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Basis for Conclusions and Illustrative Examples
Exposure Draft ED/2010/13

Hedge Accounting

Comments to be received by 9 March 2011

Exposure Draft
HEDGE ACCOUNTING

Basis for Conclusions
and illustrative examples

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This Basis for Conclusions and illustrative examples accompany the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Hedge Accounting* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **9 March 2011**. Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

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Basis for Conclusions on the exposure draft *Hedge Accounting*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

- BC1 The International Accounting Standards Board has long acknowledged the need to improve the accounting requirements for financial instruments. In the light of the global financial crisis and the urgent need to improve the accounting for financial instruments, the Board proposed to replace IAS 39 *Financial Instruments: Recognition and Measurement* in three phases. The exposure draft *Hedge Accounting* is part of the third phase.
- BC2 This Basis for Conclusions summarises the Board's considerations in developing the proposals in the exposure draft. Individual Board members gave greater weight to some factors than to others.

Background

The project to replace IAS 39

- BC3 IAS 39 set out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The Board inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.
- BC4 Many users of financial statements and other interested parties told the Board that the requirements in IAS 39 were difficult to understand, apply and interpret. They urged the Board to develop a new standard for the reporting of financial instruments that is principle-based and less complex. Although the Board amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it had not previously undertaken a fundamental reconsideration of reporting for financial instruments.
- BC5 In April 2009, in response to the input received on its work in responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the Board announced an accelerated timetable for replacing IAS 39.

- BC6 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the Board divided its project to replace IAS 39 into three main phases. As the Board completes each phase, it deletes the relevant portions of IAS 39 and creates chapters in IFRS 9 that replace the requirements in IAS 39.
- BC7 The exposure draft *Hedge Accounting* is part of the third phase of the Board's project to replace IAS 39. The other phases are:
- (a) Phase 1: Classification and measurement of financial assets and financial liabilities. In November 2009 the Board issued the chapters of IFRS 9 setting out requirements for the classification and measurement of financial assets. In October 2010 the Board added to IFRS 9 the requirements for the classification and measurement of financial liabilities.
 - (b) Phase 2: Amortised cost and impairment. In June 2009 the Board published a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. The Board also set up a panel of credit and risk experts to consider and advise it on the operational issues arising from an expected cash flow approach. The Board is redeliberating the proposals in the exposure draft to address the comments received from respondents, and suggestions from the expert advisory panel and from other outreach activities.

Replacing the hedge accounting requirements in IAS 39

- BC8 The Board used the responses to its discussion paper *Reducing Complexity in Reporting Financial Instruments* as a basis for deliberations on the exposure draft *Hedge Accounting*. During its deliberations the Board also approached preparers, auditors and users of financial statements for views on the hedge accounting requirements in IAS 39. The objective of the Board's outreach was to gain insight into how interested parties viewed the hedge accounting requirements in IAS 39 and to obtain information on common practice issues. A particular effort was made to gain an overall understanding of how users view hedging and how an entity's hedging activities affect their analysis and decisions.

- BC9 Users of financial statements told the Board that hedge accounting should be more closely aligned to an entity's risk management activities. Furthermore, the response to the Board's outreach activities indicated that a comprehensive review of hedge accounting was needed. In particular:
- (a) *Eligibility of hedged items and hedging instruments*—Many think that the restrictions in IAS 39 of what is eligible for hedge accounting unduly hinders an entity's ability to reflect its risk management practices.
 - (b) *Groups of items and net positions*—Many think that an entity should be permitted to apply hedge accounting for situations other than a relationship between a single hedging instrument and a single hedged item. For example, they think that an entity should be permitted to apply hedge accounting to groups of items beyond the restrictions in IAS 39 (ie not only in the narrow circumstances in which individual items have fair value changes that are approximately proportional to the overall change for the group), and to hedges of net positions.
 - (c) *Effectiveness qualification*—Many think that the existing requirements for assessing hedge effectiveness are onerous and result in misleading accounting outcomes because they are too restrictive and based on arbitrary 'bright lines'.
 - (d) *De-designation and designation*—Some think that IAS 39 impairs comparability because hedge accounting is an option that can be discontinued at will at any time.
 - (e) *Fair value hedge accounting mechanics*—Some think that the different accounting mechanics in IAS 39 for cash flow hedges and fair value hedges add complexity.
 - (f) *Presentation and disclosure*—Some think that the current disclosure requirements do not provide sufficient information in the financial statements about an entity's risk management activities and focus too strongly on accounting, which limits their understandability and usefulness.
- BC10 The Board expects to complete this and the second phase of the project to replace IAS 39 in the first half of 2011.

The objective and scope of hedge accounting

The objective of hedge accounting

- BC11 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRSs. For example, the hedge accounting guidance in IAS 39 permits:
- (a) recognition of items that would otherwise not be recognised (eg a firm commitment);
 - (b) measurement of an item on a basis that is different from its normally required measurement basis (eg adjusting the measurement of a hedged item in a fair value hedge); and
 - (c) deferral of the changes in fair value of a hedging instrument for a cash flow hedge in other comprehensive income. These changes in fair value would otherwise have been recognised in profit or loss (eg hedging of a highly probable forecast transaction).
- BC12 The Board noted that although hedge accounting was an exception, it was also an indication that in many situations the information that resulted from the normal requirements without applying hedge accounting did not provide useful information or omitted important information. Hence, the Board concluded that hedge accounting should be retained.
- BC13 In the Board's view, consistent application of hedge accounting requires an objective that describes *when* and *how* an entity should:
- (a) override the general recognition and measurement requirements in IFRSs (ie when and how an entity should apply hedge accounting); and
 - (b) recognise effectiveness and/or ineffectiveness of a hedging relationship (ie when and how gains and losses should be recognised).
- BC14 During its deliberations the Board considered two possible objectives of hedge accounting—that hedge accounting should:
- (a) provide a link between an entity's risk management and its financial reporting. Hedge accounting would convey the context of hedging instruments, which would allow insights into their purpose and effect.
 - (b) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the

accounting for hedged items and manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

- BC15 However, the Board rejected both objectives. The Board thought that an objective that linked an entity's risk management and financial reporting was too broad: it was not clear enough what risk management activity was being referred to. Conversely, the Board thought that an objective that focused on the accounting anomalies was too narrow: it focused on the mechanics of hedge accounting rather than on why hedge accounting was being done.
- BC16 Consequently, the Board decided to use an objective that combines elements of the two objectives. The Board thinks that the proposed objective of hedge accounting reflects a broad articulation of a principle-based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provides for a focus on the statement of financial position and the statement of comprehensive income reflecting the effects of the individual assets and liabilities associated with the risk management activities.

Open portfolios

- BC17 In practice, risk management often assesses risk exposures on a continuous basis and at a portfolio level. Risk management strategies tend to have a time horizon (eg two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to the hedged portfolio and other exposures are removed from it.
- BC18 Hedges of open portfolios introduce complexity to the accounting for such hedges. Changes could be addressed by treating them like a series of closed portfolios with a short life (ie by periodic de-designation of the previous closed portfolio of items and redesignation of a revised closed portfolio of items). However, this gives rise to complexities regarding tracking, amortisation of hedge adjustments and reclassification of gains or losses deferred in accumulated other comprehensive income. Furthermore, it may be impractical to align such an accounting treatment with the way in which the exposures are viewed from a risk management perspective, which may update hedge portfolios more frequently (eg daily).

- BC19 Closed hedged portfolios are hedged portfolios in which items cannot be added to, removed from or substituted within the portfolio without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies the hedged items that form that particular hedging relationship.
- BC20 The Board decided not to address open portfolios or ‘macro’ hedging (ie hedging at the level that aggregates portfolios) as part of the exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross or net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship). See paragraphs BC156–BC182. The Board is continuing to discuss proposals for hedge accounting for open portfolios.
- BC21 Consequently, the exposure draft does not propose to replace the requirements in IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk.

Hedge accounting for equity investments designated as at fair value through other comprehensive income

- BC22 In accordance with IFRS 9 an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in other comprehensive income. Amounts recognised in other comprehensive income for such instruments are not reclassified to profit or loss. However, IAS 39 defines a hedging relationship as one in which the exposure to be hedged could affect profit or loss. Consequently, an entity cannot apply hedge accounting if the hedged exposure affects other comprehensive income without reclassification out of other comprehensive income to profit or loss because only such a reclassification would mean that the hedged exposure could ultimately affect profit or loss.
- BC23 The Board considered whether it should amend the definition of a fair value hedge to state that the hedged exposure could affect either profit or loss or other comprehensive income, rather than always profit or loss. However, the Board had practical concerns. These related to the matching of the changes in the fair value of the hedging instrument with the changes in the value of the hedged item attributable to the hedged risk. Furthermore, the Board was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the Board considered alternative approaches.

- BC24 The Board considered whether the hedge ineffectiveness should remain in other comprehensive income when the changes in the value of the hedged item attributable to the hedged risk are bigger than the changes in the fair value of the hedging instrument. This approach would:
- (a) be consistent with the Board's decision in IFRS 9 that changes in the fair value of the equity investment designated as at fair value through other comprehensive income should not be reclassified to profit or loss; but
 - (b) contradict the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss.
- BC25 Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:
- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but
 - (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income.
- BC26 The Board decided to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it cannot be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the Board did not want to add another exception (ie contradicting the principle in IFRS 9 of not reclassifying between other comprehensive income and profit or loss or contradicting the principle of recognising hedge ineffectiveness in profit or loss) to the existing exception of accounting for investments in equity instruments (ie the option to account for those investments at fair value through other comprehensive income).
- BC27 The Board noted that dividends from investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from such investments could be an eligible hedged item (if all qualifying criteria for hedge accounting are met).

Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

- BC28 IAS 39 requires the separation of non-closely related derivatives embedded in hybrid financial assets and liabilities (bifurcation). In accordance with IAS 39, the separated derivative is eligible for designation as a hedging instrument. In accordance with IFRS 9, hybrid financial assets are measured in their entirety (ie including any embedded derivative) at either amortised cost or fair value through profit or loss. No separation of any embedded derivative is permitted.
- BC29 In the light of the decision that it made on IFRS 9, the Board considered whether derivatives embedded in financial assets should be eligible for designation as hedging instruments. The Board considered two alternatives:
- (a) an entity could choose to separate embedded derivatives solely for the purpose of designating the derivative component as a hedging instrument; or
 - (b) an entity could designate a risk component of the hybrid financial asset, equivalent to the embedded derivative, as the hedging instrument.
- BC30 The Board rejected both alternatives. Consequently, the Board proposes not to allow derivative features embedded in financial assets to be eligible hedging instruments (even though they can be an integral part of a hybrid financial asset that is measured at fair value through profit or loss and designated as the hedging instrument in its entirety—see paragraph BC40). The reasons for the Board's decision are summarised below.
- BC31 Permitting an entity to separate embedded derivatives for the purpose of hedge accounting would retain the IAS 39 requirements in terms of their eligibility as hedging instruments. However, the Board noted that the underlying rationale for separating embedded derivatives in IAS 39 is not to reflect risk management activities, but rather to prevent an entity from circumventing the requirements for recognition and measurement of derivatives. Hence, the Board considered that reintroducing the separation of embedded derivatives for hybrid financial assets would not be an appropriate means to address any hedge accounting concerns because this notion does not target hedge accounting considerations.

- BC32 The Board also noted that designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 is not very common in practice. Consequently, the Board did not think it was appropriate to re-create the complexity associated with separating embedded derivatives when all it could achieve was an approach that was neither targeted nor applicable for situations that are not common in practice.
- BC33 Alternatively, permitting an entity to designate, as the hedging instrument, a risk component of a hybrid financial asset would allow that entity to show more accurately the results of its risk management activities. However, such an approach would be a significant expansion of the scope of the hedge accounting project because the Board would need to address the question of how to disaggregate a hedging instrument into components. In order to be consistent, a similar question would need to be addressed regarding non-financial items (eg non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with currency or commodity risk elements). The Board did not want to expand the scope of the hedge accounting project beyond financial instruments because the outcome of exploring this alternative would be highly uncertain, could possibly involve a review of other standards and could significantly delay the project.

Non-derivative financial instruments

- BC34 Hedge accounting shows how the changes in the fair value or cash flows of a hedging instrument offset the changes in the fair value or cash flows of a designated hedged item attributable to the hedged risk if it reflects an entity's risk management strategy.
- BC35 IAS 39 permits non-derivative financial assets and non-derivative financial liabilities (eg monetary items denominated in a foreign currency) to be designated as hedging instruments only for a hedge of foreign currency risk. Designating a non-derivative financial asset or liability denominated in a foreign currency as a hedge of foreign currency risk in accordance with IAS 39 is equivalent to designating a risk component of a hedging instrument in a hedging relationship. This foreign currency risk component is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because the foreign currency risk component is determined in accordance with foreign currency translation requirements in IAS 21, it is already available for incorporation by reference in the financial instruments standard. Consequently, permitting the use of a foreign currency risk component for hedge accounting purposes does not require separate, additional requirements for risk components within the hedge accounting model.

- BC36 Not allowing the disaggregation into components of a non-derivative financial instrument into risk components, other than foreign currency risk, has implications for the likelihood of achieving hedge accounting for those instruments. This is because the effects of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness assessment. Hence, in most scenarios, hedging relationships will not achieve other than accidental offsetting and therefore will fail the qualifying criteria for hedge accounting.
- BC37 In the light of this consequence, the Board considered whether it should permit non-derivative financial instruments to be eligible for designation as hedging instruments for risk components other than foreign currency risk. The Board noted that permitting this would require developing an approach for disaggregating non-derivative hedging instruments into components. For reasons similar to those set out in paragraph BC33 the Board decided not to explore such an approach.
- BC38 The Board also considered two alternatives to the requirements of IAS 39 that limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk. The Board considered whether to extend the eligibility to non-derivative financial instruments classified as at fair value through profit or loss or alternatively other categories of IFRS 9 for hedges of all types of risk (ie not limited to hedges of foreign currency risk).
- BC39 The Board noted that extending the eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow the application of hedge accounting to investments in equity instruments designated as at fair value through other comprehensive income (see paragraph BC26).
- BC40 However, the Board noted that extending the eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety (rather than risk components), would not give rise to the need to change the measurement basis of the financial instrument. The Board also noted that extending the eligibility to these financial instruments would align more closely with the classification model of IFRS 9 and make the new hedge accounting model better able to address hedging strategies that could evolve in the future. Consequently, the Board proposes that those non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments in their entirety (in addition to hedges of foreign currency risk on a risk components basis—see paragraph BC35).

