STAFF PAPER

September 2015

Project	**Insurance Contracts**		
Paper topic	Accounting consequences of mitigating risks related to insurance contracts		
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Purpose of this paper

1. This paper considers whether the IASB should enable an entity to avoid accounting mismatches that could arise when the entity:

   (a) uses the variable fee approach to account for insurance contracts that have embedded guarantees; and

   (b) hedges itself against (protects itself from) the risk from the guarantees embedded in the insurance contracts using a derivative measured at fair value through profit or loss.

Staff recommendation

2. The staff recommend that,

   (a) if an entity uses the variable fee approach to measure insurance contracts and uses a derivative measured at fair value through profit or loss to mitigate the financial market risk from the guarantee embedded in the insurance contract, the entity should be *permitted* to recognise in profit or loss the changes in the value of the guarantee embedded in an insurance contract, determined using fulfilment cash flows, only if:

(i) that risk mitigation is consistent with entity's risk management strategy;

(ii) an economic offset exists between the guarantee and the derivative, ie the values or cash flows from the embedded guarantee and the derivative generally move in opposite directions because of the risk being mitigated. An entity should not consider accounting measurement differences in assessing the economic offset; and

(iii) credit risk does not dominate the economic offset.

(b) an entity should be required to:

(i) document, before an entity starts recognising changes in the value of the guarantee in profit or loss, the entity's risk management objective and the strategy for using the derivative to mitigate the financial market risk embedded in the insurance contract.

(ii) discontinue recognising in profit or loss changes in the value of the guarantee prospectively from the date on which the economic offset no longer exists.

(iii) disclose, as part of the reconciliation of the contractual service margin, the cumulative effect of recognising changes in fulfilment cash flows of the guarantee in profit or loss instead of as an adjustment to the contractual service margin.

Layout of the paper

3. This paper provides:

(a) background that explains:

(i) the hedging activities that an entity may undertake to mitigate risks arising from insurance contracts (paragraphs 4–6);

(ii) the potential accounting mismatches that may arise when an entity undertakes those hedging activities (paragraphs 7–8);

(iii) the extent to which the existing hedge accounting requirements in IFRS 9 *Financial Instruments* enable an entity to minimise accounting mismatches (paragraphs 9–11).

(b) staff analysis that explores:

(i) possible approaches to address accounting mismatches that cannot be addressed by the hedge accounting requirements in IFRS 9 (paragraphs 12–32);

(ii) details of the application of the recommended approach, including

1. when an entity should be permitted to apply this approach (paragraphs 33–44); and
2. how to present the adjustment resulting from this approach (paragraphs 45–49).

(c) an appendix that includes relevant paragraphs from IFRS 9.

Background

Hedging activities undertaken by entities that issue insurance contracts

4. Insurance contracts promise to pay policyholders specified amounts in response to specified events. To enable the entity to meet those promises when due, an entity may hold investments. An entity could promise to pay amounts that are dependent on those investments and amounts that are not directly dependent on those investments (guarantees). Such amounts may be fixed (ie reflecting an implicit rate of return that is independent of the assets the entity holds), or variable (for example, a financial guarantee that promises a minimum return on an investment regardless of the actual performance of that investment).

5. The differences between the obligation to the policyholder and the investments that the entity holds can create risks for an entity, because such promised amounts may be independent of the amounts the entity receives from investments. Such risks include:

(a) the reinvestment risk arising from the duration mismatch, when an entity does not purchase assets that match the duration of the obligation. That may be the case because:

(i) the entity is unable to find assets that match the duration of those obligations; or

(ii) the entity receives premiums on a regular basis over the life of the contract, instead of a single premium at the beginning of the contract, and there is a risk that it may not be able to invest the premiums when received to achieve a return that matches the obligation.

(b) the financial market risk, which arises from an obligation to pay a minimum return based on financial market variables, if the return on the investments the entity holds are lower than the amounts promised to be paid.

6. As part of its risk management activities, an entity could purchase a derivative to mitigate ie protect against (or minimise) those risks. In those situations, changes in the value of the derivative will economically offset, partially or completely, changes in the value of the guarantee embedded in the insurance contract.

Potential accounting mismatches arising from hedging activities

7. Accounting mismatches arise when the extent of the economic offset between an asset and a liability is not reflected in the accounting outcome. Under the IASB's tentative decisions for insurance contracts, accounting mismatches can arise if, as part of its risk management activities, an entity protects itself from risks, for example interest rate risks arising from the guarantees embedded in the insurance contracts, using a derivative. This is because:

(a) in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9, the entity would measure the derivative at fair value and account for the changes in value of the derivatives in profit or loss.

