STAFF PAPER

September 2015

IFRS Interpretations Committee Meeting

Project	**New items for initial consideration**		
Paper topic	IFRS 9 *Financial instruments*—transition for hedge accounting		
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Introduction

1. In May 2015, the IFRS Interpretations Committee (the 'Interpretations Committee') received a request for guidance in respect of two related issues pertaining to hedge accounting in situations in which an entity makes the transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9 *Financial Instruments*.

2. More specifically, the Interpretations Committee has been asked to consider whether an entity can:

   (a) treat a hedging relationship as a continuing hedging relationship on transition from IAS 39 to IFRS 9 if that entity changes the hedged item from an *entire* non-financial item to a *component* of the non-financial item in order to align the accounting with its risk management objective (Issue 1); and

   (b) continue with its original hedge designation of the *entire* non-financial item under IFRS 9 (Issue 2).

3. We performed outreach with the International Forum of Accounting Standard Setters (IFASS), securities regulators and the global IFRS technical teams of the large accounting firms in relation to the issues described in paragraph 2 in order to find out:

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(a) how the transition requirements of IFRS 9 would be applied; and

(b) whether diversity in practice is expected to develop, as well as how prevalent such possible diversity is envisaged to be, upon mandatory application of IFRS 9.

4. The results of this outreach are included in this paper. The submission received is reproduced in full in **Appendix C** of this paper.

Purpose of the paper

5. The purpose of this paper is to:

(a) provide a description of the issue raised in the submission;

(b) provide a summary of the outreach results on the issue raised;

(c) present a staff analysis to the Interpretations Committee on the accounting;

(d) present an assessment of the issue against the Interpretations Committee's agenda criteria; and

(e) present a staff recommendation.

Submission

6. The submission considers a hedging relationship whereby an entity hedges a specific (non-foreign exchange rate) component of a non-financial item in line with its risk management objective. Under IAS 39, specifically paragraph 82, such a component would not be an eligible hedged item hence an entity would designate the non-financial item in its entirety for hedge accounting purposes. In contrast, paragraph 6.3.7 of IFRS 9 permits an entity to designate a qualifying component of a non-financial item as the hedged item.

7. The submission then considers two issues that arise when an entity makes the transition to IFRS 9 as outlined in paragraph 2(a)–2(b). With respect to these two issues, the submitter has identified the views outlined in paragraphs 8–9.

8. Issue 1**:**

(a) View A—the hedging relationship can be treated as a continuing hedging relationship on transition to IFRS 9.

On transition, the entity needs to change the way in which it describes the hedged item in the hedge documentation to reflect its risk management objective of hedging only the specific component of a non-financial item. However, this does not reflect the cessation of one hedging relationship and the creation of a new one, because the risk management objective is unchanged.

(b) View B—the existing hedging relationship under IAS 39 should be discontinued.

Allowing a change to the hedged item on transition to IFRS 9 without treating it as the termination of the original hedging relationship and the inception of a new hedging relationship would be equivalent to allowing retrospective application of IFRS 9, which is not permitted except in limited circumstances. Accordingly, changing the description of how the hedged item is designated on transition to IFRS 9 cannot be regarded as a continuation of the original hedging relationship.

9. Issue 2:

(a) View A—an entity cannot continue with the original hedge designation on transition to IFRS 9.

Under IFRS 9, the objective of hedge accounting is to represent an entity's risk management activities in the financial statements. Consequently, the entity cannot continue with the previous designation under IAS 39 of the *entire* non-financial item. In order to avail hedge accounting under IFRS 9, the entity has to designate a *component* of the non-financial item in order to align the accounting with its risk management objective.

(b) View B—the entity can continue with the original hedge designation on transition to IFRS 9.