Internal derivatives as hedging instruments

- BC41 An entity may follow different risk management models depending on the structure of its operations and the nature of the hedges. Some use a centralised treasury or similar function that is responsible for identifying the exposures and managing the risks borne by various entities within the group. Others use a decentralised risk management approach and manage risks individually for entities in the group. Some also use a combination of these two approaches.
- BC42 Internal derivatives are typically used to aggregate risk exposures of a group (often on a net basis) to allow the entity to manage the resulting consolidated exposure. However, IAS 39 is primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align risk management and accounting, the Board considered whether internal derivatives should be eligible for designation as hedging instruments. However, the Board noted that the eligibility of internal derivatives as hedging instruments is not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge is how to make hedge accounting operational for groups of items and net positions.
- BC43 The Board noted that the mitigation or transformation of risk is generally only relevant if it results in a transfer of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity does not change the risk exposure from the perspective of that reporting entity as a whole. This is consistent with the principles of consolidated financial statements.
- BC44 For example, a subsidiary might transfer cash flow interest rate risk from variable rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (rather than hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's consolidated perspective the cash flow interest rate risk has not changed but merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).

BC45 Consequently, the Board proposes that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting entity (eg intragroup derivatives in the consolidated financial statements) because they do not represent an instrument that the reporting entity uses to transfer the risk to an external party (ie outside the reporting entity). This means the related requirements in IAS 39 would be retained.

Intragroup monetary items as hedging instruments

BC46 In accordance with IAS 39 the difference arising from the translation of intragroup monetary items in the consolidated financial statements in accordance with IAS 21 can be eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.

BC47 The Board noted that IAS 21 requires the recognition of a gain or loss when translating an intragroup monetary item in the consolidated statement of comprehensive income. Consequently, in the Board's view, considering intragroup monetary items for eligibility as hedging instruments would require a review of the requirements in IAS 21 at the same time as considering any hedge accounting requirements. The Board noted that it does not have a project on foreign currency translation on its agenda. Hence, it decided that it should not address this issue as part of its project on hedge accounting. Consequently, the Board proposes not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).

Hedged items

Qualifying items

Designation of derivatives

BC48 The guidance on implementing IAS 39 states that derivatives can be designated only as hedging instruments, not as hedged items (either individually or as part of a group of hedged items). As the sole exception, paragraph AG94 in the application guidance in IAS 39 allows a purchased option to be designated as a hedged item. In practice, this has generally prevented derivatives from qualifying as hedged items. Similarly, positions that are a combination of an exposure and a derivative (aggregated exposures) do not qualify as hedged items. The implementation guidance accompanying IAS 39 provides the rationale for not permitting derivatives (or aggregated exposures that include a

derivative) to be designated as hedged items. It states that derivative instruments are always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.

- BC49 However, this rationale is difficult to justify in the light of the exception to permit some purchased options to qualify as hedged items irrespective of whether the option is a stand-alone derivative or an embedded derivative. If a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of an aggregated exposure to be part of a hedged item is arbitrary. Many raised similar concerns about the prohibition of designating derivatives as hedged items in response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*.
- BC50 The Board noted that an entity is sometimes economically required to enter into transactions that result in, for example, interest rate risk and foreign currency risk. While these two exposures can be managed together at the same time and for the entire term, the Board noted that entities often use different risk management strategies for the interest rate risk and foreign currency risk. For example, for 10-year fixed rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument but require fixed rate exposure in its functional currency only for the short to medium term (say two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates). In such a situation it is common to enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate domestic currency exposure. This is then overlaid with a two-year domestic interest rate swap that—on the basis of the domestic currency—swaps variable rate debt into fixed rate debt. In effect, the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as domestic 10-year variable rate debt for risk management purposes.
- BC51 Consequently, the Board concluded that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that aggregated exposure as a hedged item.

Designation of hedged items

Designation of a risk component

- BC52 IAS 39 distinguishes the availability of risk components for designation as the hedged item by the type of item that includes the component:
- (a) for financial items, an entity can designate a risk component if that risk component is separately identifiable and reliably measurable; however,
 - (b) for non-financial items, an entity can designate as a risk component only foreign currency risk.
- BC53 Risk components of non-financial items, even when they are contractually specified, are not eligible risk components in accordance with IAS 39. The rationale for including this restriction in IAS 39 was that permitting risk components (portions) of non-financial assets and non-financial liabilities to be designated as the hedged item for a risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing because the portion could be designated so that no ineffectiveness would ever arise.
- BC54 The hedge accounting model in IAS 39 uses the entire item as the default unit of account and then sets out rules that govern what risk components of that entire item are available for designation in hedging relationships. This has resulted in a misalignment of many risk management strategies and the hedge accounting requirements. The outcome has been that the normal approach for risk management purposes is treated as the exception by the hedge accounting requirements.
- BC55 Many of the comment letters received on the discussion paper *Reducing Complexity in Reporting Financial Instruments* criticised the prohibition on designating risk components for non-financial items. This was also the most common issue raised during the Board's outreach activities.
- BC56 The Board noted that the conclusion in IAS 39, that permitting risk components of non-financial assets and non-financial liabilities to be eligible for designation as hedged items would compromise the principles of identification of the hedged item and effectiveness testing, was not appropriate in all circumstances. As part of its deliberations, the Board considered whether risk components should be eligible for designation as hedged items when they are:
- (a) contractually specified; and
 - (b) not contractually specified.

- BC57 Contractually specified risk components determine a currency amount for a pricing element of a contract independently of the other pricing elements and, therefore, independently of the non-financial item as a whole. Consequently, these components are separately identifiable. The Board also noted that many pricing formulas that use a reference to, for example, benchmark commodity prices are designed in that way to ensure there is no gap or misalignment for that risk component compared with the benchmark price. Consequently, by reference to that risk component, the exposure can be economically fully hedged using a derivative with the benchmark as the underlying. This means that the hedge effectiveness assessment on a risk components basis accurately reflects the underlying economics of the transaction (ie that there is no or very little ineffectiveness).
- BC58 However, in many situations risk components are not an explicit part of a fair value or a cash flow. Nonetheless, many hedging strategies involve hedging of components even if they are not contractually specified. There are different rationales for using a component approach to hedging, including:
- (a) the entire item cannot be hedged because there is a lack of appropriate hedging instruments.
 - (b) it is cheaper to hedge the single components individually than the entire item (eg because an active market exists for the risk components, but not for the entire item).
 - (c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (eg because one of the risk components is particularly volatile and therefore it justifies the hedging cost).
- BC59 The Board learned from its outreach activities that entities are able to identify and measure with sufficient reliability many risk components (other than foreign currency risk) of non-financial items. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure regarding that risk. Consequently, the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances (ie careful analysis and knowledge of the relevant markets). The Board noted that as a result there is no 'bright line' to determine eligible risk components of non-financial items.

- BC60 The Board therefore proposes that risk components (both contractually specified and those not contractually specified) should be eligible for designation as hedged items as long as they are separately identifiable and reliably measurable. This proposal would align the eligibility of risk components of non-financial items with that of financial items in IAS 39.

Designation of ‘one-sided’ risk components

- BC61 IAS 39 permits an entity to designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a ‘one-sided’ risk). For example, an entity might hedge an exposure to a specific type of risk of a financial instrument (eg interest rates) above a predetermined level (eg above 5 per cent) using an interest rate cap. In this situation an entity hedges some parts of a specific type of risk (ie interest exposure above 5 per cent).
- BC62 Furthermore, the Board noted that hedging one-sided risk exposures is a common risk management activity. The Board also noted that the main issue that relates to the hedging of one-sided risk is the use of options as hedging instruments. Consequently, the Board proposes to permit the designation of one-sided risk components as hedged items, as in IAS 39, but also decided to reconsider the accounting for the time value of options (see paragraphs BC143–BC155).

Designation of a percentage component of a nominal amount

- BC63 The Board noted that components of nominal amounts are typically identifiable (they are some quantifiable nominal part of the total cash flows of the instrument). For example, a percentage component of a known amount, such as 50 per cent of the nominal value of a loan, includes all the characteristics of that loan. In other words, changes in the value and cash flows for the 50 per cent component are half of those for the entire instrument.
- BC64 The Board noted that a percentage component of a nominal amount forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The Board concluded that, if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a percentage component of a nominal amount as a hedged item (as in IAS 39).

Designation of a layer component of a nominal amount

- BC65 IAS 39 requires an entity to identify and document anticipated (ie forecast) transactions designated as hedged items with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. As a result, IAS 39 permits forecast transactions to be identified as a 'layer' component of a nominal amount. For example, the first 100 barrels of the oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item regarding the amount or timing. This uncertainty does not affect the hedging relationship to the extent that the hedged volume occurs (irrespective of which particular individual items make up that volume).
- BC66 The Board considered whether similar considerations also apply to a hedge of an existing transaction in some situations. For example, a firm commitment might also have uncertainty attached to it:
- (a) a contract with an early termination option might be terminated before maturity; or
 - (b) a contract might be cancelled for breach of contract (ie non-performance).
- BC67 Because there is uncertainty for both anticipated transactions and existing transactions, the Board decided not to distinguish between such transactions for the purposes of designating a layer component of a nominal amount.
- BC68 The Board noted that designating a percentage component of a nominal amount as the hedged item can give rise to a different accounting outcome when compared with designating a layer component of a nominal amount as a hedged item. If the designation of the component of a nominal amount is not aligned with the risk management strategy of the entity, it might result in profit or loss providing misleading or less useful information to users of financial statements.
- BC69 In the Board's view there might be circumstances when it is appropriate to designate a hedged item as a layer component of the nominal. Consequently, the Board proposes to permit the designation of a layer component of a nominal amount as the hedged item (for anticipated and existing transactions). The Board also decided that a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The Board noted that if the prepayment option's fair

value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured).

Relationship between components and the total cash flows of an item

- BC70 IAS 39 allows an entity to designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).
- BC71 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing an interest coupon at LIBOR minus a spread or an equivalent fixed rate coupon) the negative spread represents a positive margin for the borrower. This is because banks on average pay LIBOR for their funding in the interbank market. Another example where this occurs is when the reference rate is highly correlated with LIBOR and the negative spreads arise because of the better credit risk of the contributors to the reference index compared with LIBOR. When entering into hedging relationships, an entity cannot obtain (at a reasonable cost) an instrument for all homogeneous groups of transactions that are priced sub-LIBOR. Consequently, such an entity uses instruments that have LIBOR as their underlying.
- BC72 Comments received during the Board's outreach activities (see paragraph BC8) showed that some believe that the designation of a risk component that assumes cash flows that would exceed the actual cash flows of the instrument also reflects risk management in situations where the hedged item has a negative spread to the benchmark rate. Those constituents believe that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argue that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.

- BC73 The Board noted that, for risk management purposes, an entity normally does not try to hedge the effective interest rate of the instrument, but rather the change in the variability of the cash flows attributable to LIBOR. By doing this, such an entity ensures that exposure to interest rate risk is managed and that the margin is locked over time provided that LIBOR is not below the absolute of the negative spread. This risk management strategy provides offsetting changes regarding the LIBOR-related interest rate risk similar to situations where the spread above LIBOR is zero or positive. However, if LIBOR falls below the absolute of that negative spread it would result in 'negative' interest, or cost of funding inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The Board noted that these outcomes are inconsistent with the economic phenomenon to which they relate.
- BC74 To avoid these outcomes, the Board proposes to retain the restriction in IAS 39 regarding the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the Board emphasised that hedge accounting would still be available on the basis of designating all the cash flows of an item for a particular risk, ie a risk component for the actual cash flows of the item (see paragraph BC70).

Qualifying criteria for hedge accounting

Effectiveness assessment

- BC75 To qualify for hedge accounting in accordance with IAS 39, a hedge must be highly effective, both prospectively and retrospectively. Consequently, an entity must perform two effectiveness assessments for each hedging relationship. The prospective assessment supports the expectation that the hedging relationship will be effective in the future. The retrospective assessment determines that the hedging relationship has been effective in the reporting period. All retrospective effectiveness assessments are required to be performed using quantitative methods. However, IAS 39 does not specify a particular method for testing hedge effectiveness.
- BC76 The term 'highly effective' refers to the degree to which the hedging relationship achieves offsetting between changes in the fair value or cash flows of the hedging instrument and changes in the fair value or cash flows of the hedged item attributable to the hedged risk during the hedge period. IAS 39 regards a hedge as highly effective if the offset is within the range of 80-125 per cent.

- BC77 During its outreach activities (see paragraph BC8), the Board learned that:
- (a) many found the hedge effectiveness assessment in IAS 39 arbitrary, onerous and difficult to apply;
 - (b) as a result, there is often little or no link between hedge accounting and the risk management strategy; and
 - (c) because hedge accounting is not achieved if the hedge effectiveness is outside the 80-125 per cent range, it makes hedge accounting difficult to understand in the context of the risk management strategy of the entity.

