedge accounting.

The ED only includes a summary of the proposed changes rather than the detailed amendments. It appears that fair value accounting would be 'required' if an entity's risk management strategy is based on fair values. Therefore, there would be no choice for entities that clearly manage their commodity exposure including all own use contracts on a fair value basis, i.e., it would not be possible to apply to some of the own use contracts, except perhaps if these are held in different business units and only these are managed on a fair value basis.

How we see it

We are optimistic that the proposals will solve a practical issue for those IFRS reporters that adopt a fair-value based risk management strategy. However, since the full details of the changes have not been included in the ED, it is not yet possible to fully assess the impact and there is a risk that not all concerns of constituents will have been addressed.

8.4 Equity investments at fair value through OCI

The ED explicitly states that hedge accounting shall not be applied to investments in equity instruments designated as at fair value through OCI under IFRS 9. Entities may, as part of their risk management strategy, wish to hedge the foreign exchange risk of a foreign currency-denominated equity instrument designated at fair value through OCI, but will not be able to achieve hedge accounting. This is because, the hedged item (i.e., the foreign currency translation) will never affect profit or loss, whereas the ED (and IAS 39) define a hedging relationship as one in which the exposure to be hedged could affect profit or loss (also see the discussion under section 2).

9. Transition issues and disclosures



Transition

The ED proposes the prospective application of the new hedge accounting requirements, with no restatement of comparative numbers and no requirement to give the new proposed hedge accounting disclosures for comparative information. To apply hedge accounting upon the adoption of the new requirements, all qualifying criteria must be met as at that date of adoption.

All entities that engage in financial risk management activities and apply hedge accounting under the current version of IAS 39 may be affected by the changes. While it is expected that most of the previous hedge accounting relationships will still qualify under the new model, the impact of the new requirements that the hedge relationship be “unbiased” and that there is “no accidental offset”, together with the requirement to align hedge relationships with the entity’s risk management objectives, will make it necessary for entities to evaluate existing hedge relationships under IAS 39 and consider whether they still will be eligible under the new model or require rebalancing.

Any hedge relationships designated under IAS 39 that also qualify under the new model, will be treated as continuing hedge relationships. Hedge documentation may need to be updated upon transition, for example to document the analysis of sources of hedge ineffectiveness, how the entity determines the hedge ratio and the rebalancing of the ratio between hedging instrument and hedged item. Previous hedge accounting relationships that do not qualify under the proposed new model will need to be discontinued. For some hedge relationships, hedge accounting may be achievable for the first time under the new hedge accounting rules and entities need to ensure that they can demonstrate early enough the eligibility of these new relationships for hedge accounting. This is an area of particular importance for hedges of non-financial items for which hedge accounting was often not achievable under IAS 39.

The transitional guidance in the current version of the ED is relatively brief. As discussed in Section 2, hedge relationships that have been designated under IAS 39 may not be aligned with the risk management objectives and strategies. Some of these hedge relationships may not qualify upon transition and, in other cases, it might be possible to treat them as continuing hedge relationships, but only after a rebalancing exercise is first performed.

In addition, better effectiveness results may be achieved now that risk components for non-financial items are permitted. We presume that such changes could be made on transition as an extension of the existing hedge relationship. However, the ED is not clear on this point.

Although the ED does not specifically mention the issue, it is expected that, upon transition, entities will need to consider new designations that might be required because of the interaction with other phases of IFRS 9 (classification and measurement, and impairment). For example, under IAS 39, it is generally acknowledged that FVTPL instruments do not qualify as hedged items, but it may be possible to designate certain FVTPL instruments in hedge relationships under IFRS 9 provided they are neither held for trading nor are managed on a fair value basis.