(b) for insurance contracts that do not have direct participation features, (ie applying the IASB's general measurement model for insurance

contracts), the effects of changes in the interest rates are recognised in total comprehensive income in the period in which the change occurs. An entity may choose as an accounting policy to present the effect of changes in interest rates in either other comprehensive income (OCI) or profit or loss. Consequently:

(i) if an entity chooses to present the effect of changes in interest rates in OCI, an accounting mismatch will arise; and

(ii) if an entity chooses to present the effect of changes in interest rates in profit or loss, it avoids the accounting mismatches because both the derivative and the corresponding interest rate risk component of the insurance contract are measured through profit or loss.

(c) for insurance contracts with direct participation features (ie applying the variable fee approach), some effects of changes in financial market variables, including some effects of changes in interest rates, would result in an adjustment to the contractual service margin. This is because changes in some financial market variables affect the amount of the variable fee that the entity expects to earn from the contract. This results in accounting mismatches because the effect of changes in financial market variables on the fair value of the derivative would be recognised immediately in profit or loss, while the effect of the same change for the insurance contract would be adjusted against the contractual service margin.

8. Based on the analysis in the preceding paragraph, the staff conclude that, for contracts with no direct participation features, the entity could avoid accounting mismatches between changes in the measure of the insurance contract and changes in the fair value of the derivative. The entity could avoid accounting mismatches by choosing, as its accounting policy, to recognise changes in the interest rate component of the insurance contracts in profit or loss (see paragraph 7(b)). Recognising changes in the interest rate component of the insurance contract in profit or loss would provide a natural offset with the changes in the fair value of the derivative recognised in profit or loss. However, the avoidance of accounting mismatches though accounting policy choice would not be possible for insurance contracts with direct participation features (see paragraph 7(c)).

Minimising accounting mismatches using IFRS 9 hedge accounting

9. An entity may choose to apply the hedge accounting in IFRS 9 to avoid accounting mismatches between changes in the measure of the insurance contract and changes in the fair value of the derivative used to hedge the risks from the insurance contracts. There are two approaches applicable: fair value hedge accounting and cash flow hedge accounting.[1] Those approaches could be applicable to contracts with direct participation features and contracts without direct participation features provided the hedge accounting criteria in IFRS 9 are met. However, the staff note that, to qualify for hedge accounting, a risk component must be a separately identifiable and reliably measurable component of the insurance contract. The staff observe that such risk components embedded in the insurance contract may not meet the criteria that the component should be separately identifiable and reliably measurable. This is because the forthcoming insurance contracts Standard requires an entity to separate distinct components (without highly interrelated cash flows) and measure those components according to relevant IFRS. Consequently, risk components embedded in the insurance contracts would likely have highly interrelated cash flows.

10. Thus, the existing general model allows an entity to minimise accounting mismatches through either the accounting policy choices for OCI (see paragraphs 7–8), or the existing accounting methodologies provided in IFRS 9. However, neither of these alternatives provides a useful or consistent solution for contracts with direct participation features (accounted for under the variable fee approach).

11. The staff note that the IASB has an active project on its agenda that relates to accounting for dynamic risk management when an entity hedges its risks. This project was undertaken because the dynamic risk management of open portfolios introduces a level of complexity that becomes difficult to address when using the existing hedge accounting requirements. The staff believe that this project may be helpful in some aspects of accounting for insurance contracts measured using the variable fee approach but is unlikely to completely address the issue.

[1] Agenda Paper 2D for the June 2015 IASB meeting provides more detailed analysis of when an entity could use hedge accounting according to IFRS 9 or IAS 39 to avoid accounting mismatches.

Staff analysis

How the IASB could address accounting mismatches for contracts with direct participation features

12. As explained in paragraphs 7–8 an entity may have accounting mismatches between:

    (a) the changes in the value of the guarantee embedded in an insurance contract with direct participation features. Such changes in value adjust the contractual service margin in accordance with the variable fee approach; and

    (b) the changes in the fair value of a derivative that the entity holds to mitigate the risks resulting from this guarantee recognised in profit or loss.

13. As further explained in paragraphs 9–11, those mismatches could not be completely eliminated using existing hedge accounting requirements in IFRS 9. Consequently, the following section explores how the IASB could minimise these mismatches, as follows:

    (a) Approach 1: allow entities to account for contracts with direct participation features using the general model of accounting for insurance contracts (instead of the variable fee approach);

    (b) Approach 2: allow entities to recognise in profit or loss changes in the value of the guarantee embedded in the insurance contracts, determined using fulfilment cash flows; and

    (c) Approach 3: allow entities to recognise in profit or loss changes in the fair value of the guarantee embedded in the insurance contract.