The objective of the hedge effectiveness assessment

- BC78 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The Board noted that this has resulted in hedge accounting that is arbitrary and onerous. Furthermore, the arbitrary 'bright line' of 80-125 per cent has disconnected hedge accounting and risk management. Consequently, it makes it difficult to explain the results of hedge accounting to users of financial statements. To address these concerns, the Board decided that it would propose an objective-based model for testing hedge effectiveness instead of the 80-125 per cent bright line in IAS 39.
- BC79 During its deliberations, the Board initially considered an objective-based assessment to determine which hedging relationships qualify for hedge accounting. The Board's intention was that the assessment should not be based on a particular level of hedge effectiveness. The Board decided that in order to avoid the arbitrary outcomes of the assessment under IAS 39 it had to remove, rather than just move, the bright line. In the Board's view, the objective of the hedge effectiveness assessment should reflect that hedge accounting is based on the notion of offset.
- BC80 In accordance with the Board's initially considered approach, the effectiveness assessment aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment is based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. The Board believes that the proposed approach therefore strengthens the relationship between hedge accounting and risk management practice.

- BC81 However, the Board was concerned that this initially considered approach might not be rigorous enough. This is because without clear guidance, an entity might designate hedging relationships that would not be appropriate because they would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation of the hedging relationship and hence be biased. The Board noted that the bright line of 80-125 per cent in IAS 39 created a trade-off when an entity chooses a hedge ratio that would have a biased result, because that result came at the expense of higher ineffectiveness and hence increased the risk of falling outside that range. However, the Board noted that the 80-125 per cent range would be eliminated by its proposals. Therefore, the Board decided to extend its initial objective of the effectiveness assessment so that it focuses on the hedge ratio. Consequently, the objective of assessing the effectiveness of a hedging relationship is that the entity designates the hedging relationship so that it gives an unbiased result and minimises expected ineffectiveness.
- BC82 The Board noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of basis risk that the entity accepts in order to achieve a cost-effective hedging relationship. Consequently, when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument.

Frequency of assessing whether the hedge effectiveness requirements are met

- BC83 As a consequence of the Board's proposed hedge effectiveness requirements, the Board considered how frequently an entity should assess whether the hedge effectiveness requirements are met. The Board decided that an entity should perform this assessment at the inception of the hedging relationship. At inception of the hedging relationship, an entity should demonstrate that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness and that the expected offsetting between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows is other than accidental.

- BC84 Furthermore, the Board considered that an entity should assess on an ongoing basis whether the hedge effectiveness requirements are (still) met. This is because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship.
- BC85 A further consequence of the proposed hedge effectiveness requirements is that if there are changes in circumstances the hedging relationship might require an adjustment in order to continue to meet the objective of the hedge effectiveness assessment (see paragraphs BC106–BC111). Hence, the Board concluded that the reassessment of the hedge ratio should be performed at the beginning of each reporting period or upon a significant change in the circumstances underlying the effectiveness assessment, whichever comes first.

Method of assessing hedge effectiveness

- BC86 The method used to assess the effectiveness of the hedging relationship needs to be suitable to demonstrate that the objective of the hedge effectiveness assessment has been achieved. The Board considered whether the effectiveness of a hedging relationship should be assessed on either a qualitative or a quantitative basis.
- BC87 Hedging relationships have one of two characteristics that affect the complexity of the hedge effectiveness assessment:
- (a) The critical terms of the hedged item and hedging instrument match or are closely aligned. If there are no substantial changes in the critical terms or in the credit risk of the hedging instrument or hedged item the hedge effectiveness can typically be determined using a qualitative assessment.
 - (b) The critical terms of the hedged item and hedging instrument do not match and are not closely aligned. These hedging relationships involve an increased level of uncertainty regarding the degree of offset and so the effectiveness of the hedge during its term is more difficult to evaluate.
- BC88 Qualitative hedge effectiveness assessments use a comparison of the terms of the hedged item and the hedging instrument (for example, the commonly termed ‘critical-terms-match’ approach). The Board believes that in the context of an objective-based effectiveness assessment it can be appropriate to assess the effectiveness qualitatively for a hedging relationship for which the terms of the hedging instrument and the hedged item match or are closely aligned.

- BC89 However, assessing the hedging relationship qualitatively is less effective than a quantitative assessment in other situations. For example, when analysing the possible behaviour of hedging relationships that involve a significant degree of potential ineffectiveness resulting from terms of the hedged item that are less closely aligned with the hedging instrument, the extent of future offset has a high level of uncertainty and is difficult to determine using a qualitative approach. The Board believes that a quantitative assessment would be more suitable in such situations.
- BC90 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The Board noted that selecting the appropriate tool or technique will depend upon the complexity of the hedge, the availability of data and the level of uncertainty of offset in the hedging relationship. The type of assessment and the method used to assess hedge effectiveness depends on the relevant characteristics of the hedging relationship. Consequently, the Board proposes that an entity should assess the effectiveness of a hedging relationship either qualitatively or quantitatively depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. However, the Board decided not to propose prescribing any specific method of assessing hedge effectiveness.

Accounting for qualifying hedges

Financial instruments held within a business model whose objective is to collect or pay contractual cash flows

- BC91 The Board considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows (managed on a contractual cash flow basis, as described in IFRS 9). The Board focused on fair value hedges of interest rate risk because other risks (for example, credit risk and foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seems appropriate. More specifically, the Board was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the instrument is managed on a contractual cash flow basis. When an instrument is managed on a contractual cash flow basis, the objective of the entity's business model is to hold the financial instrument to collect (or pay) contractual cash flows, rather than to sell (or settle/transfer) the instrument before contractual

maturity in order to realise fair value changes. Consequently, some argue that on the basis of the assertion underlying the business model assessment the entity should be interested only in the contractual cash flows arising from these investments and not in changes in fair value.

BC92 The Board discussed several situations in which a fair value hedge of interest rate risk does not contradict that a financial instrument is managed on a contractual cash flow basis. One example is an entity that seeks to invest in a particular credit quality variable rate asset, but could obtain only a fixed rate asset of the desired credit quality. That entity could create the cash flow profile of a variable rate asset by buying both the available fixed rate investment and entering into an interest rate swap that transforms the fixed interest cash flows from that asset into variable interest cash flows. The Board noted that the examples demonstrated that what is a fair value hedge for accounting purposes is from a risk management perspective often a choice between receiving or paying fixed versus variable interest cash flows rather than a strategy to protect against fair value changes. Hence, the Board considered that a fair value hedge of interest rate risk in itself would not contradict the assertion that a financial instrument is managed on a contractual cash flow basis.

BC93 The Board also noted that under the classification model for financial instruments in IFRS 9 an entity may sell or transfer some financial instruments that qualify for amortised cost, even if they are managed on a contractual cash flow basis. Therefore, the Board proposes that fair value hedge accounting should be available for financial instruments that are managed on a contractual cash flow basis.

Hedge of a foreign currency risk of a firm commitment

BC94 IAS 39 allows an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. The Board considered whether it should continue to allow this choice.

BC95 The Board observed that requiring an entity to apply cash flow hedge accounting for all hedges of foreign currency risk of a firm commitment could result in what some regard as ‘artificial’ other comprehensive income and equity volatility (see paragraphs BC119 and BC120). The Board also noted that by requiring an entity to apply cash flow hedge accounting, the ‘lower of’ test would apply to transactions that already exist (ie firm commitments).

- BC96 However, the Board also observed that requiring an entity to apply fair value hedge accounting for all hedges of foreign currency risk of a firm commitment would require a change in the type of hedging relationship to a fair value hedge when the foreign currency cash flow hedge of a forecast transaction becomes a firm commitment. This results in operational complexity. For example, this would require changing the measurement of ineffectiveness from a 'lower of' test to a symmetrical test.
- BC97 The Board also noted that for existing hedged items (such as firm commitments) foreign currency risk affects both the cash flows and the fair value of the hedged item and hence has a dual character.
- BC98 Hence, the Board proposes to continue to permit an entity the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge.

Measuring the ineffectiveness of a hedging relationship

- BC99 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the Board proposes that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).

Time value of money

- BC100 The objective of measuring hedge ineffectiveness is to recognise in profit or loss the extent to which the hedging relationship did not achieve offset (subject to the restrictions that apply to the recognition of hedge ineffectiveness for cash flow hedges—often referred to as the 'lower of' test).
- BC101 The Board noted that hedging instruments are subject to a measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts compared with the changes in the value of the hedging instrument must also be determined on a present value basis. The Board noted that 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. As a result, the same basis (ie present value) for the hedged item must be used in order to avoid a mismatch when determining the amount to be recognised in profit or loss.

BC102 Consequently, the Board proposes that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.

Hypothetical derivatives

BC103 The Board considered the use of a 'hypothetical derivative', which is a derivative that would have critical terms that exactly match those of a hedged item and would be at the money at the time of designation of the hedging relationship. The Board considered the use of a hypothetical derivative in the context of the hedge effectiveness assessment as well as for the purpose of measuring hedge ineffectiveness.

BC104 The Board noted that the purpose of a hypothetical derivative is to measure the change in the value of the hedged item. Consequently, a hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods (for example, statistical methods or dollar-offset) to assess the effectiveness of the hedging relationship or measure ineffectiveness.

BC105 Hence, the Board proposes that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The Board noted that this notion of a hypothetical derivative means it is one possible way of determining the change in the value of the hedged item and would result in the same outcome as if that change in the value was determined by a different approach.

Rebalancing the hedging relationship

BC106 IAS 39 does not allow adjustments that were not envisaged (documented) at the inception of the hedge to be treated as adjustments to an existing hedging relationship. IAS 39 treats adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The Board noted that this resulted from a hedge accounting model that did not include the notion of accounting for changes to an existing hedging relationship as a continuation of that relationship.

- BC107 The Board noted that there are instances where, although the risk management objective remains the same, there are adjustments to an existing hedging relationship because of changes in circumstances. For example, these adjustments are often required to re-align the hedging relationship with risk management policies in view of the changed circumstances. Hence, these adjustments to the hedged item or hedging instrument do not change the original risk management objective but instead reflect a change in how it is executed owing to the changes in circumstances. The Board considered that in these situations the revised hedging relationship should be accounted for as a continuation of the existing hedging relationship rather than as a discontinuation, which would result in accounting for a new hedging relationship in order to achieve hedge accounting. The Board referred to such adjustments of hedging relationships as rebalancing.
- BC108 The Board also considered the ramifications of the new objective-based hedge effectiveness assessment, which aims to ensure that a hedging relationship is designated in such a way that it will produce an unbiased result and minimise expected hedge ineffectiveness. The Board noted that for some changes in circumstances this new hedge effectiveness assessment would create the need for an adjustment to the hedging relationship in order to ensure that the hedge effectiveness assessment would continue to be met. An example is a change in basis risk that changes the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid that the hedging relationship will produce a biased result (which would arise when using the original hedge ratio in the new circumstances).
- BC109 The Board concluded that in such situations, if the original risk management objective remains unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the Board proposes that an adjustment to a hedging relationship is treated as a rebalancing when the adjustment changes the hedge ratio in response to the new circumstances and risk management continues to hedge the original exposure using the original hedge cover (including modifications to its volume).
- BC110 However, if the adjustment represents an overhaul of the existing hedging relationship, the Board considered that treating the adjustment as a rebalancing would not be appropriate. Instead, the Board considered that such an adjustment should result in the discontinuation of that hedging relationship. An example is a hedging relationship with a hedging instrument that experiences a severe deterioration of its credit quality and hence is no longer used for risk management purposes.

BC111 The Board also considered whether an entity should be allowed to rebalance a hedging relationship voluntarily. An entity might want to rebalance a hedging relationship because it expects that owing to changes in circumstances that relationship might fail to meet the objective of the hedge effectiveness assessment. The Board noted that the proactive use of rebalancing would allow an entity to adjust hedging relationships on a timely basis and at the same time would strengthen the link between hedge accounting and risk management. The Board therefore proposes to permit voluntary rebalancing that aims to ensure that the hedging relationship will continue to qualify for hedge accounting (ie the adjustment aims at reducing the likelihood of failing the qualifying criteria). The Board noted that such a proactive adjustment is consistent with the objective-based hedge effectiveness assessment, particularly regarding the determination of the hedge ratio.

Discontinuation of hedge accounting

BC112 In accordance with IAS 39, an entity must discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria (including when the hedging instrument no longer exists or has been sold). However, in accordance with IAS 39, an entity may also voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).

BC113 The Board noted that entities voluntarily discontinue hedge accounting often because of how the effectiveness assessment in IAS 39 works. For example, entities revoke the designation of a hedging relationship and redesignate it as a new hedging relationship in order to apply a different method of assessing hedge ineffectiveness from the method originally documented (expecting that the new method will be a better fit). Another example is entities revoking the designation of a hedging relationship because they want to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument (typically in response to a change in the basis risk). The hedging relationship is then redesignated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The Board noted that in these situations the hedging relationship is discontinued and then restarted even though the risk management objective of the entity has not changed. In the Board's view these outcomes create a disconnection between the hedge accounting model in IAS 39 and hedging from a risk management perspective.

- BC114 The Board concluded that the proposed hedge accounting model would improve the link between hedge accounting and risk management because:
- (a) the new hedge effectiveness assessment requirements would not involve a percentage band or any other bright line criterion and would result in changing the method for assessing hedge effectiveness in response to changes in circumstances as part of a continuing hedging relationship; and
 - (b) the notion of rebalancing would allow the adjustment of the hedge ratio as part of a continuing hedging relationship.
- BC115 The Board also noted that sometimes a hedging relationship is discontinued because of a decrease in the hedged quantities of forecast transactions (ie the volume that remains highly probable of occurring falls or is expected to fall below the volume designated as the hedged item—the layer). Under IAS 39 this has resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the layer in its entirety. The Board considered that the quantity of forecast transactions that were still highly probable of occurring was in fact a continuation of the original hedging relationship (albeit with a lower volume). Hence, the Board decided that hedge accounting should be discontinued only for the volume that was no longer highly probable of occurring and that the remaining volume that was still highly probable of occurring should be accounted for as a continuation of the original hedging relationship. In the Board’s view, this would more closely align hedge accounting with risk management.
- BC116 However, the Board was concerned that this accounting might possibly undermine the requirement that forecast transactions must be highly probable in order to qualify as a hedged item. Hence, the Board decided to clarify that a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur would call into question the entity’s ability to predict similar forecast transactions accurately. This would affect the assessment of whether similar forecast transactions are highly probable and hence their eligibility as hedged items.
- BC117 In view of its aim to better link hedge accounting to risk management, the Board also discussed whether it should retain an entity’s choice to revoke the designation of a hedging relationship. The Board considered that the choice to revoke the designation of a hedging relationship (and hence discontinue hedge accounting) at will does not result in useful information. The Board noted that this would allow discontinuing hedge

accounting even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective that was part of the qualifying criteria and hence initially allowed the entity to achieve hedge accounting. The Board believed that in such situations voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. Hence, the Board decided not to allow entities a free choice to revoke the designation of a hedging relationship in this situation. The Board also noted that if the hedging relationship no longer reflected the risk management objective of the entity, discontinuation of hedge accounting was not a choice but was required because the qualifying criteria would no longer be met. The Board considered that applying hedge accounting without a risk management objective would not provide useful information.

