IFRS 9 *FINANCIAL INSTRUMENTS* (HEDGE ACCOUNTING AND AMENDMENTS TO IFRS 9, IFRS 7 AND IAS 39)
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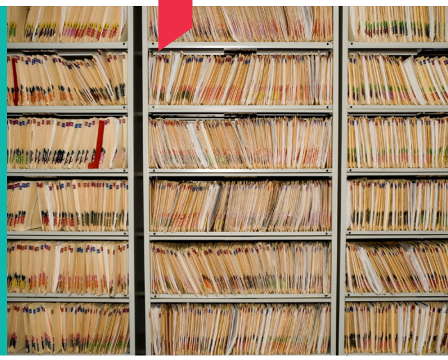

STATUS
Final

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Reduced 'artificial' profit or loss volatility and better reflection of entity's risk management activities in the financial statements.

Summary

On 19 November 2013, the International Accounting Standards Board (IASB) published IFRS 9 *Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)*, making three significant amendments to IFRS 9 *Financial Instruments*:

– Adding new hedge accounting requirements to IFRS 9
– Deferring the effective date of IFRS 9, and
– Making available for early adoption the presentation of changes in 'own credit' in other comprehensive income (OCI) for financial liabilities that are measured under the fair value option without early applying the other IFRS 9 requirements.

The new hedge accounting requirements that have been added to IFRS 9 are more principles-based, less complex, and provide a better link to risk management and treasury operations than the requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. The new model allows entities to apply hedge accounting more broadly to manage profit or loss mismatches, and as a result reduce 'artificial' hedge ineffectiveness that can arise under IAS 39.

Key changes introduced by the new model include:

– Simplified effectiveness testing, including removal of the 80-125% highly effective threshold
– More items qualify for hedge accounting, e.g. pricing components within a non-financial item, and net foreign exchange cash positions
– Entities can hedge account more effectively the exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods
– Less profit or loss volatility when using options, forwards, and foreign currency swaps
– New alternatives available for economic hedges of credit risk and 'own use' contracts which will reduce profit or loss volatility.

Under the new model, entities that have entered into economic hedges are more likely to qualify for hedge accounting. The new requirements will also lead to reduced 'artificial' profit or loss volatility which can arise from the existing strict rules in IAS 39. Depending on an entity's risk management strategy, the cost of applying hedge accounting is likely to be lower for entities with relatively simple risk management strategies.

Entities that are most likely to be able to achieve hedge accounting under the new requirements include:

– Those in the mining and natural resources sector, airlines, agriculture and other commodities industries
– Entities with significant foreign currency transactions or foreign currency funding that use derivatives to manage risk in their business activities.

The new requirements will allow entities to better reflect their risk management activities in their financial statements. Management may wish to consider the new requirements carefully as there may be benefits from early adoption. However, because IFRS 9 needs to be adopted as a complete package, the classification and measurement requirements of IFRS 9 also need to be considered.

Deferral of the effective date for IFRS 9

The IASB normally leaves a period of at least 18 months between the date of issue of a finalised IFRS, and the start of the period of its adoption. Because the impairment phase of IFRS 9 is not yet finalised, the previous mandatory effective date of 1 January 2015 would not allow sufficient time for entities to prepare to apply IFRS 9. Therefore, the IASB has deleted the previous 2015 effective date of IFRS 9 and has left the revised effective date open until all the other outstanding phases of IFRS 9 have been finalised.

Presentation of changes in 'own credit'

Under IFRS 9, entities that use the fair value option and designate financial liabilities at fair value through profit or loss (FVTPL) present the fair value changes in 'own credit' in OCI instead of profit or loss. This element of IFRS 9 can now be early adopted without applying any other aspects of IFRS 9.

Therefore, for financial liabilities designated a FVTPL, entities can continue to apply IAS 39 but follow the presentation requirement in IFRS 9 and present the changes in 'own credit' in OCI, provided that the adoption of IFRS 9 is permitted. It should be noted that for those entities that report in accordance with EU-endorsed IFRS, early adoption is not possible as IFRS 9 has not yet been endorsed.

This amendment is expected to mainly affect financial institutions and insurers.