14. The staff note that each of the approaches in paragraph 13 is intended to minimise accounting mismatches and provide a more faithful representation of the economics of the entity's risk management activities. In addition, similar to hedge accounting, each of the approaches would result in a different measurement of the insurance contract. Therefore it will decrease comparability between similar insurance contracts depending on whether the entity uses derivatives to mitigate risks arising from the contract or not. Consequently, the staff considered how to ensure that there are

appropriate boundaries around the reduced comparability, based on the criteria for the two methods available in IFRS 9 and IAS 39:

(a) hedge accounting, which has the objective of reflecting the effects of an entity's risk management activities in the financial statements. Hedge accounting is permitted when there is an economic relationship between the hedged item and the hedging instrument but is subject to prescriptive requirements for designating, tracking and analysing the hedging relationship.

(b) the fair value option, which is intended to mitigate some anomalies that result from the different measurement attributes of financial instruments. The IASB decided it would not develop prescriptive eligibility criteria for the fair value option because accounting mismatches arise in a wide variety of circumstances and, in the IASB's view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the IASB concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. However, fair value option needs to be chosen at initial recognition of such financial instruments and is irrevocable so that an entity is unable to 'cherry pick' which fair value gains and losses would be recognised immediately in profit or loss.

15. The staff discuss in paragraphs 33–44 what criteria should apply for the approach recommended in this paper.

Approach 1: account for the contracts with direct participation features using the general model

16. In Approach 1, the entity would be permitted to apply the general measurement model, rather than the variable fee approach, to insurance contracts with direct participation features.

17. Consequently, Approach 1 would allow an entity to:

(a) apply the variable fee approach to contracts with direct participation features and accept the accounting mismatches that arise if the entity uses derivatives to hedge risks related to those insurance contracts and cannot apply hedge accounting; or

(b) apply the general model to contracts with direct participation features, which would enable the entity to minimise the accounting mismatch by:

(i) recognising in profit or loss (or OCI) the effect of changes in the interest rates of those contracts (including the interest on the guarantee embedded in insurance contracts) (see paragraph 7(b)); and

(ii) applying hedge accounting whenever the qualifying criteria are met (see paragraph 9).

Approach 2: recognise changes in the value of the guarantee in profit or loss, determined using fulfilment cash flows

18. Approach 2 permits an entity to recognise changes in the guarantee embedded in the insurance contract in profit or loss instead of adjusting the contractual service margin. According to this approach the change in the value of the guarantee excluded from the contractual service margin would be measured using fulfilment cash flows according to the forthcoming insurance contracts Standard. Recognising the effect of the changes in the value of the guarantee in profit or loss would provide a partial offset to the changes in the fair value of the derivative.

19. As a consequence:

(a) the change in the value of the guarantee excluded from the contractual service margin would be measured consistently with the amounts that were recognised in the contractual service margin.

(b) the changes in the fair value of the derivative that are recognised in profit or loss may not fully offset the changes in the value of the guarantee even if the derivative provides a perfect economic offset. This is because the derivative is measured at fair value and the guarantee is measured using the fulfilment cash flow model. Thus, this approach may not fully eliminate the accounting mismatch.

Approach 3: recognise changes in the fair value of the guarantee in profit or loss

20. Approach 3 permits an entity to recognise changes in the value of the guarantee embedded in the insurance contracts in profit or loss instead of the contractual service margin (similar to Approach 2). However, according to this approach, the change in the value of the guarantee would be measured at fair value using a hypothetical derivative, ie a derivative that matches the critical terms of the guarantee embedded in the insurance contract.[2]

21. As a consequence:

    (a) the effect of the change in the measurement of the guarantee recognised in profit or loss would be the same as that of the derivative and therefore changes in the value of the guarantee will offset changes in the value of the derivative to the extent that an economic offset exists between them.

    (b) the change in the value of the guarantee recognised in profit or loss will be measured at fair value even though the value of the guarantee in the statement of financial position would be measured using fulfilment cash flows. This would create a measurement difference that will be accounted for as an adjustment recognised in the statement of financial position either to the value of the insurance contract liability or as a separate line item.

Comparison of approaches

22. The advantage of Approach 1 is that it would be the least complex to apply because:

    (a) the guarantee embedded in the insurance contract would be measured consistently and together with the other components of the insurance contract. This avoids the complexity related to the need for the entity to consider how to separate the interrelated cash flows between the guarantee and the remaining part of the insurance contract.

[2]According to IFRS 9 (paragraph B6.5.5) using a hypothetical derivative is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach. Hence, using a 'hypothetical derivative' is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedged item. Consequently, a hypothetical derivative cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item).

(b) using the general approach would avoid developing additional accounting requirements to minimise or eliminate accounting mismatches because it would use the existing mechanisms.

23. The disadvantage of Approach 1 is that an entity would apply the general model to contracts with direct participation features, which would require an entity to recognise in profit or loss not only changes in the value of the guarantee but also changes in the value of the shareholder's share. The IASB has tentatively decided that the variable fee approach appropriately reflects the economics of such contracts. Accordingly, permitting some contracts with direct participation features to be measured on a different basis may not reflect appropriately the economics of those contracts for the components unrelated to the guarantee. As a consequence, it will decrease comparability of similar contracts for which the variable fee approach should apply.