- BC118 The Board did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a business combination. The Board noted that this is a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.

Fair value hedges

Accounting for fair value hedges

- BC119 The Board considered reducing the complexity of hedge accounting by replacing the fair value hedge accounting mechanics with the cash flow hedge accounting mechanics. Such an approach would recognise gains or losses on the hedging instruments outside profit or loss in other comprehensive income instead of remeasuring the hedged item. The Board considered such an approach because it would:
- (a) improve the usefulness of the reported information for users. In accordance with such an approach, all hedging activities to which hedge accounting is applied (including hedges of fair value risk) would be reflected in other comprehensive income, resulting in greater transparency and comparability. In addition, the measurement of the hedged item would not be affected.
 - (b) simplify existing requirements. Although fair value and cash flow hedge accounting are designed to address different exposures, the same mechanisms can be used to reflect how an entity manages these exposures in the financial statements. Eliminating one of two different methods (fair value hedge accounting or cash flow hedge accounting) would reduce complexity. Such an approach

would align fair value hedge accounting and cash flow hedge accounting resulting in a single method for hedge accounting.

- (c) be an expeditious approach to finalise this phase of the project to replace IAS 39. Such an approach would draw on the existing mechanics of cash flow hedge accounting in IAS 39, and consequently such an approach would not require much further development.

BC120 However, during its outreach activities the Board received mixed views on that approach. Some supported the approach for the reasons the Board had considered, which was consistent with the feedback received on the discussion paper *Reducing Complexity in Reporting Financial Instruments*. However, some others raised concerns that such an approach:

- (a) would not reflect the underlying economics. They argued that if an entity applies a fair value hedge, the hedged item exists and hence there is an actual gain or loss on the hedged item (not just an anticipated gain or loss on a forecast transaction that does not yet exist). Therefore, hedge accounting should not cause ‘artificial’ volatility in other comprehensive income and equity.
- (b) would make the movements in other comprehensive income less understandable.
- (c) would make it difficult to identify the type of risk management strategy that the entity employs.
- (d) could result in scenarios where equity would be significantly reduced or even negative because of losses on the hedging instrument deferred in other comprehensive income. This could have serious implications in terms of solvency and regulatory requirements.

BC121 In the light of the views received, the Board decided to propose a different approach. The Board proposes to continue to account for fair value hedges differently from cash flow hedges. However, the Board proposes some changes to the presentation and mechanics of fair value hedge accounting:

- (a) *Gain or loss on remeasuring the hedging instrument*—IAS 39 requires the gain or loss to be recognised in profit or loss. The Board proposes to require recognising the gain or loss in other comprehensive income.
- (b) *Gain or loss on the hedged item*—IAS 39 requires such a gain or loss to result in an adjustment to the carrying amount of the hedged item

and to be recognised in profit or loss. The Board proposes to require the gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position and in other comprehensive income. That separate line item is presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).

BC122 The Board noted that the separate line item represents measurement adjustments to the hedged items rather than separate assets or liabilities in their own right. The Board thought that the additional line item might be perceived to add complexity and would increase the number of line items in the statement of financial position. In addition, the Board noted that this approach is more complex than the approach initially considered, which would have eliminated fair value hedge accounting.

BC123 However, the Board decided to propose these changes because they would:

- (a) eliminate the mixed measurement for the hedged item (eg an amount that is amortised cost with a partial fair value adjustment).
- (b) avoid volatility in other comprehensive income and equity that some consider artificial.
- (c) present in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges).
- (d) provide information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges.

Linked presentation for fair value hedges

BC124 During its outreach activities, the Board was alerted to the financial reporting effect that fair value hedge accounting has on hedges of the foreign currency risk of firm commitments in a specific industry. This issue is a particular concern to that industry because of the magnitude of firm commitments that are denominated in a foreign currency because of the industry's business model. In response to that concern, the Board considered whether applying linked presentation for fair value hedges of firm commitments might be appropriate. Linked presentation is a way of presenting information so that it shows how particular assets and

liabilities are related. Linked presentation is not the same as offsetting, which presents a net asset or liability. Linked presentation displays the 'gross' amount of related items in the statement of financial position (while the net amount is included in the total for assets or liabilities).

- BC125 That industry was concerned that the presentation resulting from fair value hedge accounting would not reflect the economic effects of hedges of foreign currency risk. For example, an entity that has a large firm commitment for a sale denominated in a foreign currency enters into currency forward contracts to hedge the foreign currency risk of that firm commitment (the forward contract and the firm commitment could be considered 'linked transactions'). The fair value of the derivative liability (or asset) and the firm commitment asset (or liability) could be significant depending on the volatility of the currency being hedged. That industry was concerned that as a result, on the basis of the statement of financial position, the entity would appear to be exposed to a higher risk than it actually was. In that industry's view, confusion might arise because the statement of financial position would show large amounts for total assets and total liabilities and hence a high leverage (which typically suggests higher risk) even though the entity hedged the foreign currency risk of the firm commitment and thus reduced risk.
- BC126 That industry argued that linked presentation of the firm commitment (recognised as a result of fair value hedge accounting) and the hedging instrument could present the effect of an entity's hedging activity and the relationship of the hedged item and the hedging instrument. Linked presentation would not require changing the requirements of offsetting in IAS 32 *Financial Instruments: Presentation* or other requirements in IAS 39 and IFRS 9.
- BC127 Moreover, that industry argued that a firm commitment is recognised in the statement of financial position only when fair value hedge accounting is applied. Therefore, that industry advocated that a firm commitment and the related hedging instrument should be accounted for as two parts of a single transaction. That industry also argued that totals for assets and liabilities that include only the 'net' amount (of the linked transactions) would be most appropriate for financial analysis purposes. That industry believed that the ratios such as leverage should be calculated on the basis of the difference between the hedged item and the hedging instrument, ie the net amount rather than the gross amount of these items.

- BC128 The Board noted that while linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (eg only currency risk but not credit risk or interest rate risk). Furthermore, the Board did not consider that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affected only one risk but not all risks. Instead, the Board believes that disclosures about hedging would be a better alternative to provide information that allows users of financial statements to assess the relevance of the information for their own analysis.
- BC129 Consequently, the Board decided not to propose the use of linked presentation for the purposes of hedge accounting.

Cash flow hedges

The 'lower of' test

- BC130 When a hedge accounting relationship is fully effective, the fair value changes in the hedging instrument perfectly offset the value changes in the hedged item. Hedge ineffectiveness arises when the changes of the hedging instrument exceed that of the hedged item, or when the changes of the hedging instrument are less than those of the hedged item.
- BC131 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on these items in excess of the gains and losses on the hedging instrument is tantamount to recognising gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument). The Board noted that this would be conceptually questionable as well as a counter-intuitive outcome.
- BC132 IAS 39 requires a 'lower of' test for determining the amounts that are recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensures that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not

recognised in profit or loss. In contrast, the 'lower of' test does not apply to fair value hedges because for that type of hedge the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRSs, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.

- BC133 The Board discussed whether the requirements for measuring the hedge ineffectiveness that is recognised in profit or loss should be aligned for fair value hedges and cash flow hedges. The Board noted that the two requirements could be aligned by applying the 'lower of' test also to fair value hedges or by eliminating it for cash flow hedges. In the Board's view, aligning the requirements would reduce complexity. However, the Board considered that for conceptual reasons recognising gains and losses on items that do not yet exist instead of only deferring the gain or loss on the hedging instrument was not appropriate. Hence, the Board proposes that the 'lower of' test is retained for cash flow hedges.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

- BC134 A forecast transaction could subsequently result in the recognition of a non-financial asset or a non-financial liability. Similarly, a forecast transaction for a non-financial asset or non-financial liability could subsequently result in the recognition of a firm commitment for which fair value hedge accounting is applied. In these cases IAS 39 permits an entity as an accounting policy choice:
- (a) to reclassify the associated gains or losses that were recognised in other comprehensive income to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or
 - (b) to remove the associated gains or losses that were recognised in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability. This approach is commonly referred to as basis adjustment.
- BC135 The Board considered whether to continue to allow this accounting policy choice. The Board noted that if an entity is precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging relationship has ended) and to match them to the period or periods in which the non-financial item that results from the hedged transaction affects profit or loss. The entity would also need to consider whether or not the

remaining amount in other comprehensive income is recoverable in one or more future periods. In contrast, if an entity applies a basis adjustment, the hedging gain or loss is included in the carrying amount of the non-financial item and the hedging gain or loss is automatically recognised in profit or loss in the period in which the related non-financial item affects profit or loss (eg through depreciation expense for items of property, plant and equipment or cost of sales for inventories) and it would also be automatically considered when an entity tests a non-financial asset for impairment. The Board noted that for a non-financial asset that is tested for impairment as part of a cash-generating unit tracking amounts in other comprehensive income and including them in the impairment test is difficult (even more so if the composition of cash-generating units changes over time).

- BC136 The Board acknowledged that there are different views on whether a basis adjustment achieves or impairs comparability. One view is that two identical assets purchased at the same time and in the same way (except for the fact that one was hedged) should have the same initial carrying amount. From this viewpoint, basis adjustments impair comparability.
- BC137 The other view is that basis adjustments allow identical assets for which the acquisitions are subject to the same risk to be measured so that they have the same initial carrying amount. For example, Entity A and Entity B want to purchase the same asset from a supplier that has a different functional currency. Entity A is able to secure the purchase contract denominated in its functional currency. Conversely, while Entity B also wants to fix the purchase price in its functional currency, it has to accept a purchase contract denominated in the functional currency of the supplier (ie a foreign currency) and is therefore exposed to the variability in cash flows arising from exchange rate movements. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract thus, in effect, fixing the price of the purchase in its functional currency. When taking into account the currency forward contract, Entity B has in effect the same foreign currency risk exposure as Entity A. From this viewpoint, basis adjustments would enhance comparability.
- BC138 The Board also considered the interaction between basis adjustments and the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge (see paragraphs BC94–BC98). The Board noted that for hedges of the foreign currency risk of a firm commitment the basis adjustment at the end of the cash flow hedge has the same effect on the presentation of the

hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for these firm commitments is tantamount to a basis adjustment. The Board thought that in this context basis adjustments would also enhance comparability.

BC139 Consequently, the Board decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The Board proposes that when the entity removes the associated gain or loss that was recognised in other comprehensive income in order to include them in the initial cost or other carrying amount of the asset or liability that gain or loss should be directly applied against the carrying amount of the asset or liability. This means it would not be a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence would not affect other comprehensive income when removing it from equity and adding it to or deducting it from the asset. The Board noted that accounting for the basis adjustment as a reclassification adjustment would distort comprehensive income because the amount would affect comprehensive income twice but in different periods:

- (a) first in the period in which the non-financial item is recognised (in other comprehensive income); and
- (b) then again in the later periods when the non-financial item affects profit or loss (eg through depreciation expense or cost of sales).

The Board further noted that presenting a basis adjustment as a reclassification adjustment would create the misleading impression that the basis adjustment was a performance event.

BC140 The Board acknowledged that the total comprehensive income across periods will be distorted because the gain or loss on the hedging instrument during the period of the cash flow hedge is recognised in other comprehensive income whereas the cumulative hedging gain or loss that is removed from the cash flow hedge reserve (ie from equity) and directly applied to the subsequently recognised non-financial item does not affect other comprehensive income. The Board considered that one type of distortion of other comprehensive income was inevitable (ie either in the period of the basis adjustment or over the total period) and hence there was a trade-off. The Board concluded that, on balance, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect on the total period of not using a reclassification adjustment.

Hedges of a net investment in a foreign operation

- BC141 The Board decided not to address a hedge of a net investment in a foreign operation as part of the third phase of the project to replace IAS 39. The Board noted that a net investment in a foreign operation is determined and accounted for in accordance with IAS 21. The Board noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similarly to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC47) the Board considered that addressing this type of hedge comprehensively would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements. The Board also noted that IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (issued in July 2008) provided further guidance on that type of hedge accounting. The Board did not think it was appropriate to change the requirements so soon after issuing the Interpretation.
- BC142 Consequently, the Board decided to retain the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

Accounting for the time value of options

- BC143 IAS 39 allows an entity a choice:
- (a) to designate an option-type derivative as a hedging instrument in its entirety; or
 - (b) to separate the time value of the option and designate as the hedging instrument only the intrinsic value element.
- BC144 The Board noted that under the IAS 39 hedge accounting model entities typically designate option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option is treated as held for trading and is accounted for as at fair value through profit or loss, which can give rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from risk management. For risk management purposes entities typically consider the time value of an option (at inception, ie included in the premium paid) as a cost of hedging. It is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes.