Disclosures

In addition to the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* the ED requires entities to disclose further information, that falls into three categories:

Category	Comments/purpose
<ul style="list-style-type: none"> ▶ An entity's risk management strategy and how it is applied to manage risk 	<p>Information disclosed about an entity's risk management strategy should help users of financial instruments to understand and evaluate:</p> <ul style="list-style-type: none"> ▶ How each risk arises ▶ How the entity manages each risk, which includes whether the entity hedges an item in its entirety for all risks or hedges a risk component(s) of an item ▶ The extent of risk exposures that the entity manages
<ul style="list-style-type: none"> ▶ How the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows 	<p>Entities must provide a breakdown that discloses, for each subsequent period that the hedging relationship is expected to affect profit or loss, the following:</p> <ul style="list-style-type: none"> ▶ The monetary amount or other quantity (e.g., tonnes or cubic metres) to which the entity is exposed for each particular risk (for hedges of groups of items, an entity must explain the risk exposure in the context of a group or net position) ▶ The amount or quantity of the risk exposure being hedged ▶ In quantitative terms, how hedging changes the exposure (i.e., the exposure profile after hedging, such as the average rate at which the entity has hedged the exposure) <p>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. Other sources that may emerge shall also be explained.</p>
<ul style="list-style-type: none"> ▶ The overall effect that hedge accounting has had on the entity's financial statements – including statement of financial position, statement of comprehensive income and statement of changes in equity 	<ul style="list-style-type: none"> ▶ Entities must disclose, in a tabular format, the carrying amounts and notional amounts relating to the hedging instruments (financial assets separately from financial liabilities) and accumulated gains or losses on hedged items, 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).

The information is required to be disclosed for each category of risk (e.g., interest rate risk, equity risk, and commodity risk, etc.), determined on the basis of the risk exposure an entity decides to hedge and for which hedge accounting is applied. The disclosures should be presented either in a single note or in a separate section in the financial statements. But an entity can work with cross-references to avoid duplication of information already disclosed elsewhere in the financial report. See Appendix II for an illustration of the proposed disclosure requirements.

How we see it

The proposed disclosures are extensive, but generally consistent with the objective that hedge accounting is aligned to, and reflective of, an entity's risk management activities. However, as previously mentioned in section 2, we consider that the linkage needs to be better articulated. In respect of disclosures, this might be achieved by requiring entities to disclose how the entity's risk management strategy might differ from the hedge accounting permitted by the ED.



10. On balance

Most preparers will find that, in principle, the IASB's hedge accounting ED offers significant flexibility compared with the existing rules in IAS 39 and the FASB's proposed amendments to the US GAAP hedge accounting rules. Based on the outreach conducted by the IASB staff, the main criticism of IAS 39 was that, in many cases, the accounting did not reflect how entities manage risk. Most of the changes proposed in the ED are in response to this criticism.

The key improvements can be summarised as follows:

- ▶ No more arbitrary 80-125% retrospective effectiveness testing to qualify for hedge accounting
- ▶ Risk components of both financial and non-financial items can be hedged items – this is a significant change, particularly for hedging commodity risks
- ▶ Eligible hedge items are now expanded to include combinations of derivatives and non-derivatives, as well as portions or layer components of individual financial and non-financial items
- ▶ Ability to use qualitative effectiveness testing in some circumstances
- ▶ Rebalancing (which is a common risk management technique) will not necessarily result in de-designation and re-designation; the consequential ineffectiveness that arises due to non-zero fair value derivatives on re-designation can therefore be avoided
- ▶ Proportional de-designation/partial discontinuation is now possible in some circumstances
- ▶ There are significant relaxations of the rules relating to hedges of groups of gross or net positions as well as layer components of gross groups
- ▶ Option premiums (time value of options) can be deferred in OCI and are either included in the cost of the hedged item or amortised to profit or loss. This reflects the risk management function of option contracts rather than their time value being treated as trading derivatives
- ▶ 'Own use' commodity contracts can be fair valued in certain circumstances if managed on a fair value basis rather than applying hedge accounting

Although the new hedge accounting proposals are more closely aligned with entities' risk management activities, the ED appears to present some new challenges. One obvious challenge is that hedge accounting may no longer be possible for risk management objectives that simply do not qualify for hedge accounting. This contrasts with IAS 39, which allows hedge accounting for any eligible hedging instrument and hedged item that are matched and the relationship complies with the 80-125% effectiveness test, even when this does not align with an entity's actual risk management strategy (see section 2).