New hedge accounting model

Background

The hedge accounting model in IAS 39 has been criticised as being complex, rules based, and not reflecting risk management activities of organisations, leading to the recording of profit or loss volatility from what might be regarded as 'artificial' hedge ineffectiveness. To improve financial reporting and to better reflect an entity's risk management activities the IASB decided that comprehensive changes were needed for hedge accounting.

The IASB decided to split the hedge accounting phase into two separate work streams due to the complexity of the topic:

- General hedge accounting, and
- Macro hedge accounting model - for dynamic hedging relationships where the hedge position changes constantly (e.g. on a daily basis).

The IASB is still currently deliberating the macro hedge accounting project and is expecting to publish a discussion paper in early 2014.

Changes from IAS 39

While there are some fundamental changes to the hedge accounting model which are outlined below, the general accounting mechanics of hedge accounting under IAS 39 remain largely unchanged:

- The new model retains the cash flow, fair value, and net investment hedge accounting mechanics
- Entities are still required to measure hedge effectiveness and recognise any ineffectiveness in profit or loss
- Hedge documentation is still required.

In addition, starting to hedge account will remain optional although, as noted below, once an entity has started to hedge account for a transaction there is no option to stop.

(i) Effectiveness testing

The 80-125% quantitative threshold criteria for applying hedge accounting under IAS 39 have been removed.

To qualify for hedge accounting under the new model, the hedge transaction must meet the following criteria:

– An economic relationship exists between the hedged item and the hedging instrument – i.e. the hedging instrument and the hedged item must be expected to have offsetting changes in fair value

– The effect of credit risk does not dominate changes in fair value – i.e. the fair value changes due to credit risk should not dominate changes in the fair value of either the hedging instrument or the hedged item

– The hedge ratio needs to be designated based on actual quantities (or values) of the hedged item and hedging instrument (unless doing so would create deliberate hedge ineffectiveness) – i.e. the hedge ratio applied for hedge accounting purposes should be the same as the hedge ratio used for risk management purposes.

(ii) Rebalancing

If the quantity of the hedged item or hedging instrument changes for risk management purposes, the hedge ratio for hedge accounting purposes must also change, i.e. the hedge ratio is required to be adjusted prospectively if the hedge ratio is adjusted for risk management purposes.

(iii) Hedged items – risk components, aggregated exposures and equity investments at FVTOCI

The new model allows more items to qualify as eligible hedged items compared to the IAS 39 hedge accounting model.

IFRS 9 aligns the requirements for financial and non-financial items such that risk components of non-financial items can also be eligible hedged items (previously under IAS 39, while risk components of financial items qualified for hedge accounting, only the foreign exchange risk components of non-financial items could be separated). Under the new model, to be an eligible risk component the risk component needs to be separately identifiable and reliably measurable. The eligible risk component can be contractually or non-contractually specified.

An aggregated exposure is a combination of a derivative item and a non-derivative item. Under IAS 39, derivatives cannot be designated as hedged items. This resulted in complexity and hedge ineffectiveness for entities with a portfolio of fixed and floating rate debt which have a policy under which, for example, 50% of debt at any point is either fixed rate or hedged to fixed rate. Due to differing loan maturities, this could result in derivatives being 'layered' on each other to arrive at the appropriate net risk position. However IFRS 9 now allows an entity to designate an exposure that combines a derivative and a non-derivative known as an aggregated exposure as a hedged item, provided that aggregated exposure is managed as one exposure. This change allows entities to hedge account more effectively those exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods.

Equity investments designated at fair value through other comprehensive income (FVTOCI) under IFRS 9 can be designated as a hedged item. Any ineffectiveness would be recorded in OCI rather than in profit or loss.

(iv) Hedging instruments – options, forwards and foreign currency swaps

When an entity designates only the intrinsic value of the option as the hedging instrument, the initial time value of the option is deferred in OCI under the new model and is treated as a hedging cost. The accounting mechanics depend on the nature of the hedged item:

– If the hedged item is transaction related (e.g. a forecast purchase of commodity) the initial time value is deferred in OCI and capitalised into the cost of the hedged item

– If the hedged item is time period related (e.g. a 5 year interest rate cap), the initial time value is deferred in OCI and amortised over the term of the hedging relationship.

The subsequent changes in the time-value component of the option are recorded in OCI rather than profit or loss. This change effectively reduces profit or loss volatility. Under IAS 39, when an entity designates only the intrinsic value of the option as the hedging instrument, the change in the time-value of the option is recognised in profit or loss under IAS 39.