- BC145 Against this background, the Board considered how best to portray the time value of options (in the context of hedging exposures only against changes to one side of a specified level—‘a one-sided risk’). The Board noted that the standard-setting debate about accounting for the time value of options has historically been focused on hedge ineffectiveness. Many typical hedged transactions (such as firm commitments, forecast transactions or existing items) do not involve a time value notion because they are not options. Hence, such hedged items do not have a change in their value that offsets the fair value change related to the time value of the option that is used as a hedging instrument. The Board concluded that, unless the time value of the option was excluded from the designation as the hedging instrument, hedge ineffectiveness would arise.
- BC146 However, the Board noted that the time value of an option could also be considered from a different perspective—that of a premium for protection against risk (an ‘insurance premium’ view).
- BC147 The Board noted that entities that use purchased options to hedge one-sided risks typically consider the time value that they pay as a premium to the option writer or seller similarly to an insurance premium. In order to protect themselves against the downside of an exposure (an adverse outcome) while retaining the upside, they have to compensate someone else for assuming the inverse asymmetrical position, which has only the downside but not the upside. The time value of an option is subject to ‘time decay’. This means that it loses its value over time as the option approaches expiry, which occurs at an increasingly rapid rate. At expiry the option’s time value reaches zero. Hence, entities that use purchased options to hedge one-sided risks know that over the life of the option they will lose the time value that they paid. This explains why entities typically view the premium paid as being similar to an insurance premium and hence as costs of using this hedging strategy.
- BC148 The Board considered that by taking an insurance premium view, the accounting for the time value of options could be aligned with the risk management perspective as well as with other areas of accounting. The Board noted that under IFRSs some costs of insuring risks are treated as transaction costs that are capitalised into the costs of the insured asset (eg freight insurance paid by the buyer in accordance with IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*) whereas costs of insuring some other risks are recognised as expenses over the period for which the entity is insured (eg fire insurance for a building). Hence, the Board considered that aligning the accounting for the time value of options with such other areas would provide more comparable results that would also be more aligned with how preparers and users think about the issue.

- BC149 The Board took the view that, like the distinction of the different types costs of insuring risk, the time value of options should be distinguished by the type of hedged item that the option hedges into time value that is transaction related (eg the forecast purchase of a commodity) or time period related (eg hedging existing commodity inventory regarding commodity price changes). The Board considered that for transaction related hedged items the cumulative change in fair value of the option's time value should be accumulated in other comprehensive income and be reclassified similarly to the requirements for cash flow hedges. In the Board's view, this would best reflect the character of transaction costs (like those capitalised for inventory or property, plant and equipment).
- BC150 In contrast, the Board considered that for time period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the Board considered that the cost of obtaining the protection should be allocated over the relevant period on a rational basis. The Board noted that this would require accumulating the cumulative change in fair value of the option's time value in other comprehensive income and amortising the original time value paid by transferring each period an amount to profit or loss. The Board considered that the amortisation pattern should be determined on a rational basis to reflect principle-based standard-setting best.
- BC151 The Board also considered situations when the option used has critical terms (such as the nominal amount, life and underlying) that do not match the hedged item. This raises the following questions:
- (a) How much of the time value included in the premium paid relates to the hedged item (and therefore should be treated as costs of hedging) and which part does not?
 - (b) How should any part of the time value that does not relate to the hedged item be accounted for?
- BC152 The Board proposes that the part of the time value of the option that relates to the hedged item should be determined as the time value that would have been paid for an option that perfectly matches the hedged item (eg with the same underlying, maturity and notional amount). The Board noted that this would require an option pricing exercise using the terms of the hedged item as well as other relevant information about the hedged item (in particular, the volatility of its price or cash flow, which is a driver of an option's time value).

- BC153 The Board noted that the accounting for the time value of the option would need to differentiate whether the initial time value of the purchased option (actual time value) is higher or lower than the time value that would have been paid for an option that perfectly matches the hedged item (aligned time value). The Board noted that if, at inception of the hedging relationship, the actual time value is higher than the aligned time value the entity pays a higher premium than what reflects costs of hedging. Hence, the Board considered that the amount that is recognised in accumulated other comprehensive income should be determined only on the basis of the aligned time value whereas the remainder of the actual time value should be accounted for as a derivative.
- BC154 Conversely, the Board noted that if, at inception of the hedging relationship, the actual time value is lower than the aligned time value the entity actually pays a lower premium than it would have to pay to cover the risk fully. The Board considered that in this situation, in order to avoid accounting for more time value of an option than was actually paid, the amount that is recognised in accumulated other comprehensive income would have to be determined by reference to the lower of the cumulative fair value change of:
- (a) the actual time value; and
 - (b) the aligned time value.
- BC155 The Board also considered whether the balances accumulated in other comprehensive income would require an impairment test. The Board decided that because the accounting for the time value of the option was closely linked to hedge accounting an impairment test that uses features of the hedge accounting model would be appropriate. Hence, for transaction related hedged items the impairment test would be similar to that for the cash flow hedge reserve. For time period related hedged items the Board considered that the part of the option's time value that has not been amortised should be immediately recognised in profit or loss when the hedging relationship is discontinued. That would reflect that the reason for amortising the amount would no longer apply after the insured risk (ie the hedged item) no longer qualifies for hedge accounting. The Board noted that when the hedged item is impaired, the criteria for qualifying hedges are no longer met and hence result in an impairment loss for the remaining unamortised balance of the time value of the option.

Hedges of a group of items

- BC156 IAS 39 restricts the application of hedge accounting for groups of items. For example, hedged items that together constitute a net position cannot be designated into a hedging relationship with that net position as the hedged item. Other groups are eligible if the individual items within that group have similar risk characteristics and share the risk exposure that is designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group must be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of these restrictions is that a group will generally qualify only if the hedged items in a group would qualify for hedge accounting for the same hedged risk on an individual basis.
- BC157 In response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to hedge account for groups of items, including net positions, has resulted in a hedge accounting model that is inconsistent with the way in which an entity actually hedges (ie for risk management purposes). Similar concerns about the restrictions of IAS 39 for applying hedge accounting to groups of items were raised as part of the Board's outreach activities for its hedge accounting project.
- BC158 In practice, most entities hedge their risk exposures using different approaches. These approaches result in hedges of:
- (a) individual items;
 - (b) groups of items that form a gross position; or
 - (c) groups of (partially) offsetting items that result in a net position.
- BC159 The group hedging approach involves identifying the risk from particular groups of items (including a net position), and then hedging some or all of that risk with one or more hedging instruments. The group hedging approach views the risk at a higher aggregated level. The reasons for taking this approach include:
- (a) items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group and therefore those offsetting risks do not need to be separately hedged.
 - (b) hedging derivatives that hedge different risks together can be more readily available than individual derivatives that each hedge a different risk.

- (c) the expediency (cost, practicality etc) of entering into fewer derivatives to hedge a group rather than hedging individual exposures.
- (d) the minimisation of counterparty credit risk exposure, because offsetting risk positions are hedged on a net basis (this aspect is particularly important for an entity that has regulatory capital requirements).
- (e) the reduction of gross assets/liabilities in the statement of financial position because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.

BC160 The restrictions in IAS 39 prevent an entity that hedges on a group or net basis from presenting its activities in a manner that is consistent with its risk management practice. For example, an entity may hedge the net (ie residual) foreign currency risk from a sequence of sales and expenses that arise over several reporting periods (say two years) using a single foreign currency derivative (that matures in two years' time). Such an entity cannot designate the net position of sales and expenses as the hedged item. Instead, if it wants to apply hedge accounting it must designate a gross position that best matches its hedging instrument. However, the Board noted there are a number of reasons why this would not give rise to useful information. For example:

- (a) A matching hedged item might not exist, in which case hedge accounting cannot be applied.
- (b) If the entity did identify and designate a matching two-year gross exposure from the sequence of sales and expenses, that item would be portrayed as the only hedged item and would be presented at the hedged rate. All other transactions (eg in earlier reporting periods) would appear unhedged and would be recognised at the prevailing spot rates, which would give rise to volatility in some reporting periods;
- (c) If the designated hedged transaction did not arise, but the net position remained the same, hedge ineffectiveness would be recognised for accounting purposes even though it does not exist from an economic perspective.

BC161 Consequently, the Board proposes that groups of items (including net positions) should be eligible for hedge accounting. However, the Board also proposes to limit the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC168–BC173).

BC162 The following subsections set out the Board's considerations regarding the application of hedge accounting in the context of groups of items.

Criteria for the eligibility of a group of items as a hedged item

BC163 An individual hedge approach involves an entity entering into one or more hedging instruments to manage a risk exposure from an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, for a group hedge approach an entity seeks to manage the risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument.

BC164 An individual hedge approach and a group hedge approach are similar in concept. Hence, the Board decided that the requirements for qualifying for hedge accounting should also be similar. Consequently, the Board proposes that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions were retained for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different reporting periods (see paragraphs BC168–BC173).

Designation of a layer component of a nominal amount for hedges of a group of items

BC165 As part of the proposals in this exposure draft, the Board proposes that an entity can designate a layer component of a nominal amount (a layer) of a single item in a hedging relationship (see paragraph B21 of the exposure draft). The Board also considered whether it would be appropriate to extend that decision on single items to groups of multiple items and hence allow designating a layer of a group in a hedging relationship.

BC166 The Board decided that the benefits of identifying a layer component of a nominal amount of a group of items are similar to the benefits it considered for layer components of single items (see paragraphs BC65–BC69). However, the Board also noted additional reasons that support the use of components for groups of items:

- (a) Uncertainties such as breach (or cancellation) of contracts, or prepayment, can be better modelled when considering a group of items.

- (b) In practice, hedging layers of groups of items (eg a bottom layer) is a common risk management strategy.
- (c) Arbitrarily identifying and designating (as hedged items) specific items from a group of items that are exposed to the same hedged risk can:
 - (i) give rise to arbitrary accounting results if the designated items do not behave as originally expected (while other items, sufficient to cover the hedged amount, do behave as originally expected); and
 - (ii) can provide opportunities for earnings management (for example by choosing to transfer and derecognise particular items from a group of homogeneous items when only some were specifically fair value hedged and therefore have fair value hedge adjustments attached to them).

BC167 The Board noted that, in practice, groups of items hedged together are not likely to be groups of identical items. Given the different types of groups that could exist in practice, in some cases it could be easy to satisfy the proposed conditions and in some cases it could be more challenging or impossible. The Board decided that it is not appropriate to define the cases where the conditions in paragraph 36 of the exposure draft are satisfied because it will depend on the specific facts and circumstances. The Board believes a criteria-based approach would be more operational and appropriate. This would allow hedge accounting to be applied in situations where it is easy to meet the criteria as well as in cases where it is more challenging, but an entity is prepared to undertake the necessary efforts, for example to invest in systems in order to achieve compliance with the hedge accounting requirements.

Cash flow hedges of a group of items that constitutes a net position that qualifies for hedge accounting

BC168 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred through other comprehensive income to be reclassified later from other comprehensive income to profit or loss when the hedged item affects profit or loss (see paragraphs 29 and 30). For net position hedges, items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group (ie the gains on some items offset the losses on others). Hence, for a cash flow hedge of a net position that is a group of forecast transactions, the effective part of the cumulative change in value (from the inception of the hedge) of some

forecast transactions must be deferred through other comprehensive income. This is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss (or used as a basis adjustment) in the later phase when the last hedged item in the net position occurs.

- BC169 However, forecast transactions that constitute a hedged net position might affect profit or loss in different accounting periods. For example, sales and unrelated expenditure hedged for foreign currency risk may affect profit or loss in different reporting periods. When the hedged items affect profit or loss in different periods, the cumulative change in value of the designated sales (to be reclassified later when the expenditure is recognised as an expense) needs to be excluded from profit or loss and instead be deferred through other comprehensive income. This is required in order to ensure that the sales recognised in profit or loss are measured at the hedged exchange rate.
- BC170 Hence, the Board noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in other comprehensive income of cumulative gains and losses on some forecast transactions from the time they occur until some other forecast transactions occur in later periods. The Board considered that this would be tantamount to measuring the transactions that occur first at a different amount from the transaction amount (or other amount that would be required under general IFRS requirements) in contemplation of other forecast transactions that are expected to occur in the future that would have an offsetting gain or loss. When those other transactions occur, their measurement would be adjusted for the amounts deferred in other comprehensive income on forecast transactions that occurred earlier.
- BC171 The Board acknowledged that this approach would not result in recognising gains and losses on items that do not yet exist but instead defer gains and losses on some forecast transactions as they occur. However, the Board considered that this approach would be a significant departure from general IFRSs regarding the items that result from the forecast transactions. The Board further considered that this departure would affect the forecast transactions:
- (a) that occur in the early phases of the hedging relationship, ie those for which gains and losses are deferred when the transaction occurs; and
 - (b) those that occur in the later phases of the hedging relationship and are adjusted for the gains or losses deferred on the forecast

transactions as they occurred in the early phases of the hedging relationship.

- BC172 The Board noted that the accounting for the forecast transactions that occur in the later phases of the hedging relationship is comparable to that of forecast transactions that are hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occur in the early phases of the hedging relationship would be more similar to that of a hedging instrument than a hedged item. The Board concluded that this would be a significant departure from general IFRS requirements and the requirements of the hedge accounting model for hedging instruments.
- BC173 Consequently, the Board proposes that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting cash flows would affect profit or loss in different periods. The Board noted that when the offsetting cash flows affect profit or loss in the same period those concerns would not apply in the same way as no deferral in other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the Board proposes that such net positions should be eligible as hedged items.

Presentation when the group of items in the net position affects profit or loss in the same period

- BC174 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items might affect different income statement line items. Consequently, for a cash flow hedge of such a group, when amounts are reclassified from other comprehensive income to profit or loss that raises the question of how they should be presented. The Board noted that the reclassified amounts would need to be grossed up to offset each of the hedged items individually.
- BC175 The Board noted that if it proposed to adjust (gross up) all the affected line items in the income statement it would result in the recognition of gross (partially offsetting) gains or losses that do not exist, and that this would not be consistent with general accounting principles. Consequently, the Board decided not to propose to adjust (gross up) all affected income statement line items.
- BC176 Instead, the Board proposes that amounts that are reclassified from other comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. This avoids the problem of distorting gains or losses with amounts that

do not exist. However, the Board acknowledged that this results in additional disaggregation of information in the income statement. This would also result in hedges of net positions being presented differently from hedges of gross positions.