24. Consequently, the staff do not recommend this approach.

25. The advantage of Approaches 2 and 3 over Approach 1 is that they enable an entity to use the variable fee approach for direct participation contracts while still addressing the accounting mismatches caused by the recognition of changes in the value of the guarantee in the contractual service margin. This retains a greater level of consistency in the accounting for contracts with direct participation features, and ensures that the accounting exception targeted at reducing the economic risks of guarantees are restricted to the economic effect of those guarantees. This is because, under both approaches, an entity will recognise only the changes in the value of the guarantee in profit or loss, and not other value changes which would continue to be adjusted in the contractual service margin.

26. However, one consequence of Approaches 2 and 3 is the need to separate the change in the value of the guarantee from other value changes. The staff note that the cash flows relating to the guarantee are interrelated with the other cash flows of the insurance contract. As a consequence, separating the change in value of the guarantee from other changes in value may mean an arbitrary allocation of the interrelated components between the guarantee and the remaining insurance contract. In particular, the staff note that the guarantee would be unlikely to be separately identifiable and reliably measurable in the context specified for IFRS 9 (discussed further in paragraph 14(a)). However, the staff note that the IFRSs do require

separation of the interrelated cash flows even when they do not necessarily meet the separately identifiable and reliably measurable criteria. For example, IFRS 9 and IAS 32 *Financial Instruments: Presentation* require the separation of the embedded derivative and compound instruments when certain conditions are met even when such cash flows are interrelated.

27. The primary advantage of Approach 2 is that the measurement of the guarantee remains consistent with the measurement of insurance contracts using a current fulfilment cash flows. According to the forthcoming insurance contracts Standard, the measurement of the liability is not affected by changes in asset strategy, unless that asset strategy has a direct effect on the amount and timing of the entity's obligation to the policyholder, or the policyholder's obligation to the entity. This measurement approach is consistent with the view that:

    (a) the guarantee will be realised through the fulfilment of the insurance liability in a manner consistent with the other cash flows included in the measurement of the liability,

    (b) the purchase of a derivative to mitigate the exposure from insurance contracts has not changed the expected fulfilment cash flows related to those insurance contracts; and

    (c) the measurement of the insurance liability in accordance with the forthcoming insurance contracts Standard is already at a current value.

28. An additional advantage of Approach 2 is that it would be simpler to apply than Approach 3 because the measurement of the guarantee in the statement of financial position remains the same and the only difference is that the changes in the measurement of the guarantee are recognised in profit or loss rather than adjusted in the contractual service margin. Consequently, it does not require an entity to:

    (a) measure the guarantee twice: using the fulfilment cash flows to adjust the contractual service margin and using the fair value to recognise changes of the fair value in profit or loss; and

    (b) recognise measurement adjustments in the statement of financial position.

29. The disadvantage of Approach 2 is that the guarantee may be measured on a different basis from the derivative used to mitigate the guarantee, causing some accounting mismatches in profit or loss.

30. The advantage of Approach 3 is that it is more consistent with the objective of reflecting risk mitigation activities and it will better portray in profit or loss the extent to which the risk is mitigated. This is because the changes of the guarantee and the underlying derivative are measured on a consistent basis ie at fair value.

31. The disadvantage of Approach 3 is complexity because the entity would need to identify and value a notional derivative that perfectly matches the promise to the policyholder. Even though modelling the notional derivative is an established practice in hedge accounting under IAS 39 and IFRS 9, it is a complex process and some entities may not be able to use this approach in practice. In addition, Approach 3 causes a measurement difference between the value of the guarantee recognised in the statement of the financial position (which is based on fulfilment cash flows) and the fair value changes of the guarantee recognised in profit or loss. That difference would need to be recognised in the statement of financial position either as a separate line item or as part of the insurance contract liability and amortised.

32. On balance, if an entity measures the insurance contract using the variable fee approach and therefore recognises changes in the guarantee embedded in the insurance contracts in the contractual service margin, the staff recommend that the IASB should permit Approach 2. This Approach allows an entity, subject to limiting criteria explained in paragraphs 33–44, to recognise changes in the fulfilment cash flows of the guarantee in profit or loss instead of by adjusting the contractual service margin. Consequently, it would allow an entity to minimise accounting mismatches that occur when an entity hedges risks without the complexity of revaluing the guarantee using fair value (as proposed in Approach 3) or changing the measurement for the whole insurance contract (as proposed in Approach 1).