In addition, in relation to hedging risk components, there are several practical issues in identifying the valid risk components and measuring them reliably as required by the ED (see section 3), especially when the components are not contractually specified. Also, economic hedges involving certain components are precluded from hedge accounting – this includes non-contractually specified inflation in financial instruments, a benchmark component with a negative indexation (sub-LIBOR), and credit risk.

The other new challenge created by the ED is the replacement of the prospective and retrospective 80-125% test with the requirement to ensure there is no bias in the hedge relationship prospectively and to re-balance the hedge relationship to remove bias in order to continue to qualify for hedge accounting. From a practical perspective, currently, entities with numerous hedge relationships can simply rely on automated processes to determine whether a mathematical calculation is within a boundary of 80-125% without significant manual intervention. Under the ED, significant judgment is now required to ensure whether each hedge relationship is unbiased and also whether a hedge relationship is required to be re-balanced i.e., automated software solution may be helpful to highlight trends, but human intervention will be required to apply judgment and determine the point in time when rebalancing needs to take place.

11. Comparison with the FASB ED

The IASB ED is more ambitious than the hedging portion of the FASB's financial instruments ED. As a result, this presents significant convergence challenges. For the most part, the FASB ED preserves the fundamental accounting structure of the US GAAP hedging model, including what constitutes an eligible hedge strategy, how hedge ineffectiveness is measured and how the effects of hedge accounting are presented in the balance sheet and income statement.

Unlike the IASB ED, the FASB ED purposefully has not revisited large-scale issues such as allowing a non-financial risk component to be separately hedged, permitting a non-derivative financial instrument measured at FVTPL to be a hedging instrument, or permitting a net risk position to constitute an eligible hedged item. The novel IASB concept of not only requiring a rebalancing when the hedge relationship loses effectiveness and the risk management objective is still the same (and the offset is not accidental), but also viewing the post-rebalanced hedge as part of the same hedge relationship, does not exist in the current or proposed FASB model. The FASB has always viewed a rebalanced hedge relationship as a new relationship that must have a fresh start to hedge documentation and hedge effectiveness assessment.

Instead, the FASB ED has taken the approach of preserving the hedge accounting model as it is presently known under US GAAP, but making it easier for companies to qualify to use the model, and to stay qualified so as to continue using it. In this sense, the FASB's approach was to respond to requests from constituents who wanted relief from the challenges of auditors and regulators who sometimes had different interpretations of the FASB's strict hedge qualification rules and what truly constituted a "highly effective" hedge relationship. The FASB's proposal to permit "reasonably effective" hedges, combined with the reaffirmation of qualitative approaches to assessing hedge effectiveness and the removal of the mandatory quarterly reassessments, is designed to provide that relief.

The FASB's proposed use of a "reasonably effective" model for hedge qualification focuses on the expected results of a hedge design from a prospective point of view, and the actual results of the hedge design from a retrospective point of view. In contrast, the IASB ED focuses only on a prospective point of view and whether the hedge is designed from the outset to produce an unbiased result other than accidentally, and does not require a retrospective look-back (other than to measure the ineffectiveness in profit or loss). Despite this key difference, both the FASB and IASB propose to "lower the bar" for what constitutes a qualifying hedge and make it easier to achieve hedge accounting, but they do not propose to do this in the same way.

An apparent similarity is that both Boards have ruled out voluntary terminations of hedge accounting aside from effectively terminating the hedging instrument itself. However, the IASB proposal would permit, even require, an early hedge termination if the risk management objective changes, a seemingly low hurdle that turns the similarity into a difference.

Other important topics that are not converged in the two EDs that affect cash flow hedges include the treatment of "under-hedges" and the accounting for the time value of purchased options. Currently, there is convergence in that both the IASB and FASB models view "under-hedges" (whereby the effective portion of the derivative's fair value change is less than the hedged item's fair value change) as not resulting in the recording of ineffectiveness in earnings. While the IASB ED carries forward this requirement, the FASB ED proposes to change this treatment and require ineffectiveness to be recorded.