When an entity designates the spot element of the forward contract as the hedging instrument, the entity has a choice under the new model to either:

– Recognise the changes in forward points in profit or loss, or

– Defer the initial forward points in OCI, amortise in profit or loss the initial forward points over the term of the hedging relationship and recognise subsequent fair value changes in forward points in OCI.

The above treatment on forward points would also apply to foreign currency basis spreads in foreign currency swaps.

(a) Hedging instruments – financial instruments at FVTPL

Any financial instruments that are measured at FVTPL under IFRS 9 (e.g. an investment in a commodity linked note) are eligible as hedging instruments.

(v) Groups and net positions

The new model:

– Permits fair value hedges of net positions, and

– Permits cash flow hedging of a net position for foreign exchange risk, but entities must specify at the start how and when each of the items that make up the net position will affect profit or loss.

For net position hedges, any recycling of the hedging instrument's gains or losses into profit or loss is presented as a separate line item in profit or loss, i.e. it is not adjusted to the related individual line items.

(vi) Discontinuation

The new model restricts the ability to discontinue hedge accounting to situations where the qualifying criteria are no longer met (e.g. the hedged item or hedging instrument no longer exists or is sold, or the hedging objective has changed). Voluntary discontinuation is not permitted.

(vii) Own use scope exception

The new model provides an option for entities to account for contracts that meet the 'own use' exception in IAS 39 at fair value if applying fair value accounting to these contracts eliminates or significantly reduces an accounting mismatch.

(viii) Changes that mainly affect financial institutions

The following changes in the new model are expected mainly to affect financial institutions:

– It may be possible to hedge inflation risk for fixed rate financial instruments under the new model (IAS 39 specially prohibits hedging inflation risk for fixed rate financial instrument). Examples are provided in the IFRS 9 of when inflation risk can be an eligible risk component, and when it is not.

– Entities that use credit derivatives (e.g. credit default swaps) to manage credit exposures arising from loans and/or loan commitments can elect to account for the loan and/or the loan commitments at fair value through profit or loss (subject to qualifying criteria).

– For entities that engage in portfolio hedge accounting, the new model provides entities with an accounting policy choice either to:

  – Apply the new hedge accounting requirements of IFRS 9, or

  – Continue to apply the existing hedge accounting requirements in IAS 39.

    This means that those entities that choose to apply the new hedge accounting requirements under IFRS 9, fair value hedge accounting of the interest rate exposure of a portfolio of financial assets or financial liabilities in IAS 39 would still be available.

    The new hedge accounting related disclosure requirements (see below) would apply to all entities applying hedge accounting under IFRSs (even if electing to continue to apply IAS 39 for hedge accounting).

(ix) Disclosures

New disclosure requirements accompany the new model and have been added to IFRS 7 *Financial Instruments: Disclosure*. The disclosures are only required for exposures to which hedge accounting is being applied.

The new model requires an entity to disclose, by risk category:

– A description of the risk management strategy

– Information about the notional amount, timing of the cash flows and the average price or rate of the hedging instrument

– The effect that hedge accounting has had on the financial statements.

For dynamic hedging relationships (i.e. where frequent changes in hedged items and hedging instruments results in frequent resets of the hedging relationship) certain disclosures are exempt. Instead, the IASB requires the entity to describe its risk management strategy, how hedge accounting is applied and how frequently the hedging relationships are reset.

(x) Transition

The new requirements would apply prospectively. The exception is for the time value of options, forward points, and foreign currency basis spreads where retrospective application applies.

The following practical expedients are allowed at transition:

– Entities can consider applying the new model, immediately after ceasing to apply IAS 39 (i.e. dedesignate the old IAS 39 hedging relationship and start a new hedging relationship under IFRS 9)

– For rebalancing, the starting point will be the hedge ratio used under IAS 39.

For contracts that fall under the 'own use' scope exception, entities may make a one-off election for all existing contracts (on an all-or-nothing basis for similar contracts) to account for these at fair value.

(xi) Effective date

In releasing the new Hedging proposals the IASB has deleted the previous effective date of IFRS 9 (periods beginning on or after 1 January 2015) and has instead left the effective date open until all the other outstanding phases of IFRS 9 have been finalised.

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