Question 1: Approach to eliminate an accounting mismatch
Does the IASB agree that, if an entity uses the variable fee approach to measure insurance contracts and uses a derivative measured at fair value through profit or loss to mitigate the financial market risk from the guarantee embedded in the insurance contract, an entity should be *permitted* to recognise in profit or loss the changes in the value of the guarantee embedded in an insurance contract, determined using fulfilment cash flows?

When an entity should be permitted to apply approaches to minimise accounting mismatches

33. In the following paragraphs, the staff assumes that the IASB agrees with the staff recommendation in Question 1 that, subject to limiting criteria explained in the following paragraphs, an entity will be permitted to recognise in profit or loss changes in the fulfilment cash flows of the guarantee embedded in an insurance contract with direct participation features.

34. The staff note that recognising changes in the value of the guarantee in profit or loss instead of adjusting the contractual service margin will result in a different measurement of the insurance contract and therefore will decrease comparability between similar insurance contracts depending on whether the contract is hedged or not. Consequently, the staff considered methods for specifying criteria for when an entity would be permitted to recognise such changes in profit or loss, as follows:

    (a) Method A: premised on reflecting the risk management activities of an entity (similar to the objective for hedge accounting); and

    (b) Method B: premised on mitigating anomalies that result from different measurement attributes (similar to the objective for the fair value option).

35. In the following paragraphs, the staff considers whether the objective of recognising changes in the value of the guarantee in profit or loss is to reflect risk management activities (as proposed in Method A), or rather to align the measurement basis (as proposed in Method B). As a consequence, the staff propose to consider which set of limiting criteria would be more helpful in achieving this objective.

Method A: Risk management approach

36. The objective of reflecting risk management activities in financial statements is consistent with that of hedge accounting. Hedge accounting is intended to represent in the financial statements the effect of an entity's risk management activities when the entity uses financial instruments to manage exposures arising from particular risks. The hedge accounting requirements:

    (a) ensure that hedge accounting is applied only to represent hedging activities that are consistent with the entity's risk management objective and strategy for undertaking that hedge; and

    (b) minimise opportunities for 'cherry picking' of the accounting outcome.

37. IFRS 9 requires that a hedging relationship qualifies for hedge accounting only if all of the following criteria are met:[3]

    (a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items;

    (b) at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge; and

    (c) the hedging relationship meets all of the following hedge effectiveness[4] requirements:

        (i) there is an economic relationship between the hedged item and the hedging instrument;

        (ii) the effect of credit risk does not dominate the value changes that result from that economic relationship; and

        (iii) 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.

[3] Please refer to the Appendix for the relevant IFRS 9 requirements.

[4] IFRS 9 defines hedge effectiveness as the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (paragraph B6.4.1).

38. It would be consistent with hedge accounting to specify similar criteria that ensure that an entity recognises the changes in the value of the guarantee in profit or loss only when doing so actually represent an entity's risk management activities. In the paragraphs below, the staff considered which of the limiting criteria from hedge accounting could be appropriate:

(a) ***hedge accounting applicable only to eligible hedged items:*** The staff does not believe including this criteria would meet the objective of the recommended proposal in this paper. This is because, as noted in paragraph 9, many entities could not use hedge accounting because their insurance contracts would fail the requirement that an eligible item should be separately identifiable and reliably measurable.

(b) ***documentation exists at inception of the hedging relationship:*** Such documentation explains the entity's risk management strategy and how hedging activity is part of that strategy. Consequently, it prevents an entity from using hedge accounting for transactions that are outside the risk management strategy. The staff believe that such a requirement is useful as a criteria for allowing an entity to recognise changes in the profit or loss instead of the contractual service margin because it would limit the use of the exception to the measurement of the insurance contracts recommended in this paper to situations when an entity mitigates the risk. Therefore the staff proposes that an entity could choose to recognise changes in the value of the guarantee in profit or loss:

(i) if the risk mitigation between the derivative and the guarantee is consistent with entity's risk management strategy; and

(ii) there is documentation of the entity's risk management strategy for using the derivative to mitigate the financial market risk embedded in the insurance contracts before an entity chooses to recognise changes in value of the guarantee in profit or loss.

(c) ***economic relationship between the hedged item and the hedging instrument:*** The requirement that there should be an economic relationship between the hedged item and the hedging instrument is intended to ensure

that hedge accounting does not result in a biased representation of risk management in the financial statements. In IFRS 9, economic relationship exist when the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is hedged risk.

However, the staff note that including the requirement that there should be an economic relationship between the guarantee (hedged item) and the derivative (hedging instrument) would imply that entities should also consider the extensive application guidance in IFRS 9 related to the economic relationship. This could potentially limit the operational measurement relief provided in this paper or may result in inappropriate analogies being drawn from the new insurance contracts Standard to IFRS 9.

