



IFRS 9 Financial Instruments: Hedge accounting

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Monthly Newsletter

Phase 3 of the IFRS 9 project provides requirements for hedge accounting which aligns hedge accounting more closely with risk management, establishes a more principles-based approach to hedge accounting and addresses inconsistencies and weaknesses in IAS 39's hedge accounting model.

Qualifying criteria for hedge accounting:

All of the following criteria must be met:

- The hedging relationship consists only of eligible hedging instruments and eligible hedged items;
- At inception, there is formal documentation of the hedging relationship and the risk management objective and strategy for undertaking the hedge; identification of the hedging instrument and the hedged item; the nature of the risk being hedged; and how the entity will assess whether the relationship meets the hedge effectiveness requirements; and
- Hedge effectiveness requirements must be met, namely the existence of an economic relationship between the hedging instrument and hedged item; the value changes are not dominated by credit risk; and the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

Eligible hedging instruments

Only those from contracts with external parties that are:

- A derivative measured at fair value through profit or loss (FVTPL) may be designated as a hedging instrument, except for written options that are not designated as an offset to a purchased option; and
- A non-derivative measured at FVTPL, unless it is a financial liability where the changes in fair value due to changes in credit risk are accounted for in other comprehensive income (OCI).

Eligible hedged items

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item must be reliably measurable.

Three types of hedging relationships

Fair value hedges

- Gain or loss on hedging instrument recognised in profit or loss, or in OCI if the hedged item is an equity instrument where the entity has elected to present changes in fair value in OCI.
- Gain or loss on hedged item is recognised through profit and loss, including financial assets measured at fair value through OCI. However, for hedged items that are equity instruments where the entity has elected to present changes in fair value in OCI, the gain or loss shall remain in OCI.

- When a hedged item is an unrecognised firm commitment, the cumulative change in fair value is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss.

A hedge of a foreign currency risk of a firm commitment can be accounted for as a cash flow hedge or a fair value hedge

Cash flow hedges

- Hedge effectiveness is recognised in OCI.
- Hedge ineffectiveness is recognised in profit or loss.
- The lower of the cumulative gain or loss on the hedging instrument or fair value of the hedged item is recognised in a cash flow hedge reserve ("reserve").
- If a forecast transaction subsequently results in a non-financial asset or non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment where fair value hedging is applied, the entity shall transfer the reserve to the initial cost of the asset or liability.
- For all other forecast transactions, the amount recognised in the reserve is reclassified to profit and loss in the periods when the cash flows are expected to affect profit and loss.

Net investment in a foreign operation

- Hedge effectiveness is recognised in OCI.
- Hedge ineffectiveness is recognised in profit or loss.
- Upon disposal of the foreign operation, accumulated amounts in reserve are reclassified to profit or loss.

Fair value hedges address risks that arise from prices or rates that are fixed/known and attempts to "unlock" those variables. Cash flow hedges attempt to "lock" prices or rates that are variable

Rebalancing

When the hedge ratio hedge effectiveness test ceases to be met, the entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (rebalancing), if the risk management objective of the hedging relationship remains the same.

Discontinuation

Hedge accounting will be discontinued prospectively where:

- the hedging relationship ceases to meet the qualifying criteria after taking into account rebalancing;
- the expiration, exercise or sale of the hedging instrument.

Discontinuation will not occur as a result of a rollover or replacement if in line with the risk management objectives, or novation of hedging instruments (subject to certain criteria).