BC177 In a fair value hedge, changes in the fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in other comprehensive income. Any difference, which is the hedge ineffectiveness, is transferred to profit or loss (see paragraph 28(c)). Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the Board does not believe it is necessary to propose any changes to the fair value hedge accounting mechanics to accommodate net positions. However, in cases where some hedging instrument gains or losses are recognised in profit or loss (eg the net interest accrual on an interest rate swap), those gains or losses should be presented in a separate line when the hedged item is a net position for the same reasons that the Board considered for cash flow hedges in relation to their presentation in the income statement.

Identifying the hedged item for hedges of a group of items that constitutes a net position

BC178 The Board considered how an entity that applies net position hedge accounting should identify the hedged item. The Board concluded that an entity would need to designate a combination of gross positions if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the Board decided that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item.

Hedges of a group of items that constitutes a net position resulting in a net position of nil

BC179 When an entity manages and hedges risks on a net basis, the net risk from hedged items may be designated in a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the Board acknowledged that there might be circumstances where by coincidence the net position of hedged items for a particular period is nil.

- BC180 The Board considered whether, when an entity hedges risk on a net basis, a nil net position should be eligible for hedge accounting. Such a hedging relationship could be in its entirety outside the scope of hedge accounting if it did not include any financial instruments. Furthermore, eligibility for hedge accounting would be inconsistent with the general requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.
- BC181 However, the Board noted that the accounting result of prohibiting the application of hedge accounting to nil net positions could distort the financial reporting of an entity that otherwise hedges (with eligible hedging instruments) and applies hedge accounting on a net basis. For example:
- (a) in periods where hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument) the transactions would reflect an overall hedged rate or price; whereas
 - (b) in periods where hedge accounting would not be permitted (because the net position is nil), transactions would be recorded at prevailing spot rates or prices.
- BC182 Consequently, the Board proposes that nil net positions should qualify for hedge accounting. However, the Board notes that such situations would be coincidental and hence it expects that nil net positions would be rare in practice.

Disclosures

- BC183 The Board considered disclosure requirements in the context of hedging relationships that qualify for hedge accounting. Consequently, if an entity does not apply hedge accounting the proposed hedge accounting disclosures would not apply. When these requirements are finalised, the disclosures will be incorporated into IFRS 7 *Financial Instruments: Disclosures*.
- BC184 During its deliberations, the Board engaged in outreach activities with users of financial statements. This outreach included soliciting views on presentation and disclosures. The Board used the responses received from those outreach activities to develop the proposed hedge accounting disclosures.
- BC185 The Board was told that many users do not find the hedge accounting disclosures in financial statements helpful. Many also think that the hedge accounting disclosures in IFRS 7 do not provide transparency on an entity's hedging activities.

- BC186 To provide relevant information that enhances the transparency on an entity's hedging activities, the Board proposes hedge accounting disclosures that meet particular objectives (see paragraph 40). Clear disclosure objectives allow an entity to apply its judgement when it provides information that is useful and relevant to users of financial statements.
- BC187 The following subsections set out the Board's considerations regarding the proposed hedge accounting disclosures.

General considerations

Location of disclosures

- BC188 The Board proposes that all hedge accounting disclosures should be presented in one location within an entity's financial statements. However, if such information is already presented elsewhere the Board decided that in order to avoid duplication an entity should be allowed to incorporate that information by cross-reference, which is similar to the approach used by IFRS 7 for some disclosures that can be incorporated by reference.

Disclosures by risk category

- BC189 The Board noted that recognition and measurement requirements allow for only a partial reflection of the economic hedging activities in the financial statements, which results in a limitation of an entity's reporting of its hedging activities. Hence, the Board considered that the transparency of an entity's hedging activities could be enhanced by an approach that considers:
- (a) information that provides a clear picture of those risk management activities of an entity that are captured by hedge accounting (this information is not necessarily provided in the primary financial statements); and
 - (b) information included in the primary financial statements.
- BC190 To provide information that is useful to users of financial statements, there should be a clear link between the hedge accounting information included in the primary financial statements and the hedge accounting information that is not included in the primary financial statements. To provide such a link, the Board proposes that an entity should provide hedge accounting disclosures by risk category. Consequently, an entity should disclose by risk category:

- (a) information not included in the primary financial statements (see paragraphs BC192–BC196); and
- (b) information included in the primary financial statements (see paragraphs BC197–BC204).

BC191 The Board decided not to prescribe the risk categories by which the disclosures need to be disaggregated. In the Board’s view 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 all the proposed hedge accounting disclosures.

The risk management strategy

BC192 Users of financial statements need to understand how an entity’s risk management strategy is applied to manage risk. Understanding an entity’s risk management strategy for each risk helps users to understand the accounting information disclosed.

BC193 Consequently, the Board proposes that an entity should provide an explanation of its risk management strategy for each category of risk. The risk management strategy disclosure would relate to only those risks that an entity has decided to hedge and for which hedge accounting is applied.

The amount, timing and uncertainty of future cash flows

BC194 The Board decided that in order to meet the objectives of hedge accounting disclosures, an entity would have to provide sufficient quantitative information to help users of financial statements understand how its risk management strategy for each particular risk affects the amount, timing and uncertainty of future cash flows. In this context, risk exposure refers only to risks that the entity has decided to hedge and for which hedge accounting is applied.

BC195 Consequently, the Board proposes that an entity should provide:

- (a) quantitative information on the risk exposure the entity manages and the extent to which the entity hedges that exposure; and
- (b) a breakdown of that information for each future period that a hedging relationship (which exists at the reporting date) is expected to affect profit or loss.

BC196 The Board also proposes that an entity should disclose information about the sources of hedge ineffectiveness of hedging relationships for each particular risk category. In the Board's view this would assist users in identifying the reasons for hedge ineffectiveness that is recognised in profit or loss. It would also assist users in determining how hedging relationships will affect profit or loss.

The effects of hedge accounting on the primary financial statements

BC197 One function of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures should therefore increase the transparency of how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the entity's statement of comprehensive income and statement of financial position.

BC198 To provide information on the effects of hedge accounting on the statement of comprehensive income and the statement of financial position, the Board proposes disclosures that should be presented in a tabular format that separates the information by risk category and by type of hedge. Providing disclosures in a tabular format allows users to identify clearly the relevant numbers and their effects on the entity's statement of comprehensive income and statement of financial position.

BC199 During the Board's outreach activities, users said that they do not analyse an entity's hedging activities by type of hedging relationship (eg cash flow hedge or fair value hedge). They said that it is more important to understand the risks that the entity manages and the results after hedging. However, to provide information effectively on the effects of hedge accounting on the statement of comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (eg cash flow hedge accounting or fair value hedge accounting). The Board believes that if the proposed table is prepared by risk category and by type of hedge, the table would provide sufficient links between the accounting information and the risk management information.

BC200 The Board does not propose prescribing levels of aggregation or disaggregation for the information that should be disclosed in a tabular format. An entity should apply judgement when it determines the appropriate level of aggregation or disaggregation. However, the Board proposes that an entity should consider other disclosure requirements

(for example, fair value disclosures in IFRS 7) when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to compare amounts that are disclosed and measured at fair value between the fair value disclosures and the proposed hedge accounting disclosures.

- BC201 Cash flow hedge accounting requires an entity to defer in other comprehensive income gains or losses on the hedging instrument (see paragraph 31 of the exposure draft). The deferred amounts are reflected in the statement of changes in equity in the cash flow hedge reserve. IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. In conformity with its objectives for hedge accounting disclosures, the Board proposes that the reconciliation required by IAS 1 should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of comprehensive income. The Board also proposes that the reconciliation should be by type of risk. The Board considered that such a disclosure would allow users of financial statements to evaluate the effects of hedge accounting on equity and the statement of comprehensive income.

Time value of options accumulated through other comprehensive income

- BC202 The Board proposes accounting requirements that involve other comprehensive income for the time value of an option when an entity elects to separate the time value of the option and designate (as the hedging instrument) only its intrinsic value (see paragraph 8(a)). Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.
- BC203 The Board noted that IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. Consequently, as a result of IAS 1, an entity would disclose the amounts in relation to the time value of options that would be accumulated in other comprehensive income and the movements in that balance.

BC204 However, the Board proposes that an entity should differentiate between transaction related hedged items and time period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.

Other considerations

BC205 An entity might enter into a transaction to manage an exposure to a particular risk that might not qualify for hedge accounting (for various reasons). For example, it is an item that is not eligible to be designated as a hedged item or hedging instrument. Information on such transactions might enable users to understand why an entity has entered into a transaction and how it manages the particular risk, even though those transactions do not qualify for hedge accounting.

BC206 However, the Board thought that mandating such disclosures would require it to determine which part of an entity's risk management was relevant for the purpose of this disclosure and then define this part to make the disclosure requirement operational. The Board did not believe that this was feasible as part of its hedge accounting project but would have a much wider, generic scope.

BC207 Furthermore, users of financial statements can often obtain information on an entity's hedging activities from information in management reports and sources outside the financial reporting context. That often gives a reasonable overview of why hedge accounting might be difficult to achieve. Hence, the Board decided not to propose disclosures about hedging when hedge accounting does not apply.

Accounting alternatives to hedge accounting

BC208 One of the functions of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for the hedging instrument and the accounting for the hedged item. The Board considered two situations where it could change the recognition and measurement requirements for items, rather than requiring an entity to mitigate the recognition and measurement anomaly through hedge accounting. The Board considered changing the recognition and measurement requirements in the context of:

- (a) accounting for a contract for a non-financial item; and

- (b) accounting for hedges of credit risk using credit derivatives.

Accounting for a contract for a non-financial item as a derivative

- BC209 Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell a non-financial item that can be settled net in cash (including net settlement in another financial instrument by exchanging financial instruments), as if the contracts were financial instruments. In addition, IAS 39 specifies that there are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. For example, a contract is considered to be settled net in cash even if it is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash.
- BC210 However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39. The 'own use' scope exception in IAS 39 mostly applies to contracts for commodity purchases or sales.
- BC211 It is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative. Many commodity contracts meet criteria for net settlement in cash because in many instances commodities are readily convertible to cash. When such a contract is accounted for as a derivative, it is measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the change in the fair value of the commodity contract, that derivative will also be measured at fair value with changes in fair value recognised in profit or loss. Because the changes in the fair value of the commodity contract and the derivative are recognised in profit or loss, an entity does not need hedge accounting.
- BC212 However, in situations where a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sales or purchase contract (executory contract). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value or cash flow exposures arising from a commodity supply contract that is not within the scope of IAS 39, it creates an accounting mismatch. 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 (unless the contract is onerous).

- BC213 To eliminate the accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as a hedged item in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the changes would offset the changes in fair value of the derivative instruments (to the extent that they are effective). However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts, and within the large volume of contracts some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. The net position is typically monitored, managed and adjusted daily. Because of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil, an entity would have to adjust the fair value hedge relationship frequently if the entity were to apply hedge accounting.
- BC214 The Board noted that in such situations hedge accounting is not an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Hence, the Board considered amending the scope of IAS 39 so that it would allow a commodity contract to be accounted for as a derivative in such situations. The Board considered two alternatives for amending the scope of IAS 39:
- (a) allowing an entity to elect to account for commodity contracts as derivatives (ie a free choice); or
 - (b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair value-based risk management strategy.
- BC215 The Board noted that giving an entity the choice to account for commodity contracts as derivatives would be tantamount to an elective 'own use' scope exception, which would have outcomes that would be similar to the accounting treatment in US generally accepted accounting principles. This approach in effect would allow an entity to elect the 'own use' scope exception or derivative accounting at inception or a later date. Once the entity had elected to apply the scope exception it would not be able change its election and switch to derivative accounting.
- BC216 However, the Board noted that such an approach would not be consistent with the approach in IAS 39 because:

- (a) the accounting treatment in accordance with IAS 39 is dependent on the purpose (whether it is for 'own use') for which the contracts to buy or sell non-financial items are entered into and continue to be held for. This is different from a free choice, which would not depend on the purpose of the contract.
- (b) in accordance with IAS 39, if similar contracts have been settled net, a contract to buy or sell non-financial items that can be settled net in cash must be accounted for as a derivative. Hence, a free choice would allow an entity to account for a commodity contract as a derivative regardless of whether similar contracts have been settled net in cash.

Consequently, the Board decided not to propose that entities can elect to account for commodity contracts as derivatives.

BC217 Alternatively, the Board considered applying derivative accounting to commodity contracts if that is in accordance with the entity's underlying business model and how the contracts are managed. Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would not consider only the purpose (based solely on the actual type of settlement) but also how the contracts are managed. As a result, if an entity's underlying business model changes and the entity no longer manages its commodity contracts on a fair value basis, the contracts would revert to the 'own use' scope exception. This would be consistent with the criteria for using the fair value option for financial instruments (ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis).

BC218 Hence, the Board proposes that derivative accounting would apply to contracts that would otherwise meet the 'own use' scope exception if that is in accordance with the entity's fair value-based risk management strategy (see Appendix C regarding amendments to other IFRSs). The Board believes that this approach would faithfully represent the financial position and performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.

