

Practical guide General hedge accounting

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1. Introduction

1.1. Overview of IFRS 9

The International Accounting Standards Board (the 'Board') has been reviewing accounting issues that have emerged as a result of the global financial crisis, including those identified by the G20 and other international bodies such as the Financial Stability Board. As part of this, the Board commenced its project to replace IAS 39 and sub-divided it into three main phases, as described below:

1. **Classification and measurement** – The Board completed the classification and measurement for financial assets in 2009 and for financial liabilities in 2010. However, the Board has since proposed limited modifications to the original requirements. An exposure draft on these limited amendments was issued in November 2012. Currently the Board expects to finalise the limited amendments during the first half of 2014.
2. **Impairment** – The Board issued an exposure draft in March 2013 proposing to replace the current 'incurred loss' with an 'expected loss' impairment model. Currently the Board expects to finalise this phase during the first half of 2014.
3. **Hedge accounting** – The new requirements on hedge accounting were finalised in November 2013. It is important to note that, while these changes provide the general hedge accounting requirements, the Board is working on a separate project to address the accounting for hedges of open portfolios (usually referred as 'macro hedge accounting').

This practical guide focuses on the third phase of IFRS 9, 'Financial Instruments', covering general hedge accounting.

1.2. General hedge accounting

The rules on hedge accounting in IAS 39 have frustrated many preparers, as the requirements have often not been linked to common risk management practices. The detailed rules have, at times, made achieving hedge accounting impossible or very costly, even where the hedge has reflected an economically rational risk management strategy. Similarly, users have found the effect of the current rules for hedge accounting less than perfect, and they have sometimes struggled to fully understand an entity's risk management activities based on its application of the hedge accounting rules. So, users and preparers alike supported a fundamental reconsideration of the current hedge accounting requirements in IAS 39.

The new standard, IFRS 9, improves the decision-usefulness of the financial statements by better aligning hedge accounting with the risk management activities of an entity. IFRS 9 addresses many of the issues in IAS 39 that have frustrated corporate treasurers. In doing so, it makes some fundamental changes to the current requirements, by removing or amending some of the key prohibitions and rules within IAS 39.

Overall, we believe that, by placing greater emphasis on an entity's risk management practices, the publication of the third phase of IFRS 9 is an improvement for hedge accounting. It will provide more flexibility, and it might allow companies to apply hedge accounting where previously they would not have been able to. As a result, this is an opportunity for corporate treasurers and boards to review their current hedging strategies and accounting, and to consider whether they continue to be optimal in view of the new accounting regime.

1.2.1. Scope and interaction with macro hedging

IFRS 9 hedge accounting applies to all hedge relationships, with the exception of fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities (commonly referred as 'fair value macro hedges'). This exception arises because the Board has a separate project to address the accounting for macro hedges. In the meantime, until this project is completed, companies using IFRS 9 for hedge accounting can continue to apply IAS 39 requirements for fair value macro hedges.

The reason for addressing such hedges separately is that hedges of open portfolios introduce additional complexity. Risk management strategies tend to have a time horizon over which an exposure is hedged; so, as time passes, new exposures are continuously added to such hedged portfolios, and other exposures are removed from them.

The Board expects to issue a discussion paper on macro hedges in the first quarter of 2014, with a comment period of 180 days.

PwC insight:

This scope exception is not applicable when hedging closed portfolios. IFRS 9 addresses the accounting for hedges of closed portfolios or groups of items that constitute a gross or net position (refer to section 5 below for further details).

It is expected that the macro hedging project will be relevant for financial institutions, but also for corporates, since the Board intends to broaden the scope to consider other than fair value macro hedges of interest rate risk (for example, macro hedges of commodity price risk).

1.2.2. Accounting policy choice

IFRS 9 provides an accounting policy choice: entities can either continue to apply the hedge accounting requirements of IAS 39 until the macro hedging project is finalised (see above), or they can apply IFRS 9 (with the scope exception only for fair value macro hedges of interest rate risk). This accounting policy choice will apply to all hedge accounting and cannot be made on a hedge-by-hedge basis.

PwC insight:

This accounting policy choice refers to the application of the hedge accounting only, and has no impact on the implementation of the other two phases of IFRS 9 (that are, 'classification and measurement' and 'impairment').

If an entity initially decides to continue applying IAS 39 hedge accounting, it can subsequently decide to change its accounting policy and commence applying the hedge accounting requirements of IFRS 9 at the beginning of any reporting period (subject to the other transition requirements of IFRS 9).

Whichever accounting requirements are applied (that is, IAS 39 or IFRS 9), the new hedge accounting disclosure requirements in IFRS 7 will be applicable.

2. *Hedge accounting*

2.1. *What is hedge accounting?*

Entities are exposed to financial risks arising from many aspects of their business. Different companies are concerned about different risks (for example, some entities might be concerned about exchange rates or interest rates, while others might be concerned about commodity prices). Entities implement different risk management strategies to eliminate or reduce their risk exposures.

The objective of hedge accounting is to represent, in the financial statements, the effect of risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (P&L) or other comprehensive income (OCI).

In simple terms, hedge accounting is a technique that modifies the normal basis for recognising gains and losses (or revenues and expenses) on associated hedging instruments and hedged items, so that both are recognised in P&L (or OCI) in the same accounting period. This is a matching concept that eliminates or reduces the volatility in the statement of comprehensive income that otherwise would arise if the hedged item and the hedging instrument were accounted for separately under IFRS. Under IFRS 9, hedge accounting continues to be optional, and management should consider the costs and benefits when deciding whether to use it.

2.2. *Accounting for hedges*

IFRS 9 broadly retains the three hedge accounting models within IAS 39, as summarised below:

2.2.1. *Fair value hedge*

What remains the same?

The risk being hedged in a fair value hedge is a change in the fair value of an asset or liability or an unrecognised firm commitment that is attributable to a particular risk and could affect P&L. Changes in fair value might arise through changes in interest rates (for fixed-rate loans), foreign exchange rates, equity prices or commodity prices.

The carrying value of the hedged item is adjusted for fair value changes attributable to the risk being hedged, and those fair value changes are recognised in P&L. The hedging instrument is measured at fair value, with changes in fair value also recognised in P&L.

What has changed?

For fair value hedges of an equity instrument accounted for at fair value through other comprehensive income (FVOCI) – under IFRS 9, gains/losses of equity instruments are never recycled to P&L – changes in the fair value of the hedging instrument are also recorded in OCI without recycling to P&L.

2.2.2. *Cash flow hedge*

What remains the same?

The risk being hedged in a cash flow hedge is the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability, an unrecognised firm commitment (currency risk only) or a highly probable forecast transaction, and could affect P&L.

Future cash flows might relate to existing assets and liabilities, such as future interest payments or receipts on floating rate debt. Future cash flows can also relate to forecast sales or purchases in a foreign currency. Volatility in future cash flows might result from changes in interest rates, exchange rates, equity prices or commodity prices.

Provided the hedge is effective, changes in the fair value of the hedging instrument are initially recognised in OCI. The ineffective portion of the change in the fair value of the hedging instrument (if any) is recognised directly in P&L.

