Grant Thornton
An instinct for growth™

Special Edition on Hedge accounting

IFRS News

December 2013

IFRS 9 Hedge accounting

The IASB has published Chapter 6 'Hedge Accounting' of IFRS 9 'Financial Instruments' (the new Standard). The new requirements look to align hedge accounting more closely with entities' risk management activities by:

- increasing the eligibility of both hedged items and hedging instruments
- introducing a more principles-based approach to assessing hedge effectiveness.

As a result, the new requirements should serve to reduce profit or loss volatility. The increased flexibility of the new requirements are however partly offset by entities being prohibited from voluntarily discontinuing hedge accounting and also by enhanced disclosure requirements.

This special edition of IFRS News informs you about the new Standard, and the benefits and challenges that adopting it will bring.

"IAS 39 'Financial Instruments: Recognition and Measurement', the previous Standard that dealt with hedge accounting, was heavily criticised for containing complex rules which either made it impossible for entities to use hedge accounting or, in some cases, simply put them off doing so.

We therefore welcome the publication of IFRS 9's requirements on hedge accounting. The new requirements should make it easier for many entities to reflect their actual risk management activities in their hedge accounting and thus reduce profit or loss volatility.

At the same time, entities should be aware that while it will be easier to qualify for hedge accounting, many of the existing complexities associated with it (measuring hedge ineffectiveness, etc) will continue to apply once entities are using it."

Andrew Watchman
Executive Director of International Financial Reporting

Introduction

The IASB has published Chapter 6 'Hedge Accounting' of IFRS 9 'Financial Instruments'. The new requirements represent a major accounting change which merits a corresponding level of planning and consideration from entities.

We outline in the table below the major features of the new Standard before considering the changes from the requirements of the previous Standard in more detail in the main body of the newsletter.

IFRS 9's hedge accounting requirements at a glance

Features	Key points
Objective of the Standard	• to better align hedging from an accounting point of view with entities' underlying risk management activities
Similarities with IAS 39	• hedge accounting remains an optional choice • the three types of hedge accounting (fair value hedges, cash flow hedges and hedges of a net investment) remain • formal designation and documentation of hedge accounting relationships is required • ineffectiveness needs to be measured and included in profit or loss • hedge accounting cannot be applied retrospectively
The major changes	• increased eligibility of hedged items • increased eligibility of hedging instruments and reduced volatility • revised criteria for hedge accounting qualification and for measuring hedge ineffectiveness • a new concept of rebalancing hedging relationships • new requirements restricting the discontinuance of hedge accounting

Where do the hedge accounting requirements fit in?

The new requirements on hedge accounting represent the latest step in the IASB's phased plan to replace the existing Standard on financial instruments, IAS 39 'Financial Instruments: Recognition and Measurement'.

Under the IASB's phased approach, new chapters are added to IFRS 9 as each stage of the project is completed. The table below shows the status of the main parts of the project following the publication of the hedge accounting chapter, and the timing of expected future developments.

IFRS 9 Financial Instruments – stage of completion

Chapter	Status
Scope	• complete
Recognition and derecognition	• complete
Classification and measurement	• part complete – Exposure Draft on Limited Amendments published November 2012, final requirements expected Qtr 1 or Qtr 2 2014
Impairment	• discussions ongoing – final requirements expected Qtr 1 or Qtr 2 2014
General hedge accounting	• complete
Macro hedging	• discussions ongoing – Discussion Paper expected Qtr 1 2014

Why are IAS 39's hedge accounting requirements being replaced?

IAS 39, the previous Standard dealing with hedge accounting requirements, was heavily criticised for containing complex rules which either made it impossible for entities to use hedge accounting or, in some cases, simply put them off doing so. In part, this was a reflection of the fact that the hedge accounting requirements were an exception to the normal requirements of that Standard. Nevertheless, there was a perception that hedge accounting did not properly reflect entities' actual risk management activities, thereby reducing the usefulness of their financial statements.

The project to replace IAS 39, which had originally been launched following criticism of the Standard and its alleged role in contributing to the financial crisis, offered an ideal opportunity to address these concerns. In setting the requirements of the new Standard, the IASB has introduced an overall objective of 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 (or, where appropriate, other comprehensive income). Applying hedge accounting is still a voluntary choice, however, and an exception from IFRS 9's normal accounting requirements.