Furthermore, under IFRS 9, the hedged item and the hedging instrument are measured on the same basis, ie fair value. In contrast, the value of the guarantee, under the staff recommendation in Question 1, is measured using fulfilment cash flows, and the derivative is measured at fair value.[5] Therefore, the staff propose that the IASB should specify criteria different from IFRS 9, but with a similar objective. This criterion would be that an entity should be permitted to recognise changes in the fulfilment cash flows of the guarantee in profit or loss for insurance contracts with direct participation features if an entity mitigates the financial market risk from that guarantee with a derivative. The risk from the guarantee is mitigated if an economic offset exists, such that the guarantee and the derivative have values or cash flows that generally move in opposite directions because of changes in the risk being mitigated. Also, the staff recommend that an entity should not consider accounting measurement differences in assessing the economic offset.

In addition the staff do not propose that the IASB specify a method for assessing economic offset. The staff believe that an entity should use a

[5] The staff note that according to Approach 3 described in paragraph 20, the change in the value of the guarantee would be measured using fair value and therefore this problem would not occur.

method that captures the relevant characteristics of the relationships including any sources of mismatches in economic offset and the method used for determining economic offset should be consistent with that used for the purposes of risk management.

(d) ***credit risk should not dominate the value changes:*** the IASB noted that in some circumstances, changes in value of credit risk could make the offset between values erratic even if an offsetting economic relationship exists between items. The staff believe that a similar risk could be present for derivatives that hedge exposure from insurance risk and therefore the staff believe it is a relevant criteria for recognising changes in the value of the guarantee in profit or loss.

(e) ***hedge ratio used for accounting purposes must be the same as the one resulted from economics of the hedging:*** This requirement ensures that an entity does not use hedge accounting in the improper way, for example, to avoid recognising hedge ineffectiveness. However, it has complex and extensive guidance on how to assess the ratio, especially when the hedging transaction changes. The staff believe that a similar objective is achieved by the proposal in paragraph (c) about the mitigation of risk when economic offset exists and by the proposal in paragraph (b) that the documentation related to risk management should exist before an entity chooses to recognise changes in the value of the guarantee in profit or loss instead of adjusting the contractual service margin.

39. Consistent with the hedge accounting requirements under IFRS 9, the recognition of changes in the value of the guarantee in profit or loss could be elected when the relationship meets the criteria and needs to be discontinued when they are not met. This could be for example when the derivative expires or is sold, terminated or exercised or economic offset ceases to exist (please see Appendix for more details).

Method B: Accounting mismatch approach

40. A key objective of the fair value option in IFRS 9 is to mitigate some anomalies that result from the different measurement attributes in financial instruments standards[6].

41. The fair value option has the following restrictions:

    (a) the IASB did not provide prescriptive guidance about when the fair value option could be applied, because it concluded that accounting mismatches arise in a variety of circumstances and an entity should have the opportunity to eliminate them whenever they arise.

    (b) the fair value option could be elected only at inception of the financial instrument and is irrevocable. The IASB noted that this requirement would mean that an entity would be unable to 'cherry pick' the financial result. This is because it will not be known at inception whether the fair value of the instrument will increase or decrease.

42. If this IASB were to choose an accounting mismatch approach, an entity would be permitted to recognise changes in the value of the guarantee in profit or loss. Such designation:

    (a) would be permitted only if it reduces or eliminates an accounting mismatch; and

    (b) would be irrevocable and made at inception of the insurance contract.

43. The advantages of permitting an entity to recognise changes in the value of the guarantee in profit or loss are that it would be simple for an entity to apply and interpret. It would also be similar to the existing practice under IFRS 4 *Insurance Contracts*, in which an entity may choose to unbundle some components of insurance contracts and measure them in accordance with financial instruments standards. The disadvantage of this approach is that:

    (a) it may be applicable to more circumstances than considered in this paper. Accounting mismatches could exist for contracts with direct participation features in situations other than those described in this paper ie when an

[6] Please refer to the Appendix for the relevant IFRS 9 requirements.

entity mitigates its risk through a derivative measured at fair value through profit or loss; and

(b) it may not allow an entity to reflect changes in risk management. For example, an entity may find it difficult to justify a mismatch at inception of the insurance contract, but an entity would not be able change designation after inception if a mismatch later occurs. The nature of many insurance contracts is such that the liability builds over time and risk mitigation activities may occur later in the life cycle of a contract.

44. On balance, the staff recommend that the IASB should use criteria based on the entity's risk management (Method A). This is because the staff believe that objective of this method is closer to the objective of recognising changes in the value of the guarantee in profit or loss.