The amount recognised in OCI should be the lower of:

- The cumulative gain or loss on the hedging instrument from the inception of the hedge, and
- The cumulative change in the fair value (present value) of the expected cash flows on the hedged item from the inception of the hedge.

If the cumulative change in the hedging instrument exceeds the change in the hedged item (sometimes referred to as an 'over-hedge'), ineffectiveness will be recognised. If the cumulative change in the hedging instrument is less than the change in the hedged item (sometimes referred to as an 'under-hedge'), no ineffectiveness will be recognised. This is different from a fair value hedge, in which ineffectiveness is recognised on both over – and under-hedges.

For cash flow hedges of a forecast transaction which result in the recognition of a financial asset or liability, the accumulated gains and losses recorded in equity should be reclassified to P&L in the same period or periods during which the hedged expected future cash flows affect P&L. Where there is a cumulative loss on the hedging instrument and it is no longer expected that the loss will be recovered, it must be immediately recognised in P&L.

What has changed?

IFRS 9 introduces changes to the cash flow hedge accounting model, as follows:

- For cash flow hedges of a forecast transaction which results in the recognition of a non-financial item (such as a fixed asset or inventory), or where a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the carrying value of that item must be adjusted for the accumulated gains or losses recognised directly in equity (often referred to as 'basis adjustment').

Under IAS 39, the entity could elect, as a policy choice, either the treatment described in the preceding paragraph or to maintain the accumulated gains or losses in equity and reclassify them to P&L at the same moment that the non-financial item affects P&L. This accounting policy choice is no longer allowed under IFRS 9.

- Where the net position of a group of items containing offsetting risk positions is designated as the hedged item, the cash flow hedge model can only be applied to the hedge of foreign currency risk. The designation of that net position must specify both the reporting period in which the forecast transactions are expected to affect P&L and also the nature and volume that are expected to affect P&L in each period. Hedging gains or losses must be presented in a separate line item in the statement of P&L and OCI. IAS 39 did not allow net positions to be designated as the hedged item.
- For cash flow hedges of a group of items with no offsetting risk position, the presentation of hedging gains or losses are apportioned to the line items affected by the hedged items. IAS 39 did not prescribe the presentation of gains or losses in P&L.

2.2.3. Net investment hedge

What remains the same?

An entity might have overseas subsidiaries, associates, joint ventures or branches ('foreign operations'). It might hedge the currency risk associated with the translation of the net assets of these foreign operations into the parent entity's functional currency.

The amount of a net investment in a foreign operation under IAS 21 is the reporting entity's interest in the net assets of that operation, including any recognised goodwill. Exchange differences arising on the consolidation of these net assets are deferred in equity until the foreign operation is disposed of or liquidated. They are recognised in P&L, on disposal or liquidation, as part of the gain or loss on disposal.

The foreign currency gains or losses on the hedging instrument are deferred in OCI, to the extent that the hedge is effective, until the subsidiary is disposed of or liquidated, when they become part of the gain or loss on disposal.

What has changed?

No changes are introduced by IFRS 9.

3. Qualifying criteria for hedge accounting

An entity's risk management strategy is central to the objective of hedge accounting under IFRS 9. However, hedge accounting is still seen as an exception to the normal accounting rules, and therefore, some restrictions are still necessary to determine whether or not a proposed hedging relationship qualifies for hedge accounting. As a result, an entity is only allowed to apply hedge accounting if it meets the specified qualifying criteria.

A comparison of the qualifying criteria in IAS 39 as against IFRS 9 is summarised in the following table, and detailed further below:

	IAS 39	IFRS 9
3.1	<p>Formal designation and documentation of:</p> <ul style="list-style-type: none"> Risk management objective and strategy Hedging instrument Hedged item Nature of risk being hedged Hedge effectiveness 	<p>Formal designation and documentation of:</p> <ul style="list-style-type: none"> Risk management objective and strategy Hedging instrument Hedged item Nature of risk being hedged Hedge effectiveness (including sources of ineffectiveness and how the hedge ratio is determined)
3.2	<p>Hedging relationship consists only of eligible hedging instruments and eligible hedged items.</p>	<p>The general requirement remains unchanged. However, some items that were not eligible as hedged items or hedging instruments under IAS 39 are now eligible under IFRS 9 (refer to sections 4 and 5 below).</p>
3.3	<p>Hedge effectiveness requirements:</p> <ul style="list-style-type: none"> Effectiveness can be reliably measured Hedge is expected to be highly effective (prospective testing) Hedge is assessed on an on-going basis and determined actually to have been highly effective (retrospective testing 80%-125%). 	<p>Hedge effectiveness requirements (prospective):</p> <ul style="list-style-type: none"> Economic relationship exists Credit risk does not dominate value changes Designated hedge ratio is consistent with risk management strategy.
3.4	<p>Voluntary discontinuation of hedge accounting is allowed.</p>	<p>Discontinuation of hedge accounting only under specified circumstances.</p>

3.1. *Formal designation and documentation*

The nature of IFRS 9's documentation requirements is not very different from the requirements in IAS 39. Formal designation and documentation must be in place at the inception of the hedge relationship. As a result, from the documentation point of view, there is not much relief from the administrative work necessary to start hedge accounting.

Entities should also take into consideration that, as a result of the new hedge accounting requirements under IFRS 9, documentation will no longer be static but must be updated from time to time. Examples of situations where modification of the hedge documentation would be required are where the hedge ratio is rebalanced (see below) or where the analysis of sources of hedge ineffectiveness is updated.

In addition, at the date of transition to IFRS 9, entities will need to update their hedge documentation for all their existing hedging relationships under IAS 39 that continue to be eligible under the new standard, in order to comply with the IFRS 9 documentation requirements. Some of the expected changes are the incorporation of the hedge ratio and the expected sources of ineffectiveness (since this is not required by IAS 39) and the removal of the retrospective effectiveness test (which is no longer required under IFRS 9).

3.2. *Eligible items*

The hedging relationship should consist only of eligible hedging instruments and hedged items. There are changes to what is eligible for both hedged items and hedging instruments, which are discussed in detail in sections 4 and 5 below.

3.3. *Hedge effectiveness*

Hedge effectiveness is defined as the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item.

IFRS 9 introduces three hedge effectiveness requirements:

3.3.1. *Economic relationship*

IFRS 9 requires the existence of an economic relationship between the hedged item and the hedging instrument. So there must be an expectation that the value of the hedging instrument and the value of the hedged item would move in the opposite direction as a result of the common underlying or hedged risk. For example, this is the case for forecast fixed interest payments and an interest rate swap that receives fixed interest payments and pays variable interest.

An on-going analysis of the possible behaviour of the hedging relationship during its term is required in order to ascertain whether it can be expected to meet the risk management objective.

PwC insight:

Whilst the requirement for an economic relationship is new, it would be unlikely that an entity would use an instrument that did not provide a valid economic relationship for risk management purposes, and so this is unlikely to be an onerous requirement in most cases.