Increased eligibility of hedged items

The new Standard includes some significant changes from IAS 39 which increase the eligibility of items that can be hedged. The areas of change include:

- **risk components**
- **groups of hedged items and net positions**
- **items that include derivatives**
- **equity instruments at fair value through other comprehensive income.**

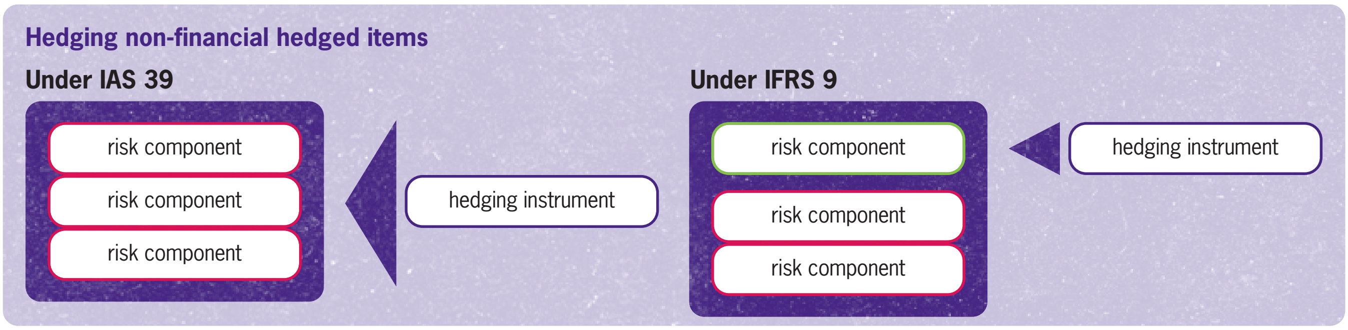
By expanding the population of hedged items, the IASB hopes to align hedge accounting more closely with entities' risk management activities, thereby encouraging more entities to engage in hedge accounting.

Risk components

The new Standard will make it easier to achieve hedge accounting for individual components (or 'portions') of an identified risk.

Under IAS 39 it was possible to hedge financial assets or financial liabilities with respect to an individual component of an overall risk, provided that the exposure to the significant risk component was identifiable and separately measurable. For example, a portion of the interest rate exposure of an interest-bearing liability (representing say a risk-free interest rate or benchmark interest rate component of the total interest rate exposure) could be designated as the hedged risk. With the exception of foreign currency risk, it was not possible to do this for individual components of non-financial items however. This was a major restriction for some entities which prevented them from reflecting their actual risk management practices.

The new Standard removes this restriction making it now possible to treat a 'risk component' as an eligible hedged item irrespective of whether the risk is a financial or a non-financial risk provided that it is separately identifiable and reliably measurable. This will be beneficial for entities that for example hedge non-financial items for a commodity price risk that is only a component of the overall risk of the item. Under the new Standard an entity might for instance be able to hedge the exposure to the benchmark crude oil price in relation to an overall exposure to changes in the price of aviation fuel.



The requirement for the risk component to be separately identifiable does not mean that it has to be contractually specified, although it is likely to be significantly harder to fulfil the requirement where it is not. The assessment of whether a financial or a non-financial risk component is separately identifiable and measurable should instead be performed within the context of the particular market structure of the item in concern.

Inflation as a risk component

The new Standard contains a rebuttable presumption that inflation risk is not separately identifiable and reliably measurable, and therefore not an eligible risk component that can be hedged, unless it is contractually specified within the hedged item.

However, in limited cases, it is possible to identify a risk component for inflation risk that will be an eligible risk component because of the particular circumstances of the inflation environment and the relevant debt market. The Standard mentions as an example an entity that issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. Constructing such a calculation where inflation has not been contractually specified as a risk component is however likely to be challenging in practice for many entities.

Groups of hedged items and net positions

Rather than hedging individual positions, many entities group similar risk exposures together and hedge only the net position. This enables them to take advantage of naturally offsetting risk positions (for example, the net amount of forecast purchases and sales in a foreign currency), thus reducing the financial cost of taking out hedging instruments.

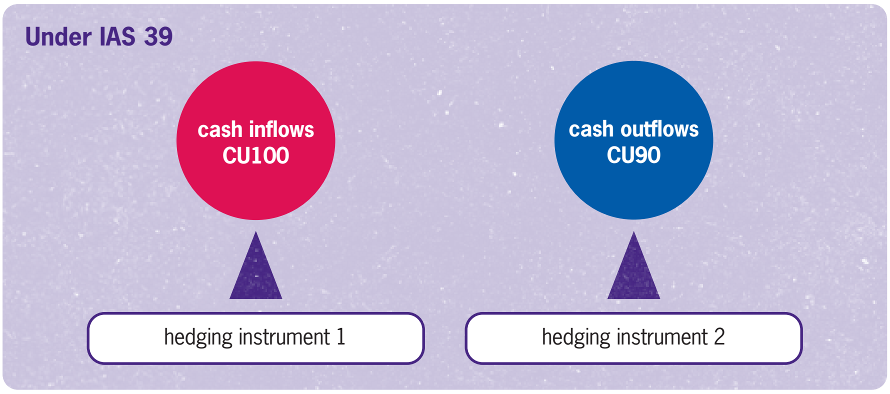
IAS 39 only permitted items to be aggregated and hedged as a group where the individual assets or individual liabilities in the group shared the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group had to be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. Many entities felt that these restrictions were not consistent with the way that they managed risk.