With respect to the time value of purchased options used in cash flow hedges, the IASB ED would provide a different accounting model depending on whether the hedged forecast transaction is viewed as “transaction-related” or “time period-related”. Transaction-related hedges would potentially allow full deferral of time value in OCI, while time period-related hedges would allow only modest deferral because the time value would have to be amortised into earnings on a rational basis over the life of the option. The FASB’s proposed model for time value of purchased options only contemplates the latter treatment and would apply it to both transaction-related and time period-related hedges.

In September 2010, many commentators on the FASB *Financial Instruments* ED withheld significant reaction to the hedging portion because they said they wanted to see the IASB version. Many of those same commentators, including Ernst & Young, particularly wanted the FASB to seriously consider permitting the hedging of risk components for non-financial items as the IASB ED was expected to do. Now that the IASB ED has been issued, the FASB has announced plans to expose the IASB ED to their constituents during Q1 2011, with a “wrap-around” set of questions for which the FASB will seek input. Simultaneously, the FASB will re-deliberate and consider amending its hedging model. One question that we foresee the FASB wanting to ask in this “wrap-around” is whether the FASB’s constituents believe that certain provisions in the IASB ED are “auditable.” For example, how operational are hedge criteria based on terms such as “ensuring an unbiased result” or “other than accidental”?

How we see it

Champions of convergence are likely to feel discouraged as they look at the two hedge accounting models, and may feel that the two current models are more converged than the two proposed models. We strongly support convergence and we are heartened by one fundamental similarity in that both Boards preserved hedge accounting and tried to make it more accessible to their constituents. The FASB has done so without changing its basic framework of what constituted eligible hedge relationships. But the IASB has gone much further, attempting comprehensive expansion of its framework to encompass more sophisticated and more dynamic hedge strategies. However, as noted throughout this document, we believe there are clarifications needed on the IASB ED, which we hope will be addressed by the Board during the post-comment period and before the final standard is issued.

12. Effective date, early adoption

It is proposed that application of the standard will be mandatory for annual periods beginning on or after 1 January 2013, with earlier application permitted. The first phase on classification and measurement has already been issued and the second and third phases, impairment and hedge accounting respectively, are expected to be in place later in 2011. However, given the IASB's phased approach to the project, many jurisdictions have not yet endorsed IFRS 9 (as issued to date). It seems clear that entities, particularly in such jurisdictions, may not have sufficient time to prepare for the adoption of IFRS 9 by the mandatory effective date.

In the meantime, the IASB and the FASB have published consultation documents on "Effective dates and Transition Methods", seeking views about the time and effort involved in implementing the proposed new standards that are due to be issued by June 2011, including transition methods. The results of this consultation may have a significant bearing on the timing of the mandatory effective date and transitional relief afforded in IFRS 9.

When finalised, the new hedge accounting requirements will form part of IFRS 9 and can only be adopted if the other finalised IFRS 9 requirements are adopted at the same time or have been adopted earlier. On the other hand, a company that wants to early adopt the previously finalised IFRS 9 requirements, such as classification and measurement, does not need to adopt early the new hedge accounting requirements.

In the first year of application of the proposed ED, the comparative numbers and disclosures will, due to the prospective application, still reflect the IAS 39 hedge relationships. This will, therefore, impose a limitation on comparability between reporting periods.

How we see it

The information presented in financial statements could be confusing because other phases of IFRS 9 (e.g., classification and measurement, impairment) will need to be applied retrospectively while the hedge relationships in the comparative information will still reflect the IAS 39 hedge relationships. Our view is that entities that do not early adopt the standard (i.e., those that adopt at the mandatory effective date) should be allowed to designate their IFRS 9 hedge relationships in parallel (and without the benefit of hindsight) so as to permit restatement of comparative information.

13. What do I need to do and how can EY help?

The ED provides opportunities to better align hedge accounting and economic hedging activities. Entities in both financial services and non-financial services sectors may wish to: (i) review their current economic hedging activity in order to identify new avenues; and (ii) revisit their risk management objectives and strategies and clarify them as necessary in order to apply hedge accounting under the new model. In addition, entities could facilitate a smoother transition by determining what hedge relationships will need to be designated in the future and by developing the related hedge documentation, in time for adoption.