The Board has regarded 'proxy hedging' (which is a designation that does not exactly represent an entity's actual risk management) as an eligible way of designating the hedged item under IFRS 9, as long as designation reflects the risk management in that it relates to the same type of risk that is managed and the instruments used for that purpose.

As part of the basis for conclusions in IFRS 9, the Board included as an example the fact that because IFRS 9 (in the same way as IAS 39) does not allow cash flow hedges of interest rate risk to be designated on a net position basis, entities must instead designate part of the gross positions. This requires the use of proxy

hedging, because the designation for hedge accounting purposes is on a gross position basis, even though risk management typically uses a net position basis.

Corporates refer to proxy hedging where for example they hedge commodity price risk but as a result of the availability of commodity derivatives, entities use a hedging instrument referenced to a commodity different to the actual commodity they are economically hedging (for example, jet fuel as compared to Brent oil), but the price of the two commodities are correlated enough to make the hedge relationship work.

In addition, some financial institutions use intragroup derivatives for risk management purposes. However, as intragroup derivatives do not qualify for hedge accounting, they are required to define external derivatives as proxy hedges.

3.3.2. Credit risk

Even if there is an economic relationship, a change in the credit risk of the hedging instrument or the hedged item must not be of such magnitude that it dominates the value changes that result from that economic relationship. Because the hedge accounting model is based on a general notion of there being an offset between the changes of the hedging instrument and those of the hedged item, the effect of credit risk must not dominate the value changes associated with the hedged risk; otherwise, the level of offset might become erratic.

For example, where an entity wants to hedge its forecast inventory purchases for commodity price risk, it enters into a derivative contract with Bank X to purchase a commodity at a fixed price and at a future date. If the derivative contract is uncollateralised and Bank X experiences a severe deterioration in its credit standing, the effect arising from changes in credit risk might have a disproportionate effect on the change in the fair value of the derivative contract arising from changes in commodity prices; whereas the changes in the value of the hedged item (forecast inventory purchases) would depend largely on the commodity price changes and would not be affected by the changes in the credit risk of Bank X.

PwC insight:

IFRS 9 does not provide a definition of 'dominate'. However, it is clear that the effect of credit risk should be considered on both the hedging instrument and the hedged item. For example, an entity hedging the interest rate or foreign currency risk of a financial asset (such as a bond) will need to look at the credit risk of the bond. If the bond has high credit risk, the bond might not qualify for hedge accounting. During the financial crisis, there were many situations where entities purchased loans to troubled financial institutions, and the amount that would ultimately be realised was very uncertain. These might not have qualified for hedge accounting.

Currently changes to regulations relating to derivatives in different countries have been or are in the process of being introduced. One of the main objectives of these changes is to mitigate credit risk and it is expected they will result in more collateralised derivatives. Once these regulations start being effective, this hedge effectiveness requirement is less likely to be a problem.

3.3.3. Hedge ratio

The hedge ratio is defined as the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting. IFRS 9 requires that the hedge ratio used for hedge accounting purposes should be the same as that used for risk management purposes.

One of the key objectives in IFRS 9 is to align hedge accounting with risk management objectives. There is no retrospective effectiveness testing required under IFRS 9, but there is a requirement to make an on-going assessment of whether the hedge continues to meet the hedge effectiveness criteria, including that the hedge ratio remains appropriate.

This means that entities will have to ensure that the hedge ratio is aligned with that required by their economic hedging strategy (or risk management strategy). A deliberate imbalance is not permitted. This requirement is to ensure that entities do not introduce a mismatch of weightings between the hedged item and the hedging

instrument to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. This does not imply that the hedge relationship must be perfect, but only that the weightings of the hedging instruments and hedged item actually used are not selected to introduce or to avoid accounting ineffectiveness.

In some cases, there are commercial reasons for particular weightings of the hedged item and the hedging instrument even though they create hedge ineffectiveness. This is the case, for example when using standardised contracts that have a defined contract size (for instance, 1 standard aluminium future contract in the LME has a contract size of 25 tonnes). When an entity wants to hedge 90 tonnes of aluminium purchases with standard aluminium future contracts, due to the standard contract size, the entity could use either 3 or 4 future contracts (equivalent to a total of 75 and 100 tonnes respectively). Such designation would result in a hedge ratio of either 0.83:1 or 1.11:1. In that situation the entity designates the hedge ratio that it actually uses, because the hedge ineffectiveness resulting from the mismatch would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting. Hedge ineffectiveness is still required to be measured and accounted for in P&L.

PwC insight:

In situations such as the above, where due to the standard size of contracts the hedge relationship may result in an under-hedge, an alternative that entities might want to consider is the possibility of designating as hedge item a layer component as described in section 5.4 below.

3.3.4. Rebalancing

IFRS 9 introduces the concept of ‘rebalancing’. Rebalancing refers to adjustments to the designated quantities of either the hedged item or the hedging instrument of an existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. This allows entities to respond to changes that arise from the underlying or risk variables. This is good news, as rebalancing does not result in de-designation and re-designation of a hedge, but it is accounted for as a continuation of the hedging relationship. However, on rebalancing, hedge ineffectiveness is determined and recognised immediately before adjusting the hedge relationship.

Rebalancing is consistent with the requirement of avoiding an imbalance in weightings at inception of the hedge, but also at each reporting date and on a significant change in circumstances, whichever comes first.

When rebalancing a hedging relationship, an entity must update its documentation of the analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term.

In some circumstances, rebalancing is not applicable (for example, where the changes in the hedge relationship – which might arise from changes in the derivative counterparty credit risk – cannot be compensated by adjusting the hedge ratio). In addition, if the risk management objective has changed, rebalancing is not allowed, and hedge accounting should be discontinued.

Example – Rebalancing assessment

Rebalancing not required

An entity with a EUR functional currency has a forecast purchase in HKD in six months’ time amounting to HKD7.8 million. In order to hedge its future exposure, the entity wants to purchase foreign currency (that is, enter into foreign currency forward contracts) to effectively fix the purchase price in EUR.

HKD is pegged to the USD (which means that the exchange rate is maintained within a band or at an exchange rate set by the Hong Kong Monetary Authority).

The entity could enter into a forward contract to buy HKD and pay EUR. However, entering into a forward contract to buy HKD and pay EUR is more expensive than entering into an agreement to buy USD and pay EUR (as there is a smaller market and less liquidity in HKD compared with USD). The entity decides instead to enter

into a USD:EUR forward. As long as the HKD remains pegged to the USD, using a USD derivative as a hedging instrument will provide an economic hedge of the forecast HKD purchase.

The peg ratio is HKD7.8:USD1. However, even though it is pegged, it is not completely fixed (as the HKD is allowed to trade within the narrow range of HKD7.75 to 7.85). Since the range is very small, the entity is willing to accept this risk, so it enters into a forward contract for USD1 million (HKD7.8 million).

Rebalancing is not required where ineffectiveness arises merely because of fluctuations in exchange rates within the narrow trading range around the hedge ratio.