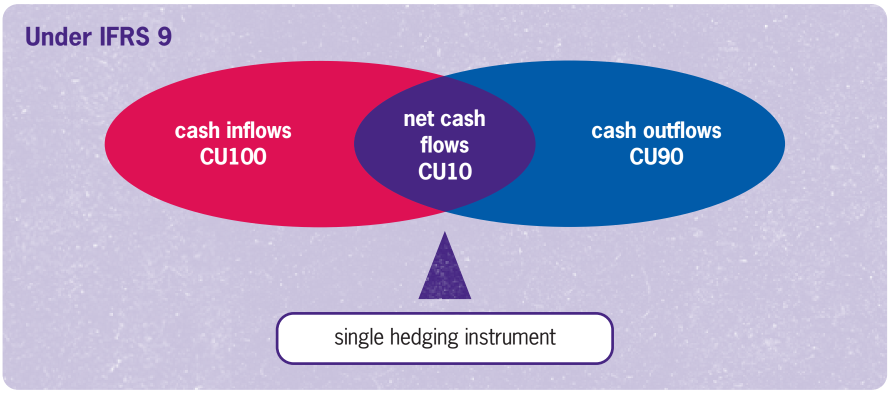
The new Standard relaxes these requirements, making it easier for groups of items to qualify as hedged items. Under the new Standard, a group of items (including a group of items that constitute a net position) is an eligible hedged item if:

- it consists of items (including components of items) that individually are eligible hedged items
- the items in the group are managed together on a group basis for risk management purposes.

Additional restrictions apply for a cash flow hedge of a group of items with offsetting risk positions (ie a net position). Such hedges are only allowed for net positions of foreign currency risk. In addition, the hedge documentation needs to specify the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

It is notable that the new Standard permits cash flows within a net position to affect profit or loss in different periods (for example in a hedge of the foreign currency risk of a net position of foreign currency sales and foreign currency expenses, the sales may occur in a different period than the expenses). As a result, the change in fair value of cash flows that affect profit or loss in an earlier period has to be carried forward to offset the change in fair value of cash flows that will occur in a later period. This is done by deferring the earlier gains (or losses) in other comprehensive income and then recycling them to profit or loss when the later cash flows affect profit or loss.





Items that include derivatives

The new Standard permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative (sometimes referred to as 'synthetic positions'). This was not permitted under IAS 39, which created problems for entities that managed risk in this way.

Example

An entity has a forecast purchase requirement of coffee purchases in 24 months' time, which must be settled in foreign currency. It may decide to enter a two-year forward contract to fix the price of the coffee in terms of the foreign currency. In 12 months' time, the entity may wish to hedge the risk that arises on the combination of the forecast purchase requirement and the derivative that has been entered into. Unlike under IAS 39, it is possible for such an aggregated exposure (ie one including a derivative) to qualify as a hedged item under the new Standard. In this example, the hedged item would then be a fixed purchase in a foreign currency amount. A foreign currency derivative could be used as a hedging instrument to hedge this exposure.

Equity instruments at fair value through other comprehensive income

The new Standard allows hedge accounting for equity instruments at fair value through other comprehensive income, even though there will be no impact on profit or loss from these investments. This is a change from IAS 39 and responds to concerns from entities who told the IASB that it is a common risk management strategy for an entity to hedge the foreign exchange risk exposure of equity investments irrespective of whether they were designated for accounting purposes at fair value through profit or loss or at fair value through other comprehensive income. Entities may also wish to hedge the equity price risk to protect themselves against volatility even though they may not be intending to sell the particular equity investment.

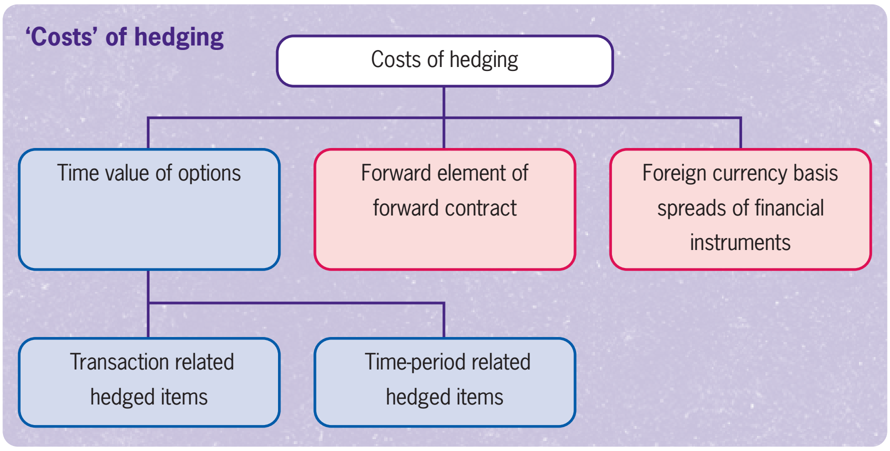
Increased eligibility of hedging instruments and reduced volatility