As we have noted in each of the sections above, there are a number of points of detail that need to be clarified by the Board before issuing the final standard. It is, therefore, recommended that all interested parties provide feedback to the IASB by the deadline of 9 March 2011.

Ernst & Young has a dedicated Financial Accounting Advisory Services (FAAS) group to meet the emerging needs of IFRS reporting entities. The range and complexity of the changes in accounting are so significant that we have invested extensively in growing our team of professionals in the key financial services markets around the world. We recognise the continuing nature of regulatory and accounting change and we are committed to investing for the long term.

Issues and steps	How EY FAAS can help
Understand the changes between current IAS 39 and the ED	<ul style="list-style-type: none"> ▶ Design and deliver tailored presentations and facilitated workshops ▶ Share insights of IASB and FASB views ▶ Advise you in your response to the ED
Perform a preliminary assessment of the impact of the ED	<ul style="list-style-type: none"> ▶ Advise you in determining the new hedge accounting opportunities that arise from the ED ▶ Design and advise on the implementation of new hedge accounting strategies that were not previously possible; hedge relations involving risk components, options, complex groups, layers, etc ▶ Assist in understanding the new effectiveness testing requirements and develop methods to implement them
Plan for transition to the proposed standard	<ul style="list-style-type: none"> ▶ Help prepare for transition and evaluate the impact of the changes due to other relevant projects ▶ Assist with (re-)writing your current hedge documentation to comply with the new guidance and to ensure that it is more dynamic
Benchmark against peers and others in the industry	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the proposal, problems they encountered and solutions developed ▶ Advise you on best practice disclosures

Appendix I – Accounting for credit risk using credit derivatives (Section 3)

As noted on page 11, the IASB deliberated whether it is possible to permit hedge accounting when credit derivatives are used to economically hedge credit risk, but do not qualify because the credit risk component cannot be reliably measured. The Board has put forward four alternative approaches to tackling this issue and has requested feedback from constituents.

One alternative is simply to carry forward the restriction in IAS 39. The remaining three alternatives (see the summary table below) involve the modified use of the fair value option (FVO). It would be possible to use the FVO provided the economic relationship between the financial instrument and the credit derivative is based on the same credit risk. That is, matching the name (of the loan or loan commitment and the reference entity of the credit derivative) and the seniority (of the financial instrument and the instruments that can be delivered in accordance with the credit derivative). The FVO may be elected for a proportion (say, 90%) of the nominal amount of the hedged instrument.

Credit risk – summary of alternatives to hedge accounting

	FVO for a nominal component of the hedged instrument	FVO subsequent to initial recognition	FVO discontinued prior to derecognition ²	Difference between amortised cost and fair value recognised immediately in profit or loss
Alternative 1	Yes	No	No	N/A
Alternative 2	Yes	Yes	Yes	Yes
Alternative 3	Yes	Yes	Yes	No (amortised over life of instrument)

Alternative 1

The FVO would only be available at initial recognition of the exposure. This may not be practically useful in many situations, for instance, where financial institutions obtain credit protection for an exposure subsequent to initial recognition. Nevertheless, the requirement to apply this method at initial recognition of the exposure is an advantage, as there will be no difference between the carrying amount of the exposure at the date of election and its fair value. Therefore, Alternative 1 is less complex than the other alternatives.

Alternative 2

The FVO may be elected at initial recognition or subsequent to the exposure to credit risk. If the FVO is elected subsequently, the difference between the then carrying amount and fair value (i.e., the measurement change adjustment or MCA) is recognised immediately in profit or loss. This alternative would allow an entity to reflect its active and flexible risk management practices in the financial statements and significantly reduce the accounting mismatch between credit risk exposures and the credit derivatives. This method is operationally more complex than Alternative 1 because of the MCA.