Rebalancing required

Consider the facts of the previous example, but assume that the exchange rate HKD:USD is re-pegged to, say, HKD7.2:USD1. If the derivative continues to be for USD1 million, the hedge ratio will no longer reflect the relationship between the hedging instrument and hedged item, and so will result in mandatory rebalancing.

Rebalancing should reflect the entity's risk management strategy, which could either be reducing the hedged item to HKD7.2 million of the forecast purchase of HKD7.8 million, or increasing its hedging instrument by buying another derivative to cover the remaining HKD600,000 of the hedged item.

Rebalancing not applicable

Continuing the above example, assume that sometime after the inception of the hedge, the peg between HKD and USD is removed, such that the currency exchange rate is floating (instead of pegged) within a very broad range such that now it is not possible to demonstrate that an economic correlation exists between the two currencies. In this situation, a change in the hedge ratio would not be applicable, since this may not ensure that the hedging relationship continues to meet that hedge effectiveness requirement. Accordingly, the hedge cannot be rebalanced but may need to be discontinued (see section 3.4 below).

PwC insight:

Originally, the requirement to rebalance was seen as onerous, but it might actually be a pragmatic solution that avoids discontinuing hedging relationships that would have failed the effectiveness test in the past. In practice, entities will not need to rebalance very often if they have a good risk management strategy in place and the economic relationship is stable. There is always some volatility in any hedging relationship but, if the initial hedge ratio is appropriate and in line with the risk management strategy, rebalancing should only be necessary if the 'ideal' hedge ratio changes significantly. Entities should document their tolerance to such variations.

3.3.5. Hedge effectiveness assessment

IFRS 9 does not prescribe a specific method for assessing whether a hedging relationship meets the hedge effectiveness requirements. An entity must use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. Depending on those factors, entities can perform either a qualitative or a quantitative assessment. For example, in a simple hedge where all the critical terms match (or are only slightly different), a qualitative test might be sufficient. On the other hand, in highly complex hedging strategies, some type of quantitative analysis would likely need to be performed.

The assessment relates to expectations about hedge effectiveness, and so is only forward looking. Such assessment should be performed at inception and on an on-going basis at each reporting date or on a significant change in circumstances, whichever comes first. The intention behind these requirements is to ensure that only economically viable hedging strategies (that is, those reflecting the underlying economic relationship and aligned to the risk management strategy) qualify for hedge accounting purposes.

A comparison with IAS 39

One of the more onerous requirements of IAS 39 is that the hedge relationship should be expected to be highly effective (in other words, entities are required to perform quantitative assessments on a prospective and

retrospective basis, to demonstrate that actual results of the hedge are within a range of 80-125% effectiveness). This meant that many valid economic hedges failed because they were not close enough for hedge accounting purposes. As described above, IFRS 9 relaxes the requirements for hedge effectiveness, removing the 80-125% bright line.

PwC insight:

The elimination of the 80-125% bright line is a positive move by the Board and takes away a significant obstacle to hedge accounting for many risk management strategies. Under IAS 39, a hedge that was 81% effective would achieve hedge accounting, even though it was 19% ineffective (subject to the 'lower of test for cash flow and net investment hedges, refer to section 2.2 above). On the other hand, a hedge that was 79% effective would not achieve hedge accounting and the full fair value movements of the derivative would be recorded in P&L without any offsetting of the hedged item (that is, the accounts would show 100% ineffectiveness). From a risk management perspective, the difference between 79% and 81% effectiveness is minimal, yet the IAS 39 accounting rules did not reflect this. So we expect that many preparers and users will welcome the removal of the 80-125% bright line.

3.3.6. Discounted cash flows for measuring hedge ineffectiveness

Hedge accounting does not change the measurement of the hedging instrument, but only the location of where the change in its carrying amount is presented for cash flow and net investment hedges. Hedging instruments are subject to measurement at either fair value or amortised cost, both of which take into consideration the time value of money.

In order to be consistent, IFRS 9 introduces the requirement to measure the hedged item also on a present value basis; therefore, subsequent changes would include the effect of the time value of money (for example, an undiscounted spot approach cannot be used in a foreign currency hedge). The objective of this requirement is to ensure the measurement of the effectiveness of the hedge relationship reflects the time value of money and any mismatches in timing between the hedged item and the hedging instrument are recognised as ineffectiveness.

PwC insight:

It is a common hedging strategy to hedge the foreign currency risk of foreign sales or purchases and to assess effectiveness on an undiscounted spot basis. This new IFRS 9 requirement to consider the time value of money could have a significant impact where the risk management strategy is to hedge the spot risk (that is, pure foreign currency risk without considering the forward points), because more entities will now need to keep track of the timing of the hedged transaction and measure ineffectiveness on a discounted basis, thus capturing the ineffectiveness that arises from a difference in expected timing between the hedged transaction and the derivative.

3.4. Discontinuation of hedge accounting

Under IAS 39, an entity had a free choice to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship. Voluntary de-designation is now prohibited under IFRS 9.

Under IFRS 9, an entity cannot de-designate and thereby discontinue a hedging relationship that:

- Still meets the risk management objective; and
- Continues to meet all other qualifying criteria (after taking into account any rebalancing, if applicable).

For this purpose, it is necessary to understand the distinction between the notions of 'risk management strategy' and 'risk management objective'.

A risk management strategy is the highest level at which an entity determines how it manages risk; typically, it identifies the risks to which the entity is exposed and sets out how the entity responds to them. It is usually in place for a longer period and might include some flexibility to react to changes in circumstances. It is normally a

general document that would be cascaded down through policies containing more specific guidelines. On the other hand, a risk management objective is applied at the level of a particular hedging relationship.

A risk management strategy can (and often will) involve many different hedging relationships, each with a risk management objective. Hence, the risk management objective for a particular hedging relationship can change, even though an entity's risk management strategy remains unchanged.

If the risk management objective for a hedge relationship has changed, hedge accounting must be discontinued.

Example – Risk management strategy and risk management objective

An entity has a strategy of managing its interest rate exposure on debt. Management sets ranges for the overall entity for the mix between variable and fixed rate funding. The entity's strategy is to maintain between 20% and 40% of its total debt at fixed rate. The entity decides from time to time how to execute this strategy, depending on the level of interest rates. If interest rates are low, the entity fixes the interest for more debt than when interest rates are high.

The entity's total debt is CU100m, all of which is variable rate debt. In order to comply with its risk management strategy, it had swapped CU30m into fixed rate, resulting in a fixed to floating ratio of 30%.

Assuming that interest rates are low, the entity takes advantage by :

- Issuing additional fixed debt in a total amount of CU50m; and
- Reducing by CU20m the extent to which it previously hedged its variable rate exposure, resulting in a total of CU10m variable rate debt swapped into fixed rate debt.

As a result of the aforementioned changes, the entity has a total debt of CU150m, of which CU60m is fixed rate (that is, a fixed to floating ratio of 40%).

In this example, the risk management strategy remains unchanged, even though the entity's execution of that strategy (that is, the risk management objective at the hedging relationship level) has changed.