The new Standard includes one change from IAS 39 which will increase the eligibility of hedging instruments, thereby encouraging entities to engage in hedge accounting. More importantly however, it contains new rules on the accounting for the time value of options and the forward points in forward contracts which may reduce profit or loss volatility compared to under IAS 39. We expand on both of these points below:

Increased eligibility of hedging instruments

Under the new Standard, a non-derivative financial instrument can now be treated as a hedging instrument provided it is measured at fair value through profit or loss. This represents a change from IAS 39 which will in theory increase the ability of entities to use hedge accounting. In practice however there are relatively few non-derivative financial instruments measured at fair value through profit or loss, so this is unlikely to be a big change.

New rules on options and forward contracts



New rules on the accounting for the time value of options and the forward points in forward contracts may reduce profit or loss volatility compared to under IAS 39.

Under IAS 39, a hedging instrument usually had to be designated as part of a hedging relationship in its entirety. The only exceptions to this were that an entity could choose to:

- separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option and not the change in its time value
- separate the forward element and the spot element of a forward contract and designate as the hedging instrument only the change in the spot element and not the forward element.

These exceptions continue to apply in IFRS 9, however the Standard changes the way in which the parts of these instruments that are not designated as part of the hedging instrument are treated.

Accounting for the time value of options

Under IAS 39, the time value of an option contract is treated as a derivative normally would be, meaning the change in the fair value of the time value of the option is recognised in profit or loss. The natural (and not very popular) consequence of this treatment was volatility in the profit or loss. The changes made by IFRS 9 are intended to address this issue, recognising that the time value of the option is tantamount to a cost of hedging.

While the time value of an option contract continues to be accounted for at fair value under the new Standard, the new Standard requires the change in its fair value to be initially deferred in other comprehensive income (OCI). The Standard then sets out requirements which determine when those deferred amounts are reclassified to profit or loss. In doing so, it distinguishes between:

- a 'transaction related' hedged item
- a 'time-period related' hedged item.

Transaction related hedged items

For transaction related hedged items, the accumulated change in the fair value that has been deferred in OCI is recognised in profit or loss at the same time as the hedged item.

If the hedged item subsequently results in the recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied, the amount deferred in OCI is removed and included directly in the initial cost or other carrying amount of the asset or liability. For hedging relationships other than these, the amount deferred in OCI is reclassified in the same period as the hedged expected future cash flows affect profit or loss (for example, when a forecast sale occurs).

Time-period related hedged item

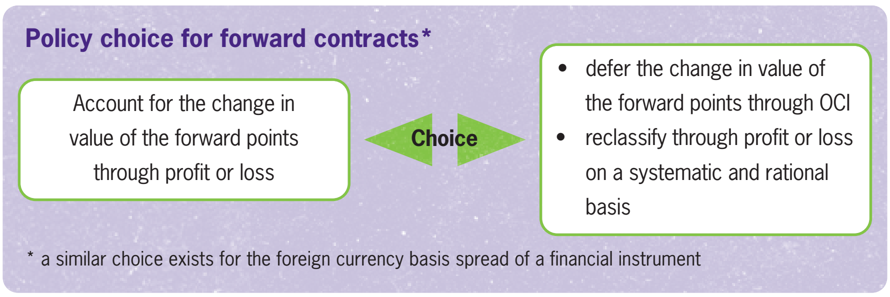
For time-period related hedged items, the amounts that have been deferred in equity are reclassified to profit or loss on a systematic and rational basis over the term of the hedging relationship. The logic here is that the option cost does not match with a specific transaction.

Accounting for the forward element of forward contracts

The Standard contains similar guidance on how to show the change in value of the forward points for hedges based on the spot rate of a forward contract. Unlike the (mandatory) requirements for options, however, entities are allowed an accounting policy choice over following the approach that was used under IAS 39 of accounting for the change in value of the forward points through profit or loss or adopting the new alternative requirements.

Foreign currency basis spreads of financial instruments

A similar choice to that for accounting for the forward element of forward contracts exists when 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.



Revised criteria for hedge accounting qualification and for measuring hedge ineffectiveness

The new Standard makes significant changes to the criteria for hedge accounting qualification, relaxing the current requirements with the objective of making it easier for entities to reflect their underlying risk management objectives.

Background

To qualify for hedge accounting under IAS 39, a hedge had to be highly effective on both a prospective and a retrospective basis. 'Highly effective' refers to the degree of offset between the changes in fair value or cash flows of the hedging instrument and the hedged item, and is defined in terms of a 'bright line' quantitative range of 80-125%. Where the actual results of a hedge were found to have fallen outside that range, IAS 39 required hedge accounting to be discontinued.