Hedging credit risk using credit derivatives

- BC219 Many financial institutions frequently use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This might also reduce the regulatory capital requirement for the loan or loan commitment while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's overall lending portfolio.
- BC220 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk.
- BC221 Some believe that credit default swap prices are the best measure of the credit risk component of a financial asset. However, the Board noted that using credit default swap pricing to measure the credit risk component of a financial instrument (eg a bond) might be conceptually flawed, at least because of the following structural differences between a credit default swap and a debt instrument:
- (a) funding—a credit default swap is a synthetic instrument and does not require funding, whereas a debt instrument is a cash instrument that requires initial cash outlay;
 - (b) coupon accrual on default—a defaulted debt instrument does not pay the coupon accruals between the last coupon date and the date of default whereas a credit default swap protection buyer pays the accrued premium until the date of default;
 - (c) counterparty credit risk—a protection buyer of a credit default swap has the risk that the protection seller will default on the credit default swap contract; and

- (d) defined credit event—events that trigger the payout of the credit default swap may not necessarily be a default.
- BC222 Other aspects that give rise to differences between the value of a credit default swap and the credit risk inherent in the reference obligation are:
- (a) features such as ‘cheapest to deliver’ options;
 - (b) differences in liquidity between the credit default swap and debt markets;
 - (c) the effect of auction processes when credit default swaps are settled as a result of a credit event; and
 - (d) the interpretation of the ‘restructuring’ credit event (and any related uncertainty about that interpretation).
- BC223 When the requirements for hedge accounting are not met, IFRS 9 and IAS 39 permit an entity to designate as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of the standard if doing so eliminates or significantly reduces an ‘accounting mismatch’. However, the fair value option is only available at initial recognition, is irrevocable and an entity must designate the financial item in its entirety (ie for its full nominal amount). Because of the various optional features and the drawdown behavioural pattern of the loans and loan commitments, credit portfolio managers engage in a flexible and active risk management strategy. Credit portfolio managers most often hedge less than 100 per cent of a loan or loan commitment. They might also hedge longer periods than the contractual maturity of the loan or the loan commitment. Furthermore, the fair value option is available only to instruments that are within the scope of IAS 39. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37 rather than IAS 39. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of its restrictions and scope.
- BC224 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 (ie those that meet the scope exception of IAS 39). The changes in fair value of the credit default swaps are recognised in profit or loss every period (as for a trading book). The accounting outcome is a ‘mismatch’ of gains and losses of the loans and loan commitments versus those of the credit

default swaps, which creates volatility in profit or loss. During the Board's outreach programme, many users pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.

- BC225 In the exposure draft, the Board proposes that a risk component should be separately identifiable and reliably measurable (see paragraph 18) in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate hedge accounting for hedges of credit risk, a different hedge accounting requirement specifically for this type of risk component would have to be developed, or the proposed hedge accounting requirements would have to be significantly modified (eg in relation to eligible hedged items and effectiveness testing).
- BC226 The Board considered three alternative approaches to address situations in which credit risk is hedged by credit derivatives. These alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (eg a bond, loan or loan commitment):
- (a) alternative 1:
 - (i) to elect fair value through profit or loss only at initial recognition;
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.
 - (b) alternative 2:
 - (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is recognised immediately in profit or loss);
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue of fair value through profit or loss accounting.
 - (c) alternative 3:
 - (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is amortised or deferred);
 - (ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

BC227 The fair value through profit or loss election would be available for a financial instrument that is managed in such a way that an economic relationship with credit derivatives on the basis of the same credit risk exists that causes offsetting changes in fair value of the financial instrument and the credit derivatives. However, this would also apply to loan commitments that fall outside the scope of IAS 39 and IFRS 9 if additional qualification criteria are met. The Board considered the following qualifying criteria for electing fair value through profit or loss:

- (a) a clearly defined set of links between the financial instrument and the credit derivative can be established through matching of the name (ie the borrower or holder of the loan commitment matches the reference entity of the credit derivative); and
- (b) the seniority (ie the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative).

BC228 The qualification criteria above are set with a view to accommodating economic hedges of credit risk that would otherwise qualify for hedge accounting, but for the fact that the credit risk component within the hedged exposure cannot be measured. The qualification criteria above are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions.

BC229 For discontinuation, the Board considered the following criteria:

- (a) an accounting mismatch no longer exists because the credit derivative expires or is sold, terminated or settled; or
- (b) the credit exposure of the financial instrument is no longer managed on a fair value basis using credit derivatives because of, for example:
 - (i) improvements in the credit quality of the borrower; or
 - (ii) changes to capital requirements imposed on the financial institution.

BC230 Given the rationale for electing fair value through profit or loss, an entity would typically discontinue accounting at fair value through profit or loss if the discontinuation criteria above are met, because that would ensure alignment with how the exposure is managed (ie the credit risk is no longer managed on a fair value basis). The Board noted that in the

circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the Board considered it would be logical to make discontinuation of fair value through profit or loss mandatory (rather than optional) if the discontinuation criteria are fulfilled.

BC231 Alternative 1 permits electing fair value through profit or loss for a part of the nominal amount of the financial instrument (nominal component) if qualifying criteria are met. This is available only at initial recognition. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with alternative 1, at the date of discontinuation of fair value through profit or loss the fair value of the financial instrument will be its deemed cost. For loan commitments outside the scope of IFRS 9 the measurement and recognition criteria of IAS 37 would apply.

BC232 Alternative 1 permits an election for a nominal component. The Board noted that when IAS 39 was issued there were concerns that allowing the designation of a component of nominal amounts could provide an incentive for earnings management. This was the reason why IAS 39 prohibits the designation of such a component. However, the Board noted that:

- (a) for the purpose of hedging credit risk, the business model is about holding the loan (or loan commitment). This is because:
 - (i) investment-grade bank loans are largely illiquid instruments and are therefore not frequently sold.
 - (ii) many of such loans result from lines of credit (loan commitments) that the holder of the commitment would not consent to be transferred to potential secondary investors (because the credit standing of the facility provider is crucial for the line of credit).
 - (iii) these instruments are typically used by banks to form an anchor relationship with clients that generates business opportunities for other services and products (cross-selling).
- (b) for financial instruments within the scope of IFRS 9, the accounting mismatch arises only for instruments that are not classified as fair value through profit or loss. Loans that are classified as amortised cost are subject to the business model test,

which means that they are held in a business model with the objective of collecting contractual cash flows. The Board addressed the issue of earnings management in this context by way of requiring information on the gains or losses from derecognising assets measured at amortised cost. This information allows users of financial statements to understand the extent and frequency of selling and the associated gains and losses.

- (c) for loan commitments outside the scope of IFRS 9, because of the business model (see (a) above), the sale of loan commitments is less likely than for loans. Moreover, loan commitments that can be settled net in cash or for which the resulting loans are sold are within the scope of IFRS 9 and therefore mandatory classification as at fair value through profit or loss applies. Consequently, the considerations above that apply to loans also apply to loan commitments (assuming that equivalent disclosure of information would be required).

BC233 The Board noted that a significant disadvantage of alternative 1 is that in many situations in practice (when a financial institution obtains credit protection for an exposure subsequently to the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and therefore would not reflect its effect. An advantage of alternative 1 is that it is less complex than the other alternatives that the Board considered. By not permitting the election of fair value through profit or loss after initial recognition (or inception of a loan commitment), the difference at later points in time between the carrying amount and the fair value of the financial instrument will not arise.

BC234 In addition to the election of fair value through profit or loss at initial recognition in accordance with alternative 1, alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was previously deteriorating and was then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.

- BC235 The Board noted that when the financial instrument is elected for measurement as fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and fair value. This difference is a result of the change in the measurement basis (eg from amortised cost to fair value for a loan). The Board considers this type of difference a measurement change adjustment. Alternative 2 proposes to recognise the measurement change adjustment in profit or loss immediately. At the date of discontinuation of fair value through profit or loss accounting, the fair value will be the deemed cost (as in alternative 1). If the financial instrument is elected again after a previous discontinuation, the measurement change adjustment at that date is also recognised immediately in profit or loss.
- BC236 A significant advantage of alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.
- BC237 A disadvantage of alternative 2 is that it is more complex than alternative 1. Furthermore, it might appear susceptible to earnings management. An entity can decide at what time to elect fair value through profit or loss accounting for the financial instrument and thus when the difference between the carrying amount and fair value at that date would be recognised in profit or loss. The accounting impact of immediately recognising the measurement change adjustment in profit or loss may also deter an entity from electing fair value through profit or loss accounting. For example, when an entity decides to take out credit protection at a time when the fair value has already moved below the carrying amount of the loan because of credit concerns in the market, it will immediately recognise a loss if it elects fair value through profit or loss accounting.
- BC238 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as alternative 2. Consequently, it also facilitates an accounting outcome that reflects the credit risk management strategy of financial institutions.

- BC239 An important difference between alternatives 2 and 3 is the treatment of the measurement change adjustment (ie the difference that could arise between the carrying amount and fair value of the financial instrument when fair value through profit or loss accounting is elected after initial recognition of the credit exposure). Alternative 3 proposes that the measurement change adjustment should be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37.
- BC240 More specifically, alternative 3 proposes the following in relation to the measurement change adjustment:
- (a) for loans within the scope of IFRS 9:
 - (i) the measurement change adjustment is amortised over the life of the instrument;
 - (ii) when the measurement change adjustment plus the fair value is greater than the carrying amount if the loan had been continued to be measured at amortised cost, the amount above amortised cost is recognised as an impairment (to the extent of the unamortised measurement change adjustment); and
 - (iii) any unamortised measurement change adjustment at the date of discontinuation is added to the fair value of the financial instrument as its new deemed cost.
 - (b) for loan commitments within the scope of IAS 37, the measurement change adjustment is deferred until the earlier of:
 - (i) the discontinuation of fair value through profit or loss accounting; and
 - (ii) recognition of a provision in accordance with IAS 37 (ie when the 'probable' threshold is met).
- BC241 As in alternative 2, a significant advantage of alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives. An advantage of alternative 3 over 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.

BC242 However, a disadvantage of alternative 3 is that it is the most complex of the alternatives. The Board noted that the measurement change adjustment in accordance with alternative 3 would have presentation implications. The measurement change adjustment could be presented in the statement of financial position in the following ways:

- (a) as an integral part of the carrying amount of the exposure (ie it could be added to the fair value of the loan): this results in a mixed amount that is neither fair value nor amortised cost.
- (b) presentation as a separate line item next to the line item that includes the credit exposure: this results in additional line items in the balance sheet (statement of financial position) and may easily be confused as a hedging adjustment.
- (c) in other comprehensive income.

BC243 The periodic charge for the amortisation of the measurement change adjustment for loans could be presented in the statement of comprehensive income as:

- (a) (part of) interest revenue: however, the Board noted that the financial instrument that the amortisation relates to would no longer be measured at amortised cost (given the election to apply fair value through profit or loss accounting) and hence this presentation would be inconsistent with requirements regarding interest revenue recognition.
- (b) other gains or losses.

BC244 The Board noted that disclosures could provide transparency on the measurement change adjustment. The Board considered a reconciliation of changes in the measurement change adjustment balance during the period that would include, for example, the following reconciling items:

- (a) additions as a result of electing fair value through profit or loss accounting;
- (b) releases:
 - (i) amortisation
 - (ii) impairment
 - (iii) discontinuation
 - (iv) transfers to allowance account for credit losses; and
- (c) the effect of foreign exchange rate changes.

- BC245 The Board also considered a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for fair value through profit or loss accounting.
- BC246 However, in the light of the complexities that the three alternatives that the Board considered would introduce, the Board proposes not to allow elective fair value accounting for part of the nominal amount of hedged credit exposures (such as loans and loan commitments).

Effective date and transition

- BC247 To be consistent with the effective date for IFRS 9, the Board proposes an effective date for accounting periods beginning on or after 1 January 2013. Earlier application would be permitted. However, in conformity with earlier decisions, an entity would be able to apply the proposed hedge accounting requirements only if it has adopted all of the existing IFRS 9 requirements, or will adopt them at the same time as the proposed hedge accounting requirements are adopted.
- BC248 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users. IAS 8 also states that retrospective application is the preferred approach to transition unless such retrospective application is impracticable. In such a scenario the entity adjusts the comparative information from the earliest date practicable. In conformity with these requirements, IFRS 9 requires retrospective application (with some relief in particular circumstances).
- BC249 The proposals in the exposure draft are a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship can be designated only prospectively. Consequently, retrospective application is not applicable.
- BC250 The Board considered two alternative approaches:
- (a) prospective application only for new hedging relationships; or
 - (b) prospective application to all hedging relationships.
- BC251 The Board rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would require the current hedge accounting model in IAS 39 to be maintained until hedge accounting is discontinued for the hedging relationships established in accordance with IAS 39. Also, the proposed disclosures would be provided only for the hedging relationships accounted for in

accordance with the proposed model. This approach entails the complexity of applying the two models simultaneously and also involves a set of disclosures that would be inconsistent and difficult to interpret. Because some hedging relationships are long-term two hedge accounting models would coexist for a potentially long period. Consequently, for users of financial statements this raises comparability concerns between entities.

- BC252 Consequently, the Board proposes the prospective application of the proposed hedge accounting requirements for all hedging relationships. This approach would resolve the problem of having to apply two models simultaneously. This approach would allow some one-off transitional provisions to ensure that 'qualifying' hedging relationships could be moved from the existing model to the proposed model and would therefore be subject to the proposed requirements from the adoption date.
- BC253 The Board does not propose to amend IFRS 1 *First-time Adoption of International Financial Reporting Standards*. This is because a first-time adopter would need to look at the entire population of possible hedging relationships as defined by risk management and assess which ones are in compliance with the qualifying criteria in accordance with the proposed model. These should be documented on or before the transition date. This is consistent with the Board's proposed transition provisions for existing users of IFRSs. The proposed approach is also consistent with the current transition requirements of IFRS 1, which state that if an entity had designated a transaction as a hedge but the hedge does not meet the qualifying criteria in IAS 39 the entity shall discontinue hedge accounting.
- BC254 The Board recently published the request for views *Effective Dates and Transition Methods*. That document was issued to obtain views on the expected time and effort involved in properly adapting to the new financial reporting requirements and on the implementation timetable and sequence of adoption that facilitates cost-effective management of the changes. The Board will take into consideration the comments received on that document and on the transition proposals in the exposure draft when finalising the transition requirements for hedge accounting.