In this situation, therefore, hedge accounting must be discontinued for CU20m, which is the portion of variable rate debt to which hedge accounting is no longer applied. Conversely, if an entity swapped a part of its new fixed rate debt into variable rate, hedge accounting would continue for its previously hedged variable rate exposure.

IFRS 9 carries forward the recent amendments to IAS 39 regarding novation of derivatives. These mean that a novation will not be an expiration or termination of the hedging instrument if the novation is a consequence of laws or regulations with the purpose of incorporating a central clearing counterparty.

Discontinuation of hedge accounting can affect a hedging relationship in its entirety or only part of it, depending on the facts and circumstances.

Examples of discontinuation of a hedge in its entirety are:

- Where the hedging relationship no longer meets the risk management objective.
- Where the hedging relationship no longer complies with the qualifying criteria.
- Where the hedging instrument has been sold or terminated.

Examples of discontinuation for only a part of the hedging relationship are:

- For the volume of hedged item, where it is no longer part of the hedging relationship due to an adjustment to the hedge ratio.
- Where part of the volume of a forecast transaction is no longer highly probable.

PwC insight:

Under IAS 39, management had discretion to voluntarily discontinue hedge accounting. Examples of reasons

for an entity electing de-designation included:

- *The high administrative burden might make hedge accounting too onerous and costly.*
- *Depending on how the effectiveness assessment worked, it wanted to apply a different method of assessing hedge ineffectiveness.*

IFRS 9 prohibits voluntary de-designation, since the Board considered that this undermines the usefulness of financial information. However, this is not expected to be a significant issue in practice, since an entity always has the ability to change its risk management objective or to terminate its hedging instruments.

4. What can be designated as hedging instruments?

There have not been many changes to the hedging instruments that are eligible under IFRS 9. Most derivative financial instruments can still be designated as hedging instruments, provided they are entered into with an external party. Intra-group derivatives do not qualify as hedging instruments in consolidated financial statements, although they might qualify in the separate financial statements of individual entities in the group. Additional guidance from IAS 39 (such as allowing the designation of a proportion of a derivative instrument in a hedge relationship) is included in IFRS 9.

The main changes to hedging instruments in IFRS 9 are: how to account for the time value of options; the interest element of forward contracts; and the currency basis of cross-currency swaps when used as hedging instruments.

An overview of the main differences for hedging instruments between IAS 39 and IFRS 9 is summarised in the table below. A detailed explanation of each of the main changes included in the table is given in the paragraphs that follow.

	IAS 39	IFRS 9
4.1	Derivatives.	Unchanged.
4.2	Non-derivative financial instruments are only allowed for hedging FX risk.	Non-derivative financial instruments continue to be allowed for hedging FX risk. In addition, if non-derivative financial instruments are measured at fair value through P&L they are also allowed for hedging risks other than FX risk.
4.3	Embedded derivatives allowed as hedging instruments.	Derivatives embedded in financial assets are no longer accounted for separately under IFRS 9. Therefore, only derivatives embedded in financial liabilities or non-financial contracts (that are accounted for separately) are allowed to be designated as hedging instruments.
4.4	Changes in the time value of an option are recognised in P&L.	Changes in the aligned time value of an option are deferred in OCI. The timing of the reclassification to P&L depends on the nature of the hedged item (whether it is transaction related or time-period related).
4.5	Two alternatives are provided for recognising fair value changes of forward points.	An additional alternative for recognising fair value changes of forward points is introduced.
4.6	No specific accounting treatment is prescribed for currency basis spreads.	Currency basis spreads are considered as costs of the hedge relationship, so changes in the currency basis spread can be recognised through OCI.

4.1. Derivative financial instruments

Neither IAS 39 nor IFRS 9 restricts the circumstances in which a derivative can be designated as a hedging instrument (provided the hedge accounting criteria are met), except for some written options.

4.2. Non-derivative financial instruments measured at fair value through P&L

Under IAS 39, non-derivative financial instruments are only allowed as hedging instruments for hedges of foreign currency risk. Under IFRS 9, non-derivative financial instruments continue to be allowed as hedging instruments of foreign currency risk provided that such non-derivative financial instruments are not investments in equity instruments for which the entity has elected to present the changes in fair value in OCI.

In addition, IFRS 9 also allows non-derivative financial instruments as hedging instruments to hedge other risks if measured at fair value through P&L. The only exception is for financial liabilities accounted for at fair value for which the changes in the liability's own credit risk are presented in OCI – these are not eligible for designation as hedging instruments.

For financial instruments that an entity has originally elected to designate at inception at fair value through P&L to mitigate an accounting mismatch (commonly referred as the 'fair value option'), a designation as hedging instruments is allowed only if such designation mitigates an accounting mismatch, without recreating another one (that is, no conflict should exist between the purpose of the fair value option and the purpose of hedge accounting).

PwC insight

Whether or not this change will have any impact in practice is debatable, as IFRS 9 requires that such an item should be designated as the hedging instrument in its entirety or a proportion of it. In the past it has not been common practice for non-financial entities to designate non-derivative financial instruments at fair value through P&L. Therefore, on transition to IFRS 9 this change might be of limited use for these entities, however, the usefulness might subsequently increase, since entities can designate new financial instruments at fair value through P&L.

4.3. Embedded derivatives

Under the requirements of IFRS 9 concerning the classification and measurement of financial instruments, embedded derivatives in *financial* assets are not accounted for separately. If there is an embedded derivative in a financial asset that would have been separated under IAS 39, the whole instrument will (in most cases) be carried at fair value through P&L. As a result, embedded derivatives in financial assets will no longer be eligible as hedging instruments on their own. As an alternative, entities could designate the instrument in its entirety (or a proportion of it) at fair value through P&L as a hedging instrument, as noted above. However, entities should note that designation at fair value through P&L is allowed only at inception; therefore, they can do this only for new financial instruments.

For financial liabilities, on the other hand, most of the classification and measurement requirements in IAS 39 have been transferred into IFRS 9, including the paragraphs for separating embedded derivatives that are not closely related to the host instrument. This means that derivatives embedded in financial liabilities continue to be separated in some circumstances. If an embedded derivative is separated from the host instrument and accounted for separately, it continues to be eligible as a hedging instrument.

4.4. Hedging with purchased options

The fair value of an option can be divided into two portions: the intrinsic value (which is determined in terms of the difference between the strike price and the current market price of the underlying) and the time value (that is, the remaining value of the option which reflects the volatility of the price of the underlying, interest rates and the time remaining to maturity). IAS 39 permits designation of either the entire fair value or only the intrinsic

value of the option. However, designating the intrinsic value only usually increases the volatility in P&L, due to the fact that changes in the time value of the option are recognised in P&L.

IFRS 9 changed the accounting requirements on using purchased options as hedging instruments. It views a purchased option as similar to purchasing insurance cover with the time value being the associated cost. If an entity elects to designate only the intrinsic value of the option as the hedging instrument, it must account for the changes in the time value in OCI. This amount will be removed from OCI and recognised in P&L, either over the period of the hedge if the hedge is *time related* (for example, six-month fair value hedge of inventory), or when the hedged transaction affects P&L if the hedge is *transaction related* (for example, a forecast sale). This should result in less volatility in P&L for these option-based hedges, and it removes an obstacle to sensible risk management practice.