Alternative 3

This alternative is similar to Alternative 2. That is, the FVO may be elected at initial recognition or subsequently, except that the MCA is deferred/amortised rather than being recognised immediately in profit or loss. The advantage of Alternative 3 over Alternative 2 is that it will not deter the use of FVO in scenarios where after initial recognition the fair value of the credit exposure has already declined. However, Alternative 3 is, operationally, the most complex approach of the three alternatives.

How we see it

Many banks and financial institutions have long wanted to achieve hedge accounting for credit risk using credit derivatives. While modifying the fair value option is an improvement and will reduce the accounting mismatch, it also creates additional complexities to financial reporting. Instead, a solution might be to create an exception within the main hedge accounting requirements. Interested parties are encouraged to carefully consider the alternatives and respond to the Board.

² If qualifying criteria no longer met or hedging instrument is sold, expired or otherwise terminated.

Appendix II – Proposed disclosure requirements (Section 9)

(Illustrative example prepared by IASB staff)

Note X to the financial statements of an oil company as at 30 June 20X9

Commodity price risk

Commodity price risk is the most important market risk for the company. The risk is managed in USD. The company has established guidelines for entering into contractual arrangements (derivatives) in order to manage its commodity price risk. Commodity price risk is managed on a mid-term basis. The commodity derivatives are priced using pricing benchmarks (mainly Brent).

The company estimates production to be an average of 55,000 barrels of oil per day for 20X0 and hedges only a certain proportion

of that production. This leaves the company in a position to benefit from rises in prices for crude oil while protecting a minimum level of profitability of its main production assets (refer to the management report, Section XX). To manage the commodity price risk, the company enters into commodity-based derivative contracts, which consist of exchange-traded put options and over-the-counter forward contracts. The company is able to integrate all its oil production (and forecasts) into a centralised risk management system because of the small size of its operations and the fact that production operations are managed from one subsidiary.

The company's hedge position can be summarised as follows:

	20X0	20X1	20X2
Basis of total price risk exposure (barrels of oil per day)	55,000.00	60,000.00	65,000.00
Exposure hedged			
Forward sales contracts			
▶ Basis of hedged exposure (barrels)	14,500.00	6,000.00	6,000.00
▶ Average hedge rate (US\$/barrel)	81.75	85.50	88.00
Put options			
▶ Basis of hedged exposure (barrels)	14,500.00	6,000.00	Nil
▶ Average hedge rate (US\$/barrel)	≥75.00	≥70.60	Nil

The oil hedges of the company involve basis risk. The grade of the oil that the company produces differs from the grade of the oil referenced in the derivative contracts. Those contracts (both for the OTC and exchange traded derivatives) mainly refer to the Brent crude oil price as a benchmark. The company's oil production trades on average at about 80 per cent of Brent crude oil prices. Hence, fluctuations around this average create hedge ineffectiveness.

OTC derivatives involve credit risk. The company uses collateral arrangements with its main lenders that are also the counterparties to the company's OTC derivative contracts to reduce credit risk (see Note XX.b on Financial Risk Management–Credit Risk). However, some credit risk remains and can result in hedge ineffectiveness.



Interest rate risk

The company manages its interest rates by converting the cash flows from long-term loans payable (CU 50 million) with fixed interest rates into floating rate interest payments. The company applies this strategy because it wants its funding costs to move in line with market changes.

Loans payable are normally borrowed at a fixed rate in local currency. These loans are converted to floating rate loans using interest rate swaps. Under interest rate swaps, the group agrees with other parties to exchange, at specified intervals, the difference between interest amounts calculated by reference to an agreed notional principal and agreed fixed and floating interest rates. The company hedges only the benchmark risk component.