Alternative view of John T Smith

AV1 Mr Smith does not support the publication of the exposure draft, *Hedge Accounting*, because he believes that, if confirmed, its proposals would not improve financial reporting. While he agrees with the objective of reducing complexity and eliminating artificial barriers that preclude hedge accounting, he believes that many of the provisions in the exposure draft are not operational, lack rigour and would produce unintended consequences. He is particularly concerned that certain provisions undermine the fundamental principle that hedge ineffectiveness should be identified and recognised in profit or loss and the fundamental qualifying condition that there should be a high expectation that changes in the value of the hedging instrument will substantially offset the changes in the value of the hedged item. Mr Smith also believes that the proposals would inappropriately expand the use of hedge accounting, provide a virtually free choice to change the measurement attribute of assets and liabilities and specified portions thereof otherwise carried at cost or amortised cost, are incompatible with and would provide a means of circumventing the existing provisions of IFRS 9 *Financial Instruments* and would reduce comparability.

Differentiating basis risk and unhedged portions

AV2 Mr Smith agrees that management should be able to designate a portion of either a financial asset or a non-financial asset as a hedged item. Accordingly, he supports the elimination of the qualifying condition in IAS 39 *Financial Instruments: Recognition and Measurement* that prohibits a portion of a non-financial asset from being a hedged item. He disagrees, however, with the method in which the hedged portion can be determined under the provisions in the exposure draft because it has the effect of characterising basis risk as an unhedged residual portion. The exposure draft specifies that a portion of an item can be designated as a hedged risk if it is separately identifiable and measurable. Mr Smith believes that this condition is substantially undermined and will have little utility because other guidance specifies that a hedged item can be a portion that is not contractually specified or a portion that is inferred. He also believes that the example in paragraph B16(b) further undermines this condition because the inferred risk in the price of jet fuel cannot be both gas oil and crude oil depending on the life of the contract. Mr Smith is also concerned that in identifying the portion being hedged there is no consideration of the residual portion, the portion of the whole that is not the subject of the hedge. He believes that it should

not be permissible for a portion to be separated from the whole if there is interdependence between it and the residual portion. Similarly it should not be permissible for a portion that is not contractually specified to be separated from the whole if it and the remaining residual portion cannot be separately priced with the sum of those prices being equal to the price of the whole. Without a requirement to ensure that the prices of each portion can be isolated and measured separately with the sum equal to the price of the whole, any basis difference giving rise to ineffectiveness will not be recognised. Mr Smith believes that the above-mentioned provisions in the exposure draft provide a means of treating basis risk as an unhedged residual portion, thereby substantially eliminating recognition of ineffectiveness in a hedging relationship for both non-financial items and financial instruments and obscuring real ineffectiveness.

Elimination of the 80–125 per cent test

AV3 Mr Smith agrees with the elimination of the 80–125 per cent effectiveness test because it was required to be applied retrospectively and required a discontinuation of hedge accounting when the test was failed, thereby precluding the recognition of any change in value of the hedged item that offset the change in value of the hedging instrument. However, Mr Smith believes that the ongoing effectiveness test specified in the exposure draft is not sufficiently rigorous to provide a basis for hedge accounting because it does not attempt to ensure that the hedging relationship will be highly effective. The exposure draft requires the hedging relationship to be neutral so as to ensure that an entity is not purposefully overhedging or underhedging. The neutrality requirement, however, does not ensure any level of precision. The exposure draft also requires that the expectation for achieving offset is other than accidental. Mr Smith believes that this condition does not ensure that the hedging results will be highly effective. In his view the other than accidental offset condition is an extremely low threshold for qualifying for hedge accounting. He believes that the elimination of the condition that the hedge will be highly effective would unduly expand hedge accounting, thereby allowing considerable free choice to change the normal recognition and measurement requirements in other IFRSs.

Reliance on risk management

- AV4 Mr Smith agrees with the Board in characterising hedge accounting as an exception to the normal recognition and measurement requirements in IFRSs. Accordingly, he believes that there should be a rigorous set of qualifying criteria to provide for the exception. However, he is concerned that the exposure draft would treat hedge accounting as the norm and not the exception because it unduly relies on risk management as the basis for hedge accounting and would inappropriately expand the use of hedge accounting to accommodate all forms of risk management activities.
- AV5 Mr Smith supported reliance on the business model as a basis for classification and measurement in IFRS 9 because a particular business model was specified, namely to hold assets in order to collect contractual cash flows. Mr Smith does not support the substantial reliance on risk management in the exposure draft as a basis for hedge accounting because risk management is not defined, it has no boundaries and is not applied uniformly. Risk management activities involve assessing risk and taking risk positions. Risk can be assessed in different ways on the basis of individual items, portfolios or groups and on a local or entity-wide basis. Risk positions are arbitrary and can be changed according to an entity's tolerance of risk, its expectations for the future and its assessment of the cost and benefits of entering into risk management activities. More important, it is not possible to determine whether risk has been increased or decreased because risk management activities involve exchanging one type of risk for another. Risk management policies are often specified at a general level and often seek to reduce earnings volatility. Accordingly, Mr Smith believes that reliance on risk management provides little rigour because policies can be written in any manner to permit an entity to move in and out of hedge accounting freely as a function of how it evaluates risk and documents its risk management policy. Mr Smith believes that the exposure draft inappropriately proposes to expand the use of hedge accounting to accommodate any risk management activity.

Hedge accounting for net positions

- AV6 The exposure draft proposes to expand the use of hedge accounting to permit net positions to be designated in a hedging relationship. It would also permit net offsetting positions involving only cash instruments to be accounted for as a hedge to accommodate circumstances that the Board considers rare. Mr Smith believes that the qualifying condition based on

risk management for establishing a hedge relationship for a net position has little rigour and essentially provides a free choice because it can be met when an entity documents that it manages risk on a net basis. He observes that a good risk manager would always consider offsetting positions in evaluating risk. He also believes that hedge accounting for net positions can easily be terminated because an entity can change the specified tolerance for risk any time on the basis of many different factors.

AV7 Mr Smith is concerned that, without other qualifying criteria, two or more combinations of cash instruments that happen to coexist in the normal course of operations can be designated in a hedging relationship just because there is some offsetting risk. Accordingly, this proposal would have the effect of overriding the requirements of IFRS 9 relating to the fair value option when an accounting mismatch exists. Whenever there is an accounting mismatch, instead of electing the fair value option at inception for the life of the instrument and for the entire fair value as required by IFRS 9, an entity could circumvent those requirements by designating a hedging relationship after inception, for a period of time and for a portion of the risk. Mr Smith observes that even if there is no accounting mismatch, such as when the offsetting cash instruments are carried at amortised cost, a hedging relationship could be established and the measurement attribute changed. Accordingly, Mr Smith believes that the exposure draft provides an option to change the measurement attribute of any cash instrument or portion thereof whenever it offsets another instrument or portion thereof, thereby permitting the change in value to be recognised for any period of time and for any portion of risk that is being offset. This would have the effect of eliminating all volatility in earnings to the extent there is anything on the balance sheet that can be identified to offset another position. Mr Smith is also concerned that the ability to designate a net cash position as hedged items may be motivated by a desire to avoid volatility in earnings when there is a real economic mismatch as in the case in which two items carried at cost or amortised cost offset each other but one of them is designated in a hedging relationship to offset a third item carried at fair value.

AV8 Mr Smith is also concerned that hedging results might not be comparable because an entity could choose to designate the net position or the portion of the gross exposure equal to the net exposure as the hedged position, or not to designate the relationship. Each of these designation choices gives rise to a potentially different presentation and impedes comparability.

Financial assets carried at fair value as hedging instruments

- AV9 The exposure draft proposes to expand the use of hedge accounting to permit financial assets and liabilities carried at fair value to be designated as hedging instruments to make the new hedge accounting model more future-proof as hedging strategies develop. Mr Smith believes that this change should not be made unless warranted by a particular practice problem that is known to exist. He also believes it might have unintended consequences by providing a means for structuring to permit the recognition in other comprehensive income of fair value changes that would otherwise be recognised in profit or loss.

Hedging aggregated exposures

- AV10 The exposure draft proposes to expand the use of hedge accounting to permit an aggregated exposure that is a combination of another exposure and a derivative to be accounted for as a hedged item and justifies this expansion by analogising to the exception in IAS 39 that permits a purchased option, which is a derivative, to be designated as a hedged item. Mr Smith is concerned that the only condition necessary to permit an aggregated exposure to be a hedged instrument is designation. Mr Smith believes that without other limiting conditions, this provision might have unintended consequences by providing a means for structuring to permit the recognition in other comprehensive income of fair value changes that would otherwise be recognised in profit or loss and to permit the bifurcation of derivatives.

Capitalising the time value of an option premium

- AV11 Mr Smith agrees that the time value of a purchased option is a cost for the protection it provides when the intrinsic value of the option is effective in offsetting a risk in a hedging relationship. He disagrees with the recognition of the time value of an option as a basis adjustment of a hedged item when the transaction results in the recognition of a non-financial asset because it does not offset a cash flow of the hedged item, is not a required part of the purchase price and does not enhance the value of the item purchased. It has the effect of spreading the cost into future periods for which protection is not provided. Mr Smith is also concerned that the three different methods described in paragraph 33 for recognising the time value of an option and changes therein depending on the nature of the hedged item adds complexity and diminishes comparability.

Separate line item presentation

AV12 Mr Smith does not support the separate line item presentation of changes in the value of hedged items in the statement of financial position. The line item amount is not an asset or liability in its own right and it changes over time because of hedging activity, amortisation and derecognition of the underlying asset or liability. He believes that it would only confuse users and make it difficult for them to understand value changes. He is particularly concerned that the exposure draft does not provide any guidance to require the items constituting the separate line item to be tracked with and specifically linked to the hedged items to which they relate. He believes that without such a requirement there exists considerable freedom to decide how to associate the line item amount with assets and liabilities that are derecognised or are no longer being hedged.

User considerations

AV13 Mr Smith does not believe that investors would find the relaxation of the effectiveness test together with the expansion of hedge accounting in reliance on risk management as proposed in the exposure draft an improvement to financial reporting. He understands that investors support accounting that is consistent with risk management. However, investors typically reject free-choice accounting because it diminishes consistency and comparability. Mr Smith believes that the significant effort to link hedge accounting to risk management decreases complexity for preparers but increases it for users because it results in considerable free-choice accounting to change recognition and measurement requirements in other IFRSs.

AV14 Mr Smith recognises that investors have difficulty understanding, and preparers have difficulty explaining, the volatility in profit or loss from the recognition of ineffectiveness under IAS 39 when hedge accounting cannot be applied or ineffectiveness resulting from basis differences is recognised. However, he believes it provided information that will no longer be available to users to serve as a starting point in a discussion with management or to allow them to make a conscious decision to ignore the amount of ineffectiveness reported in the financial statements.

AV15 Mr Smith believes that, given the substantial freedom to change normal recognition and measurement requirements, it would be impossible for users to understand the effects of risk management activities without extensive disclosures of the fair values and changes in fair values in their

entirety and the carrying amount and changes therein for assets and liabilities and firm commitments that were the subject of any hedge accounting. He believes such comparative analysis would be necessary to be used as a surrogate for identifying basis risk that would be suppressed under the proposals in the exposure draft.

Unintended consequences

- AV16 Mr Smith understands that the changes being proposed in the exposure draft are intended to provide a better link between risk management practices and accounting and to reduce complexity. However, he is concerned that in resolving the various practice issues relating to hedge accounting that have been identified, little if any consideration was given to the ensuing operational problems created by these changes and no evaluation was made to consider the interaction of these changes comprehensively. Mr Smith believes that in combination the proposed changes create operational problems and will be shown to have significant unintended consequences. Mr Smith believes that in combination these proposed changes undermine the principles in IFRS 9 relating to classification and measurement, recognition and presentation and provide a means of circumventing its requirements.

Hedge accounting

[Draft] Illustrative examples

The [draft] examples accompany, but are not part, of the [draft] IFRS.

Disclosures

- IE1 Paragraph 50 of the exposure draft proposes that specific amounts related to items designated as hedging instruments should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

	Notional amount of the hedging instrument	Carrying amount of the hedging instrument	
		Assets	Liabilities
Cash flow hedges			
Commodity price risk - Forward sales contracts	xx	xx	xx
Fair value hedges			
Interest rate risk - Interest rate swaps	xx	xx	xx
Foreign exchange risk - Foreign currency loan	xx	xx	xx

- IE2 Paragraph 51 of the exposure draft proposes that specific amounts related to items designated as hedged items should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

	Gain or loss on the hedged item presented in a separate line item in the statement of financial position		Cash flow hedge reserve
	Assets	Liabilities	
Cash flow hedges			
Commodity price risk - Forecast sales	n/a	n/a	xx
-Discontinued hedges (forecast sales)	n/a	n/a	xx
<i>continued...</i>			

<i>...continued</i>			
Fair value hedges			
Interest rate risk			
- Hedge adjustment for loan payable	-	xx	n/a
- Discontinued hedges (hedge adjustment—loan payable)	-	xx	n/a
Foreign exchange risk			
- Firm commitment	xx	xx	n/a

IE3 Paragraph 52 of the exposure draft proposes that specific amounts that have affected the statement of comprehensive income as a result of applying hedge accounting should be disclosed in a tabular format. The following example illustrates how that information might be disclosed.

Cash flow hedges ^(a)	Separate line item recognised in profit or loss as a result of a hedge of a net position	Change in the value of the hedging instrument in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)	Amount reclassified from the cash flow hedge reserve to profit or loss	Line item affected in profit or loss because of the reclassification
Commodity price risk	xx	xx	xx	Line item X	xx	Line item Y
Discontinued hedge	n/a	n/a	n/a	n/a	xx	Line item Z
(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as the proposed disclosure requirements.						

Fair value hedges	Change in the value of the hedged item recognised in other comprehensive income	Change in the value of the hedging instrument recognised in other comprehensive income	Ineffectiveness in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)
Interest rate risk	xx	xx	xx	Line item X
Foreign exchange risk	xx	xx	xx	Line item Y