These requirements were widely criticised by preparers for being unaligned with their actual risk management practices. The 80-125% accounting threshold was particularly criticised for resulting in hedge accounting discontinuance even where there had not been a breakdown in the economics of the hedge.

The new requirements

The IASB has responded to these criticisms by eliminating the 80-125% threshold and introducing more principles-based qualifying criteria. Under IFRS 9, a hedging relationship must meet all of the following requirements:

- there is an economic relationship between the hedged item and the hedging instrument
- the effect of credit risk does not dominate the value changes that result from that economic relationship
- the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

To prevent abuse of the third criteria, the IASB has included wording that prevents entities from deliberately attempting to achieve a ratio that would result in an outcome that would be inconsistent with the purpose of hedge accounting.

Economic relationship

The first requirement for an economic relationship to exist means that the hedging instrument and the hedged item are expected to move in the opposite direction because of the same risk (the hedged risk).The Standard gives the relationship between Brent and WTI crude oil as an example.

The mere existence of a statistical correlation between two variables does not, by itself, prove that an economic relationship exists however. Rather, there must be causality in the movements between the variables. An analysis of the possible behaviour of the hedging relationship during its term will therefore be needed to ascertain whether it is expected to meet the risk management objective and so demonstrate that an economic relationship exists.

Credit risk must not dominate

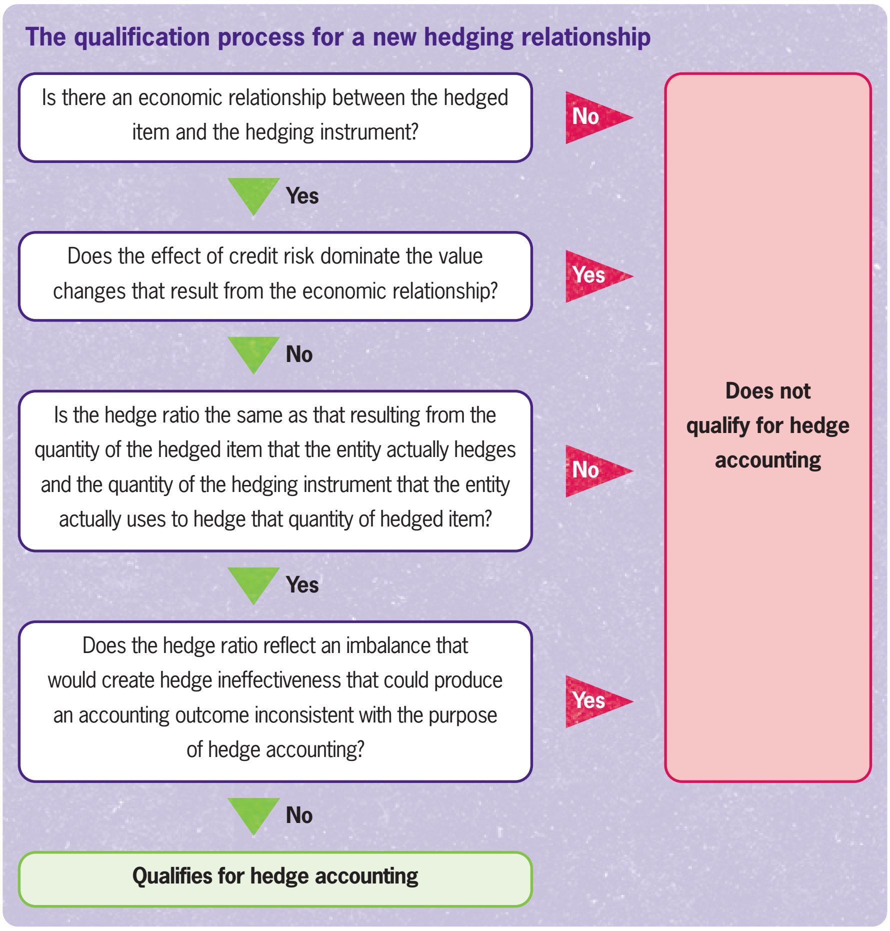
The second criteria for hedge accounting qualification is that the impact of changes in credit risk should not be of such a magnitude that it dominates the value changes that result from the economic relationship (ie the effect of the changes in the underlying variables).

Such a situation might occur where an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to the derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

Hedge ratio

The third criteria for hedge accounting qualification is that the hedge ratio of the hedging relationship must be the same as that resulting from:

- the quantity of the hedge item that the entity actually hedges and
- the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.



For example, where an entity hedges less than 100% of the exposure on an item, say 85%, it will need to designate the hedging relationship using a hedge ratio that is the same as that resulting from 85% of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge that 85%.

The designation of the hedging relationship must not however reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. This caveat is intended, for example, to prevent entities deliberately under hedging so as to minimise the recognition of ineffectiveness in a cash flow hedge.