The company's interest rate risk exposure can be summarised as follows:

	20X0	20X1	20X2	20X3
Fixed Interest – loans payable				
▶ Basis for total interest exposure (CU million)	40.00	30.00	20.00	10.00
▶ Average fixed interest rate	6%	6%	6%	6%
Exposure hedged				
▶ Basis for the exposure hedged (CU million)	40.00	30.00	20.00	10.00
▶ Receive fixed interest payments	5.90%	5.90%	5.90%	5.90%
▶ Pay floating interest rate	LIBOR + 2%	LIBOR + 2%	LIBOR + 2%	LIBOR + 2%

At the year-end, the entity had only receiver swaps. With effect from 1 January 20X9 a notional amount of CU 50 million with a 6% fixed rate was swapped for a floating rate of 3m LIBOR +200bps. This contract expires on 1 January 20X5. The result of the hedge is an effective interest expense of LIBOR +245bps (3m LIBOR + 200bps + 40bps [fixed leg differential] + 5bps [transaction cost]).

The company's interest rate swaps are subject to credit risk. The company uses collateral arrangements to mitigate credit risk (refer to the disclosure of commodity price risk above). However, the remaining credit risk can result in hedge ineffectiveness.

Under the approach used by the company, fair value hedging of the fixed rate liabilities gives rise to limited hedge ineffectiveness because of the reset interval (3 months) of the floating leg of the interest rate swap.

	1 year	2 – 5 years	> 5 years
For example Fixed interest loans payable etc	xx	xx	xx



Foreign exchange risk

The company has limited exposure to foreign exchange risks. Its purchases and sales are mostly denominated in its functional currency. The company's hedge position can be summarised as follows:

USD/EURO exposure	20X0
Basis for total foreign currency risk exposure managed (firm commitment)	6.00
Exposure hedged	
Basis for the foreign exchange risk hedged	6.00
Average hedged rate	n/a

During the year the company entered into a firm commitment transaction to purchase property, plant and equipment of EUR 10 million. The investment appraisal was based on the functional currency because of the related cash flows generated by the equipment. Consequently, the cost of the investment was locked in as an amount in the functional currency using foreign currency hedging.

The company designated EUR 10 million of a high credit quality loan of EUR 25 million as the hedging instrument for foreign exchange risk. The loan is denominated in the same currency as the currency of the firm commitment. The company did not hedge the remaining EUR 15 million of the loan. This is because that loan is naturally offset against other assets and liabilities of the entity.

This hedge is fully aligned with the exposure regarding the hedged FX risk, which is measured using the spot rate method.

Balance sheet amounts related to items designated as hedging instruments

	Notional amount of the hedging instrument	Carrying amount of the hedging instrument	
		Assets (CU millions)	Liabilities (CU millions)
Cash flow hedges			
Commodity price risk			
▶ Forward sales contracts	9,540,000 barrels	2.00	15.00
▶ Oil put option contracts	7,380,000 barrels	3.90	–
Fair value hedges			
Interest rate risk			
▶ Interest rate swaps	CU 50,000,000.00	3.00	–
Foreign exchange risk			
▶ Foreign currency loan	FC 10,000,000.00	6.00	–



Balance sheet amounts related to items designated as hedged items

	Gain or loss on the hedged item presented in a separate line item in the statement of financial position		Cash flow hedge reserve
	Assets	Liabilities	
Cash flow hedges			
Commodity price risk			
▶ Forecast sales	n/a	n/a	(9.00)
▶ Discontinued hedges (forecast sales)	n/a	n/a	–
Fair value hedges			
Interest rate risk			
▶ Hedge adjustment for loan payable	–	2.90	n/a
▶ Discontinued hedges (hedge adjustment-loan payable)	–	–	n/a
Foreign exchange risk			
▶ Firm commitment	0.40	–	n/a



The ED proposes that specific amounts that have affected the statement of comprehensive income as a result of applying hedge accounting should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

Cash flow hedges ^(a)	Change in the value of the hedging instrument in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)	Amount reclassified from the cash flow hedge reserve to profit or loss	Line item affected in profit or loss because of the reclassification
Commodity price risk	43.00	(6.90)	Hedge effectiveness	(32.00)	Revenue

^(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as the proposed disclosure requirements.

Fair value hedges	Change in the value of the hedged item recognised in other comprehensive income	Change in the value of the hedging instrument recognised in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)
Interest rate risk	2.90	(3.00)	(0.10)	Hedge ineffectiveness
Foreign exchange risk	(0.40)	0.40	-	n/a



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