An entity needs to take into consideration that, once it designates the intrinsic value of the option, the accounting introduced by IFRS 9 is not optional, but mandatory. In addition, the aforementioned accounting for the initial time value of purchased options applies only to the extent that the time value relates to the hedged item. This is called the ‘aligned time value’. Where the hedging instrument and hedged item are not fully aligned, entities need to determine the aligned time value – that is, how much of the time value included in the premium paid (actual time value) relates to the hedged item – and apply this accounting treatment to that portion. This can be determined using the valuation of the option that would have critical terms that perfectly match the hedged item. The residual amount is recognised in P&L.

4.5. Hedging with forward contracts

A forward is a contract to exchange a fixed amount of a financial or non-financial asset on a fixed future date at a fixed price. The fair value of a forward contract is affected by changes in the spot rate and changes in the forward points (in the case of an FX forward contract, the forward points arise from the interest rate differential between currencies specified in a forward contract).

Under IAS 39, for hedges of foreign currency risk, an entity has a choice of whether to hedge using either the forward rate or the spot rate:

- If the forward rate is used, the entity is hedging with the full fair value of the forward contract. Changes in the fair value of the forward are accounted for in accordance with the type of hedge (such as fair value hedge or cash flow hedge). In this type of designation, some ineffectiveness would generally arise if the hedged item is not similarly affected by interest rate differentials.
- Where an entity designates only the change in the value of the spot element as the hedging instrument, the entity is only concerned about movements in the spot rate (and not changes due to interest rates, which is the forward element). Changes in the spot rate are part of the hedge relationship, and so they are accounted for in accordance with the type of hedge, whereas the changes in fair value due to the forward points are immediately recognised in P&L.

Under IFRS 9, an entity can continue to apply both of the approaches allowed in IAS 39. However, where an entity designates only the change in the spot element as the hedging instrument an additional accounting approach exists for the forward element of the forward contracts (as compared to IAS 39 accounting). Even though a forward contract can be considered to be related to a time period, IFRS 9 states that the relevant aspect for its accounting is the characteristic of the hedged item and how it affects profit or loss. An entity must assess the type of hedge on the basis of the nature of the hedged item, regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge. An entity assesses whether the hedge is *transaction related* (for example, the hedge of a forecast purchase of inventory in foreign currency) or whether it is *time-period related* (for example, a hedge of the fair value of commodity inventory for the next six months using a commodity forward contract). The accounting treatment to be applied to the forward element of a forward contract is the same as for the time value of hedging with options (described in 4.4 above). However, unlike the accounting for options, this accounting treatment is optional rather than mandatory. This additional approach helps to reduce volatility in P&L as compared to the accounting under IAS 39.

4.6. Accounting for currency basis spreads

IAS 39 did not prescribe specific accounting criteria for currency basis spreads (that is, the liquidity charge for exchanging different currencies that is inherent in a foreign exchange contract). Many entities included this spread when applying the hypothetical derivative method for assessing hedge effectiveness for cash flow hedges. The hypothetical derivative is an accepted mathematical expedient used by entities to calculate the value of the hedged item in cash flow hedges.

FRS 9 states that a hypothetical derivative cannot include features that do not exist in the hedged item. It clarifies that a hypothetical derivative cannot simply impute a charge for exchanging different currencies (that is, the currency basis spread), even though actual derivatives under which different currencies are exchanged might include such a charge (for example, cross-currency interest rate swaps).

Under IFRS 9, where an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument, the entity can account for the changes in the currency basis spread in the same manner (that is, transaction related or time-period related) as applied to the forward element of a forward contract, as noted in 4.5 above.

PwC insight

The possibility of accounting for the currency basis spread as a cost of hedging represents a significant improvement as compared to the Board's proposals in the review draft on hedge accounting (published in September 2012), which implied that changes in currency basis spreads would be accounted for immediately in P&L. This is good news for entities and will help to mitigate volatility in P&L.

5. What can be designated as hedged items?

A number of changes are proposed to the rules for what can be designated as a hedged item. The proposed changes primarily remove restrictions that prevent some economically rational hedging strategies from qualifying for hedge accounting. The table below gives an overview of the eligible hedged items that are permitted in IFRS 9 as compared to IAS 39. A detailed explanation of each of the changes is given in the paragraphs that follow.

	IAS 39	IFRS 9
5.1	Definition of hedged item.	Unchanged.
5.2	Possible to hedge risk components of financial items only.	Also possible to hedge risk components of non-financial items.
5.3	Net positions not allowed as hedged items.	Net positions (including net nil positions) allowed as hedged items in some circumstances.
5.4	Use of layers as hedged item relatively restricted. Layers allowed only for cash flow hedges.	Layers allowed for both cash flow hedges and fair value hedges in some circumstances. Some restrictions apply for prepayable items.
5.5	Derivatives not allowed to be designated as (or be part of) hedged items.	Aggregated exposures allowed as hedged items.

5.1. Definition of hedged item

Under both IAS 39 and IFRS 9, a hedged item can be a recognised asset or liability, an unrecognised firm commitment, a forecast transaction or a net investment in a foreign operation. The hedged item can be:

- a. A single item, or
- b. A group of items.

If the hedged item is a forecast transaction, it must be highly probable.

5.2. Risk components of non-financial items

Under IAS 39, only risk components of financial items (such as the LIBOR rate in a loan that bears interest at a floating rate of LIBOR plus a spread) could be designated as a hedged item, provided they are separately identifiable and reliably measurable. Under IFRS 9, risk components can be designated for non-financial hedged items, provided the component is separately identifiable and the changes in fair value or cash flows of the item attributable to the risk component are reliably measurable. This requirement could be met where the risk component is either explicitly stated in a contract (contractually specified) or implicit in the fair value or cash flows (non-contractually specified).

Entities that hedge commodity price risk that is only a component of the overall price risk of the item, are likely to welcome the ability to hedge separately identifiable and reliably measurable components of non-financial items.

PwC insight:

An example of a contractually specified risk component that we have come across in practice is a contract to purchase a product (such as aluminium cans), in which a metal (such as aluminium) is used in the production process. Contracts to purchase aluminium cans are commonly priced by market participants based on a building block approach, as follows:

- *The first building block is the London Metal Exchange (LME) price for a standard grade of aluminium ingot.*
- *The next building block is the grade premium or discount to reflect the quality of aluminium used, as compared to the standard LME grade.*
- *Additional costs will be paid for conversion from ingot into cans and delivery costs.*
- *The final building block is a profit margin for the seller.*

Many entities may want to use aluminium LME futures or forwards to hedge their price exposure to aluminium. However, IAS 39 did not allow just the LME component of the price to be the hedged item in a hedge relationship. All of the pricing elements had to be designated as being hedged by the LME future. This caused ineffectiveness, which was recorded within P&L; and, in some cases, it caused sensible risk management strategies to fail to qualify for hedge accounting. By contrast, IFRS 9 allows entities to designate the LME price as the hedged risk, provided it is separately identifiable and reliably measurable.