A new concept of rebalancing hedging relationships

The new Standard requires rebalancing of an existing hedge relationship to be undertaken where the hedge effectiveness requirements are no longer met but the entity's risk management objective remains the same.

This involves making adjustments to the designated quantities of the hedged item or the hedging instrument so as to maintain a hedge ratio that complies with the hedge effectiveness requirements and is a new concept. By way of contrast, failure to meet the hedge effectiveness requirements under IAS 39 generally resulted in discontinuance of hedge accounting, meaning that the entity had to recommence hedge accounting with a new hedging relationship.

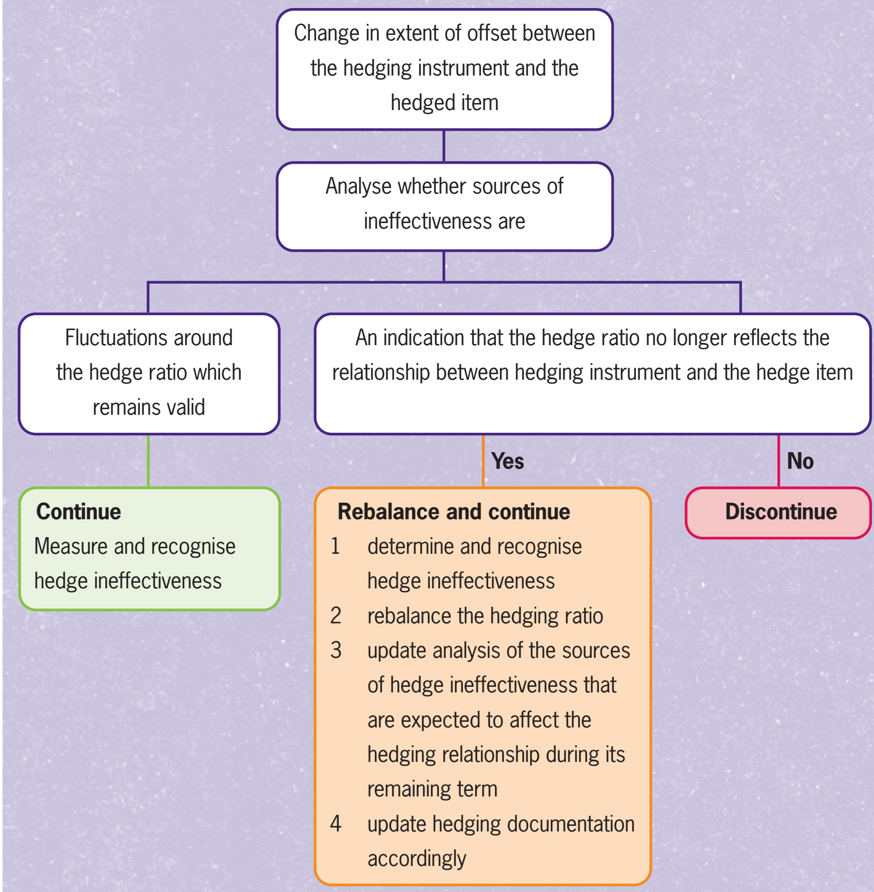
An example of a situation where rebalancing would be appropriate would be where an entity hedges an exposure to a foreign currency that is pegged to another foreign currency (ie their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority), and the peg changes.

As noted above, rebalancing is also required where an entity deliberately undertakes actual risk management that results in weightings of the hedged item and the hedging instrument that produce an accounting result that is inconsistent with the purpose of hedge accounting.

Example

An entity hedges an exposure to the Hong Kong $ using a currency derivative that references the US $. The Hong Kong $ and the US $ are pegged. If the exchange rate between the Hong Kong $ and the US $ were changed (ie a new band or rate was set), rebalancing of the hedge ratio should take place as the entity's risk management objective would remain the same.

Ongoing hedging relationships – ineffectiveness and rebalancing



Frequency of assessing whether the hedge effectiveness requirements are met

Under the new Standard, entities are required to assess whether the hedge effectiveness requirements are met both at the inception of the hedging relationship and on an ongoing basis.

The ongoing assessment is required to be performed (at least) at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. Unlike under IAS 39, the assessment is not retrospective but solely forward-looking.

Methods for assessing whether the hedge effectiveness requirements are met

The new Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements or not.

In a simple case where the critical terms of the hedging instrument and the hedged item match or are closely aligned, a qualitative assessment of hedge effectiveness may be appropriate. In situations where the critical terms of the hedging instrument and the hedged item are not closely aligned however, it may only prove possible to conclude that an economic relationship exists where a quantitative assessment is performed. Similarly it may be necessary to perform a quantitative assessment in order to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements.

Insight

Under IFRS 9, it is an entity's risk management that is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements.

This means that it is possible for the method used to assess hedge effectiveness to change over time. Where such a situation occurs, IFRS 9 requires the documentation of the hedging relationship to be updated for any changes to the methods. This is a change from IAS 39, which required an entity to specify at inception of the hedging relationship the method to be applied to assess hedge effectiveness, and to then apply that method consistently for the duration of the hedging relationship.