Question 2: Limiting criteria

Does the IASB agree that:

a. an entity that mitigates the financial market risk from the guarantee using a derivative should be permitted to recognise in profit or loss the changes in the value of the guarantee embedded in an insurance contract, determined using fulfilment cash flows, (as recommended in Question 1) only if:

(i) that risk mitigation is consistent with the entity's risk management strategy;

(ii) an economic offset exists between the guarantee and the derivative, ie the values or cash flows from the embedded guarantee and the derivative generally move in opposite directions because of changes in the risk being mitigated. An entity should not consider accounting measurement differences in assessing the economic offset; and

iii) credit risk does not dominate the economic offset.

b. an entity should be required to:

(i) document, before an entity starts recognising changes in the value of the guarantee in profit or loss, the entity's risk management objective and the strategy for using the derivative to mitigate the financial market risk embedded in the insurance contract.

(ii) discontinue recognising in profit or loss changes in the value of the guarantee prospectively from the date on which the economic offset does not exist anymore.

Cumulative effect of recognising changes in the value of the guarantee in profit or loss

45. In question 1, the staff recommended that if an entity uses a derivative measured at fair value through profit or loss to mitigate the financial market risk from the guarantee embedded in an insurance contract with direct participation features, an entity is *permitted* to recognise the changes in the value of the guarantee embedded in an insurance contract in profit or loss, instead of as an adjustment to the contractual service margin. This accounting approach results in a different contractual service margin and therefore different carrying amount for the insurance contract liability. Consequently, it would result in lack of comparability between insurance contracts, depending on the entity's risk management strategy and whether it elects to present changes in the value of the guarantee in profit or loss.

46. The staff considered whether the cumulative effect of recognising changes in the value of the guarantee in profit or loss should be presented as a line item in the statement of comprehensive income or whether it should be disclosed.

47. The staff noted that presenting a separate line item would:

    (a) maintain consistency of measurement of the insurance contract liability by entities irrespective of whether or not they engage in risk mitigation activities and elect to present changes in the value of the guarantee in profit or loss (thus similar insurance contracts would always result in similar liability measurement);

    (b) allow users of financial statements to assess more easily the extent and effect of the entity's risk mitigation activities, including understanding that effect on future periods.

48. However, the staff note that separate presentation of the adjustment that arises in hedge accounting is not required. In particular, the staff note that the 2010 *Hedge Accounting* Exposure Draft proposed presenting the measurement adjustment from

applying fair value hedge accounting in a separate line item in the statement of financial position. The IASB proposed this presentation because it would provide useful information about the effects of hedge accounting, and would mitigate the effect of applying a mixed measurement model to the hedged item[7]. The IASB ultimately rejected this approach because of the concern expressed by stakeholders that this could increase the number of line items in the statement of financial position and therefore the financial statement would appear too cluttered[8]. Instead, the IASB required an entity to disclose in the notes the adjustment resulted from applying fair value hedge accounting.

49. Nonetheless, the staff staff believe that disclosure of this amount would enable users of financial statements to determine the contractual service margin that would have arisen if the changes in the value of the guarantee had been adjusted against the contractual service margin and therefore allow users of financial statements to compare contracts that use the measurement exception and those that do not. Therefore, the staff believe that this information should be disclosed as part of the reconciliation of the contractual service margin.

Question 3: Cumulative effect of recognising changes in the value of the guarantee in profit or loss

Does the IASB agree that an entity should disclose as part of the reconciliation of the contractual service margin, the cumulative effect of recognising changes in fulfilment cash flows of the guarantee in profit or loss instead of as an adjustment to the contractual service margin?

[7] Such mixed measurement could occur because for example when the risk component of the financial instrument is measured at fair value but the whole financial instrument is measured at amortised cost.

[8] The staff also observes that, according to IAS 1 an entity could present additional line items when such presentation is relevant to an understanding of the entity's financial position.

Appendix: Relevant paragraphs from IFRS 9

Option to designate a financial liability at fair value through profit or loss

4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:

(a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or

(b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), for example, the entity's board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).

Option to designate a financial asset or financial liability as at fair value through profit or loss (Sections 4.1 and 4.2)

B4.1.27 Subject to the conditions in paragraphs 4.1.5 and 4.2.2, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

B4.1.28 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through profit or loss, paragraph 4.2.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 4.2.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation eliminates or significantly reduces an accounting mismatch

B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value through profit or loss and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a):

(a) an entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of IFRS 4) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive income or amortised cost.

(b) an entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (for example,

those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in paragraph 6.4.1 are not met.

(c) an entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through profit or loss. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of the recognition of the gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis

B4.1.33 An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, instead of on the nature of its financial instruments.

B4.1.34 For example, an entity may use this condition to designate financial liabilities as at fair value through profit or loss if it meets the principle in paragraph 4.2.2(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued ‘structured products’ containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments.

B4.1.35 As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.

B4.1.36 Documentation of the entity’s strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 4.2.2(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity’s key management personnel—clearly demonstrates that its performance is evaluated on this basis, no further documentation is required to demonstrate compliance with paragraph 4.2.2(b).

6.4 Qualifying criteria for hedge accounting

6.4.1 A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

(a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items.