When identifying the non-contractually specified risk components that are eligible for designation as a hedged item, entities need to assess such risk components within the context of the particular market structure to which the risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market.

The Board believes that there is a rebuttable presumption that, unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable, and so it cannot be designated as a risk component of a financial instrument. However, the Board considers that, in limited cases, it might be possible to identify a risk component for inflation risk, and provides the example of environments in which inflation-linked bonds have a volume and term structure that result in a sufficiently liquid market that allows a term structure of zero-coupon real interest rates to be constructed.

PwC insight:

Although allowing hedges of risk components of non-financial item is very beneficial for entities, the wording in IFRS 9 is unclear. IFRS 9 requires an entity to assess risk components (that are separately identifiable and reliably measurable) within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. However, there are no criteria specified to be used in the analysis of the market structure, nor are there any definitions of the market to be analysed. For example, a manufacturer of woollen jumpers might want to hedge its exposure to wool prices. This manufacturer considers that wool prices are separately identifiable and reliably measurable because the amount of wool used in a jumper can be computed from product specifications and wool prices are available in the market. Is the physical presence of wool in its products enough, or should additional considerations be taken into account regarding the market structure? Would the market structure differ between a manufacturer of generic woollen jumpers, as compared to a manufacturer of a well-known, expensive brand of woollen jumpers, or for manufacturers in different geographic locations? This will be an area subject to a high degree of judgement based on specific facts and circumstances.

5.3. Hedging groups of net positions

IFRS 9 provides more flexibility for hedges of groups of items, although, as noted earlier, it does not cover macro hedging. Treasurers commonly group similar risk exposures and hedge only the net position. To illustrate what is meant by a net position, consider the following example.

Example:

A EUR-functional currency entity has a sales department that sells certain items in USD. At the same time, the purchasing department buys certain products in USD. Each department is unaware of the other's activities, but both want to hedge their forecast USD sales and purchases respectively. Assume that the sales department has USD100 of sales in six months' time, so it enters into a forward contract with the entity's central treasury department. The purchasing department has forecast purchases of USD90, also in six months' time, and it also enters into an internal derivative with the central treasury department. Each department wants to use its derivative as a hedged item, but it cannot because the derivative is internal, and so it is eliminated on consolidation.

However, in order to hedge the group's exposure, the treasury department enters into a forward with a bank for USD10. By doing this, the group is economically hedged. However, under IAS 39, it was not possible to designate the net position of USD10 (comprised of USD100 sales and USD90 purchases) as a hedged item. Instead, the group had to designate USD10 out of the USD100 of future sales as the hedged item. This did not reflect the entity's risk management strategy and is not how the entity tracked the appropriateness of the economic hedge relationship. It is no surprise that this was a common complaint from preparers about IAS 39.

Under IFRS 9, however, a net position that incorporates offsetting positions can be hedged, where all items included in the group are individually eligible as hedged items and the items in the group are managed together on a group basis for risk management purposes. This means that the group can now apply hedge accounting to a net position comprised of sales of USD100 and purchases of USD90 with a USD10 derivative, which mirrors the entity's risk management.

For cash flow hedges of a group of items that are expected to affect P&L in different reporting periods, the qualifying criteria are:

- Only hedges of foreign currency risk are allowed.
- The items within the net position must be specified in such a way that the pattern of how they will affect P&L is set out as part of the initial hedge designation and documentation (this should include at least the reporting period, nature and volume).

PwC insight:

The ability to hedge net positions under IFRS 9 is a step forward, in that it allows hedge designation in a way that is consistent with an entity's risk management strategy. However, IFRS 9 requires the presentation of the gains and losses on recycling as a separate line item in P&L (separate from the hedged items), and so it does not allow an entity to present the post-hedging results of its commercial activities for those line items.

In addition, *net nil positions* (that is, where hedged items among themselves fully offset the risk that is managed on a group basis) are now allowed to be designated in a hedging relationship that does not include a hedging instrument, provided that all the following criteria are met:

- The hedge is part of a rolling net risk hedging strategy (that is, the entity routinely hedges new positions of the same type);
- The hedged net position changes in size over the life, and the entity uses eligible hedging instruments to hedge the net risk;
- Hedge accounting is normally applied to such net positions; and
- Not applying hedge accounting to the net nil position would give rise to inconsistent accounting outcomes.

The Board expects that hedges of net nil positions would be coincidental and therefore rare in practice.

5.4. Hedging layers of a group

IAS 39 allowed hedging layers of a group in very limited circumstances (for example, in specified cash flow hedges). IFRS 9 allows a layer of a group to be designated as the hedged item. A layer component can be specified from a defined, but open, population or from a defined nominal amount. Examples include:

- A part of a monetary transaction volume (such as the next CU10 cash flows from sales denominated in a foreign currency after the first CU20 in March 201X);
- A part of a physical or other transaction volume (such as the first 100 barrels of the oil purchases in June 201X, or the first 100 MWh of electricity sales in June 201X); or
- A layer of the nominal amount of the hedged item (such as the last CU80 million of a CU100 million firm commitment, or the bottom layer of CU20 million of a CU100 million fixed rate bond, where the defined nominal amount is CU100 million).

If a layer component is designated in a fair value hedge, an entity must specify it from a defined nominal amount. To comply with the requirements for qualifying fair value hedges, an entity must remeasure the hedged item for fair value changes attributable to the hedged risk. The fair value adjustment must be recognised in P&L no later than when the item is derecognised. Therefore, it is necessary to track the item to which the fair value hedge adjustment relates. Entities are required to track the nominal amount from which the layer is defined in order to track the designated layer (for example, the total defined amount of CU100 million sales must be tracked in order to track the bottom layer of CU20 million sales or the top layer of CU30 million sales).

A layer of a contract that includes a prepayment option (if the fair value of the prepayment option is affected by changes in the hedged risk) is only eligible as a hedged item in a fair value hedge if the layer includes the effect of the prepayment option when determining the change in fair value of the hedged item. In this situation, if an entity hedges with a hedging instrument that does not have option features that mirror the layer's prepayment option, hedge ineffectiveness would arise.

5.5. Aggregated exposures

Under IAS 39, a derivative could not be a hedged item, and derivatives could not be combined with another exposure to form a hedged item. This restriction was criticised by preparers because of the difficulty of achieving hedge accounting for more than one risk in a single hedging relationship, if not all risks are designated at inception.

Under IFRS 9, this restriction has been removed. An aggregated position that incorporates a derivative along with a non-derivative exposure can be designated as a hedged item.