It is also possible for an entity to use the same or different methods for assessing whether an economic relationship exists between the hedged item and the hedging instrument and whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements.

Discontinuing hedge accounting

The new Standard specifies that where the risk management objective for a hedging relationship has changed, rebalancing does not apply and the hedge relationship must instead be discontinued.

Note that under the new Standard, entities can no longer voluntarily choose to discontinue hedge accounting where the risk management objective remains the same.

In summary, hedge accounting can only be discontinued when the hedging relationship (or a part of the hedging relationship) ceases to meet the qualifying criteria (after taking account of rebalancing, if applicable).

For example when:

- the hedging relationship no longer meets the risk management objective
- the hedging instrument has expired, been sold, been terminated or exercised
- there is no longer an economic relationship between the hedged item and the hedging instrument or the effect of credit risk starts to dominate the value changes that result from that economic relationship.

Risk management strategy versus risk management objective

Guidance in the Standard distinguishes between an entity's risk management strategy and its risk management objective.

Risk management strategy

An entity's risk management strategy is established at the highest level at which it manages risk. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them. Such strategies are typically in place for lengthy periods and may include some flexibility to react to changes in circumstances that occur while the particular strategy is in place (eg changes in interest rate or commodity price levels that would result in a different extent of hedging).

Risk management objective

In contrast, the risk management objective for a hedging relationship applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item.

From this guidance it is clear that a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy.

Alternatives to hedge accounting

IAS 39 contains an option which allows an entity to designate a financial instrument that would otherwise be measured at amortised cost as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch. This is known as the 'fair value option'. As well as making the changes relating to hedge accounting discussed above, the IASB has extended the use of this fair value option in order to provide a (less onerous) alternative to hedge accounting in the following two areas:

- **contracts to buy or sell a non-financial item for own use**
- **hedging credit risk using credit derivatives.**

We discuss these two areas of change below:

Contracts to buy or sell a non-financial item for own use

Under IAS 39, the accounting for executory contracts to buy or sell a non-financial item that can be settled net in cash could give rise to accounting mismatches in some situations. This was particularly the case for commodity contracts.

Many commodity contracts are accounted for as derivatives because the commodities can be readily converted to cash and the contracts allow for them to be net settled in cash. Where this is the case, the derivative is measured at fair value through profit or loss. If an entity enters into a derivative to hedge the exposure to changes in the value of the commodity contract, then both the contract and the derivative which is being used to (economically) hedge the contract are measured at fair value and there is no need to apply actual hedge accounting, there being a natural offset.

Non-financial items that can be net settled in cash are however outside the scope of IAS 39 where they are held for the entity's 'own use'. As a result, many commodity contracts are accounted for as normal sale or purchase contracts. Where this is the case and an entity enters into a derivative contract to hedge the changes in the fair value of the contract, an accounting mismatch is created. This is 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 this accounting mismatch, an entity could apply hedge accounting. However, hedge accounting in these circumstances can be administratively burdensome as these types of contract are typically entered into in large volumes and managed on a net basis, often resulting in the net position being adjusted on a daily basis.

The new Standard provides relief from this accounting mismatch by making consequential amendments which allow an entity to elect at the date of initial recognition of the contract to irrevocably designate a contract to buy or sell a non-financial item that can be settled net in cash as measured at fair value through profit or loss.

This amendment effectively allows commodity contracts for own use to be accounted for as derivatives and therefore measured at fair value. Where an actual derivative has been taken out to hedge against the change in value of the commodity contract, there will therefore be a natural offset in terms of the effect on profit or loss and hedge accounting will therefore not be necessary. The new Standard specifies however that this option can only be used where it eliminates or significantly reduces an accounting mismatch that would otherwise result.

Hedging credit risk using credit derivatives

The second area where the 'fair value option' has been extended relates to hedging credit risk using credit derivatives.

Many financial institutions enter such hedges to manage the credit risk exposures which arise from their lending activities. In order to hedge such exposures under both the new Standard and IAS 39, the credit risk component needs to be separately identifiable and reliably measurable which can in practice prove to be challenging.

As a result, financial institutions that use credit default swaps to hedge credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments. This creates an accounting mismatch due to the credit default swaps being measured at fair value through profit or loss.

To allow for the management of credit risk, the IASB has therefore extended the fair value option to accommodate certain credit exposures as an alternative to hedge accounting.

The new Standard permits an entity to designate a credit exposure as measured at fair value through profit or loss provided the following criteria are fulfilled:

- it is hedged with a credit derivative
- the name of the credit exposure matches the reference entity of the credit derivative
- the seniority of the financial instrument or part of the financial instrument that constitutes the credit exposure matches that of the instruments that can be delivered in accordance with the credit derivative.