(b) at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the *hedge ratio*).

(c) the hedging relationship meets all of the following hedge effectiveness requirements:

(i) there is an economic relationship between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6);

(ii) the effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs B6.4.7–B6.4.8); and

(iii) 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. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs B6.4.9–B6.4.11).

(…)

6.5 Accounting for qualifying hedging relationships

6.5.1 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 6.4.1 (which include the entity's decision to designate the hedging relationship).

(…)

6.5.6 An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes instances when the hedging instrument expires or is sold, terminated or exercised. For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such a replacement or rollover is part of, and consistent with, the entity's documented risk management objective. Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:

(a) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as a counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties the requirement in this subparagraph is met only if each of those parties effects clearing with the same central counterparty.

(b) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally

cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).

Application guidance

Qualifying criteria for hedge accounting (Section 6.4)

Hedge effectiveness

B6.4.1 Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item.

B6.4.2 When designating a hedging relationship and on an ongoing basis, an entity shall analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates in accordance with paragraph B6.5.21 arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

B6.4.3 For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraph 6.5.6 shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Economic relationship between the hedged item and the hedging instrument

B6.4.4 The requirement that an economic relationship exists means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk. Hence, there must be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged (for example, Brent and WTI crude oil).

B6.4.5 If the underlyings are not the same but are economically related, there can be situations in which the values of the hedging instrument and the hedged item move in the same direction, for example, because the price differential between the two related underlyings changes while the underlyings themselves do not move significantly. That is still consistent with an economic relationship between the hedging instrument and the hedged item if the values of the hedging instrument and the hedged item are still expected to typically move in the opposite direction when the underlyings move.

B6.4.6 The assessment of whether an economic relationship exists includes 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 mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists.

The effect of credit risk

B6.4.7 Because the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item, hedge effectiveness is determined not only by the economic relationship between those items (ie the changes in their underlyings) but also by the effect of credit risk on the value of both the hedging instrument and the hedged item. The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is of such a magnitude that the credit risk dominates the value changes that result from the economic relationship (ie the effect of the changes in the underlyings). A level of magnitude that gives rise to dominance is one that would result in the loss (or gain) from credit risk frustrating the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes

were significant. Conversely, if during a particular period there is little change in the underlyings, the fact that even small credit risk-related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlyings does not create dominance.

B6.4.8 An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

Hedge ratio

B6.4.9 In accordance with the hedge effectiveness requirements, the hedge ratio of the hedging relationship must be 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. Hence, if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 per cent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 per cent. Similarly, if, for example, an entity hedges an exposure using a nominal amount of 40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (ie the entity must not use a hedge ratio based on a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units.

B6.4.10 However, the designation of the hedging relationship using the same hedge ratio as that resulting from the quantities of the hedged item and the hedging instrument that the entity actually uses shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would in turn create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, for the purpose of designating a hedging relationship, an entity must adjust the hedge ratio that results from the quantities of the hedged item and the hedging instrument that the entity actually uses if that is needed to avoid such an imbalance.

B6.4.11 Examples of relevant considerations in assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting are:

(a) whether the intended hedge ratio is established to avoid recognising hedge ineffectiveness for cash flow hedges, or to achieve fair value hedge adjustments for more hedged items with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and

(b) whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though that creates hedge ineffectiveness. For example, an entity enters into and designates a quantity of the hedging instrument that is not the quantity that it determined as the best hedge of the hedged item because the standard volume of the hedging instruments does not allow it to enter into that exact quantity of hedging instrument (a 'lot size issue'). An example is an entity that hedges 100 tonnes of coffee purchases with standard coffee futures contracts that have a contract size of 37,500 lbs (pounds). The entity could only use either five or six contracts (equivalent to 85.0 and 102.1 tonnes respectively) to hedge the purchase volume of 100 tonnes. In that case, the entity designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

Frequency of assessing whether the hedge effectiveness requirements are met

B6.4.12 An entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

Methods for assessing whether the hedge effectiveness requirements are met

B6.4.13 This Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or a quantitative assessment.

B6.4.14 For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6).

B6.4.15 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.

B6.4.16 Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty about the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6). In some situations a quantitative assessment might also be needed to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements (see paragraphs B6.4.9–B6.4.11). An entity can use the same or different methods for those two different purposes.

B6.4.17 If there are changes in circumstances that affect hedge effectiveness, an entity may have to change the method for assessing whether a hedging relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness, are still captured.

B6.4.18 An entity's risk management is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements. This means that the management information (or analysis) used for decision-making purposes can be used as a basis for assessing whether a hedging relationship meets the hedge effectiveness requirements.

B6.4.19 An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements, including the method or methods used. The documentation of the hedging relationship shall be updated for any changes to the methods (see paragraph B6.4.17).