Example:

Entity A, which has USD as its functional currency, takes out a 10-year floating rate loan in EUR (a foreign currency). It wants to eliminate its exposure to variability in cash flows from changes in interest rates, so it enters into a floating-to-fixed interest rate swap in EUR. To reduce volatility in P&L, it designates the swap in a cash flow hedge. In a later period, it also wants to eliminate the FX exposure, so it takes out a USD:EUR fixed-fixed cross-currency interest rate swap to eliminate its exposure. But IAS 39 would not allow the issuer to designate the combined loan and EUR interest rate swap as the hedged item, as a derivative generally cannot be a hedged item. Under IAS 39, the entity would instead have needed to combine the original swap and the new cross-currency interest rate swap as the hedging instrument, which would require the de-designation of the original interest rate hedge. This was not consistent with the entity's strategy of simply overlaying one derivative to eliminate the net foreign currency risk. However, under IFRS 9, the aggregated exposure (that is, a combination of the debt instrument plus the interest rate swap) is eligible to be designated as the hedged item.

6. Alternatives to hedge accounting

6.1. Extended use of fair value option for 'own use' contracts

IFRS 9 applies to all items within the scope of IAS 39. As part of the publication of IFRS 9, the remaining version of IAS 39 has been amended to extend the option to irrevocably designate and measure certain items at fair value through P&L ('fair value' option). Entities are allowed to apply the fair value option where doing so eliminates or significantly reduces an accounting mismatch.

Under IFRS 9 entities are now able to apply the fair value option to contracts to buy or sell non-financial items which qualify for the 'own use' exception. These are contracts that can be net settled but that were entered into 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.

PwC insight:

This is good news for non-financial entities, for example, entities in the utilities industry. Utilities often have a large number of contracts requiring physical delivery of the energy (that is, the contracts are not for trading purposes), generally these contracts are 'own use' contracts under IAS 39. These entities commonly hedge with energy derivatives. By electing to designate the physical sales contracts at fair value through P&L they would likely significantly reduce the measurement inconsistency between the sales contracts and the energy derivatives and thus achieve offsetting effects without the need to apply hedge accounting (and therefore comply with the hedge accounting criteria).

6.2. Option to designate a credit exposure at fair value through P&L

IFRS 9 states that the credit risk of a debt instrument is a risk component that does not meet the eligibility criteria to be designated as a hedged item. The spread between the risk free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk components and margin elements. Therefore, the Board believes that credit risk cannot be isolated, and so does not meet the separately identifiable criteria in IFRS 9.

Credit derivatives (such as credit default swaps) that are used to hedge credit risk are accounted for at fair value through P&L, while credit exposures are usually measured at amortised cost or are unrecognised (for example, loan commitments). Where there is credit deterioration, this results in recognising gains on the credit derivative while the impairment on the hedged item is measured on a different basis, which results in P&L volatility that does not reflect the credit protection obtained.

IFRS 9 now provides the option to designate the financial instrument (all or a proportion of it) at fair value through P&L. This option is available only where:

- The name of the credit exposure (for example, the borrower or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and
- The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

This fair value option is different from the one described for 'own use' contracts, since this can be elected at initial recognition, subsequently or even while the hedged credit exposure is unrecognised (for example, in the case of a loan commitment). In addition, it is not irrevocable but, once this option is elected, specified criteria must be met to discontinue its use.

PwC insight:

Banks often use credit default swaps linked to an index to hedge the credit risk for a portfolio of instruments. Due to the IFRS 9 requirement of a link between the financial instrument through the matching of the name of the borrower or seniority, such index-based credit default swaps would not be eligible hedging instruments.

Another aspect to consider is that the fair value of a financial instrument is comprised not only of credit risk but it considers additional effects (for instance, interest rate risk). When designating a financial instrument at fair value through P&L those additional effects would not be offset by the changes in the value of the credit derivative.

7. *Disclosures*

Like many other new standards, the disclosure requirements are extended. The outreach activities undertaken by the Board found that users considered that the disclosure requirements in IFRS 7 did not provide sufficient information. As a result, the Board has amended the disclosure requirements in IFRS 7.

The disclosures are required for each 'category of risk' that an entity decides to hedge (for example, interest rate risk, foreign currency risk or commodity price risk). IFRS 9 does not prescribe the risk categories to be used. An entity should apply judgement and categorise risks on the basis of how it manages its risks through hedging. However, an entity should apply its risk categories consistently throughout the entire hedge accounting disclosures.

The required hedge accounting disclosures provide information about:

- An entity's risk management strategy and how it is applied to manage risk;
- How the entity's hedging activities might affect the amount, timing and uncertainty of its future cash flows;
- The effect that hedge accounting has had on the entity's financial statements; and
- Whether the entity is applying the option to designate a credit exposure as measured at fair value through P&L.

The disclosure requirements for each of these four areas are very detailed. Entities should start early to gather and prepare all the necessary information.

The above mentioned disclosures will be applicable, even if the entity continues to apply IAS 39.

8. *Effective date and transition*

Entities have an accounting policy choice to apply IFRS 9 hedge accounting or to continue applying IAS 39 hedge accounting (refer to section 1.2 above).

For entities electing to apply IFRS 9, the recent amendments to IFRS 9 have removed the mandatory effective date. However, the standard continues to be available for immediate application.

Entities can elect to apply IFRS 9 for any of the following (*):

- 1 The own credit risk requirements for financial liabilities – Entities can early adopt the requirement to recognise in OCI the changes in fair value attributable to changes in an entity's own credit risk in financial liabilities that are designated under the fair value option.

- 2 Classification and measurement requirements for financial assets only (IFRS 9 2009 version).

- 3 Classification and measurement requirements for financial assets and financial liabilities (IFRS 9 2010 version).

- 4 The full current version of IFRS 9 (that is, classification and measurement requirements for financial assets and financial liabilities and hedge accounting).

(* *These transitional provisions are likely to change once the Board completes all phases of IFRS 9.*)

To apply hedge accounting from the date of adoption of IFRS 9, all qualifying criteria must be met as at that date.

Hedging relationships that qualified for hedge accounting in accordance with IAS 39, that also qualify for hedge accounting in accordance with IFRS 9 (after taking into account any rebalancing of the hedging relationship on transition), are regarded as continuing hedging relationships. Any gain or loss from such rebalancing must be recognised in P&L.

IFRS 9 requires prospective application of its hedge accounting requirements for all hedging relationships (except as described in the following paragraph). This means that, on the date of transition, all existing hedging relationships should be moved from the existing model under IAS 39 into the new model in IFRS 9. However, there will be no restatement of comparatives.

By way of exception to the above paragraph, retrospective application is required for:

- The accounting for time value of options if only the change in an option's intrinsic value was designated as a hedging instrument.
- The accounting requirements for novation of derivatives as a consequence of laws or regulations.

In addition, retrospective application is permitted, but not required, for:

- The accounting for the forward element of forward contracts if only the change in the spot element of the forward contract was designated as a hedging instrument.
- The accounting for foreign currency basis spreads.

Regarding the fair value through P&L election for 'own use' contracts, an entity will need to make this designation consistently for each group of similar contracts existing on the effective date of the IAS 39 amendment (refer to section 6.1 above).

Currently the European Union has not endorsed any aspects of IFRS 9 (nor the consequential amendments to other standards). As a result, European entities are not currently allowed to adopt the new accounting and disclosure requirements.



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