Designation can be made at initial recognition or subsequently or even while the credit exposure is unrecognised (which might be the case for a loan commitment for example).

Effective date

Prior to the publication of the new hedge accounting requirements, the mandatory effective date of IFRS 9 was 1 January 2015. On publication of the new requirements however, the IASB decided that this date would not allow sufficient time for entities to prepare to apply IFRS 9. Therefore at the same as publishing the amendments that introduced the disclosure requirements into IFRS 9, the IASB removed the Standard's mandatory effective date.

Early application is permitted provided that all of the other (existing) requirements of IFRS 9 have been applied or are applied at the same time. When an entity first applies IFRS 9 (as amended in November 2013), it may however chose to continue to apply IAS 39's hedge accounting requirements instead of IFRS 9's.

Macro hedging

The IASB currently has a separate, active project on accounting for macro hedging activities (covering ways to account for dynamic risk management of open portfolios).

Currently entities applying hedge accounting to such risk management activities, use a combination of IAS 39's general hedge accounting requirements and the specific model in IAS 39 for accounting for macro hedging.

IFRS 9 has been designed so that entities would not be adversely affected while the macro hedging project continues to be developed. Therefore an entity undertaking macro hedging activities can apply the new accounting model in IFRS 9 while continuing to apply the specific IAS 39 accounting for macro hedges if they wish to do so. As noted above, the IASB is also allowing entities a choice of continuing to apply IAS 39 for all their hedge accounting until the macro hedging project is completed.

Presentation and disclosure

While the accounting mechanics and presentation requirements set out in IAS 39 remain largely unchanged, the new Standard amends IFRS 7 'Financial Instruments: Disclosures' to introduce extensive new disclosure requirements to compensate in part for the increased flexibility of the new requirements.

The new Standard requires all its disclosure requirements on the effects of hedge accounting to be disclosed in one comprehensive note in the financial statements, reflecting concerns expressed by users that IAS 39's hedge accounting disclosures were not helpful. This note covers:

- the entity's risk management strategy and how it applies that strategy to manage risk
- how the entity's hedging activities affect the amount, timing and uncertainty of future cash flows
- the effects of hedge accounting on the primary financial statements

In addition, there are specific disclosures for dynamic strategies and credit risk hedging.

In making the disclosures required by the new Standard, entities should use their judgement to determine:

- how much detail to disclose
- how much emphasis to place on different aspects of the disclosure requirements
- the appropriate level of aggregation or disaggregation
- whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

Transition

The new requirements are to be applied prospectively subject to certain exceptions. The principal exceptions are:

- retrospective application for the time value of options is required where previously only the change in an option's intrinsic value has been designated under IAS 39 as a hedging instrument in a hedge relationship
- entities may elect to retrospectively apply the accounting for the forward element of forward contracts where previously only the change in the spot element of a forward contract has been designated as a hedging instrument under IAS 39, provided that the election is applied consistently
- the accounting for foreign currency basis spreads may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

Similarities with IAS 39

Amid all the change created by the publication of the new Standard, it is easy to forget that some significant areas are unchanged from the previous requirements of IAS 39. These include the following:

- hedge accounting remains a voluntary choice
- entities will still need to identify a hedged item and a hedging instrument and document the relationship between them at inception
- the three types of hedge relationship used in IAS 39 (fair value hedges, cash flow hedges and hedges of a net investment) and the mechanics of accounting for them remain the same
- the method for determining hedge ineffectiveness is unchanged
- it is not possible to use a written option as a hedging instrument.

Entities should be particularly aware that while it may be easier to qualify for hedge accounting under the new Standard, many of the existing complexities that result from the mechanics of applying it (such as calculating hedge ineffectiveness) will remain once they are using it.

The Standard requires that in order to apply hedge accounting from the date of initial application for existing hedging relationships, the hedge accounting requirements of the new Standard must be met at that date. Existing hedge relationships that qualify under the requirements of the new Standard (after taking into account any rebalancing on transition) are regarded as continuing.

Advantages and disadvantages of the new requirements

Advantages	Disadvantages
Increased opportunities to use hedge accounting: • ability to designate non-financial risk components • more flexibility to hedge groups of items • increased ability to hedge net items	Not possible to voluntarily discontinue hedge accounting
New treatment of time value of options will reduce profit and loss volatility	Need to rebalance
Increased eligibility of hedging instruments (aggregated exposures)	Reduced ability to use rollover strategies
Introduces fair value option for credit risk (removes accounting mismatch)	Cost and effort of measuring hedge ineffectiveness remain (albeit reduced)
Reduces cost and effort associated with measuring hedge ineffectiveness (80-125% retrospective test eliminated)	Costs associated with dedesignation (resulting from having to close out derivative positions in order to dedesignate)
	Lack of convergence with US GAAP

Grant Thornton
An instinct for growth™

www.gti.org