Discontinuing the original hedging relationship and redesignating a new hedging relationship, including the redesignation of the hedging instrument, would create artificial hedge ineffectiveness. This is because it is likely that the hedging instrument has a non-zero fair value, because the underlying items to which it is indexed would have changed between the dates of the original and the new hedge designation. The hedge ineffectiveness arising from this process was not present in the original hedging relationship and would not reflect the entity's risk management activity, which has not changed since the inception of the original hedge.

Summary of outreach activities

10. In order to gather information about the issue described in the submission, we sent requests to members of the IFASS, securities regulators and the global IFRS technical teams of the international networks of the large accounting firms. IFRS 9 is not yet mandatory and so we expect experience of this issue to be limited. We therefore asked respondents about their understanding of the requirements of IFRS 9 in relation to the issues outlined in the submission. In particular, we asked national standard-setters, the large accounting firms and regulators the following questions:

    (a) **Question 1:** Can the hedging relationship relating to a non-financial item be treated as a continuing hedging relationship on transition from IAS 39 to IFRS 9 despite the change in the hedged item?

    (b) **Question 2:** If the hedging relationship *cannot* be treated as a continuing hedging relationship under IFRS 9, can an entity continue with its original hedge designation of the entire non-financial item under IFRS 9?

    (c) **Question 3:** Will diversity in practice develop and are the issues described in paragraphs 8–9 expected to be prevalent upon mandatory application of IFRS 9?

Responses from national standard-setters, large accounting firms and regulators

11. We received responses from:

    (a) eight national standard-setters;

    (b) five large accounting firms; and

(c) two securities regulators.

12. We summarise the results of the outreach in the following paragraphs. The views expressed are informal opinions from national standard-setters, large accounting firms and securities regulators. They do not reflect the formal views of those organisations.

Responses received from national standard-setters

13. The geographical breakdown for the responses received from national standard-setters is as follows:

Geographical region	Number of respondents
Asia	3
Europe	4
Oceania	1
Total respondents	8

14. With respect to Question 1, national standard-setters expressed mixed views as to whether the existing hedging relationships under IAS 39 should be discontinued upon transition to IFRS 9. Some national standard-setters commented that the hedging relationship should continue if it is aligned with the entity's risk management strategy and objective (View A in paragraph 8(a)). Other national standard-setters commented that the hedging relationship should be discontinued, because changing the designation from the entire non-financial item to a component of the non-financial item represents a change in an entity's risk management strategy (View B in paragraph 8(b)).

15. With respect to Question 2, national standard-setters also expressed mixed views regarding whether an entity could continue with its original hedge designation of the entire non-financial item under IFRS 9 without providing detailed comments.

16. With respect to Question 3, national standard-setters indicated that diversity in practice could develop as a result of different interpretations of the transition provisions of IFRS 9. They commented that the references in the main text of IFRS 9 require the discontinuance of an existing hedging relationship and the commencement of a new hedging relationship when a component of a non-financial item is designated as the hedged item on transition to IFRS 9. In

contrast, these national standard-setters are of the view that the guidance in the Basis for Conclusions accompanying IFRS 9 suggests that as the hedged item remains unchanged in line with the original risk management objective and thus only the description for hedge documentation purposes would need to be changed.

Responses received from large accounting firms

17. With respect to Question 1, the majority of the large accounting firms commented that existing hedging relationships under IAS 39 should be discontinued (ie View B in paragraph 8(b)) on transition to IFRS 9. Some large accounting firms expressed mixed views and stated that both View A and View B may be acceptable interpretations of the transition requirements of IFRS 9 (see paragraph 8).

18. With respect to Question 2, the majority of the large accounting firms stated that an entity can continue with its original hedge designation of the entire non-financial item under IFRS 9, on the basis that IFRS 9 permitted hedge designations that were not an exact reflection of actual risk management.

19. For Question 3, the majority of the large accounting firms stated that it is possible that diversity in practice may develop, but that such diversity may not be significantly widespread. One large accounting firm stated that, in its experience, entities that have *already* early adopted IFRS 9 have not redesignated its hedging relationships on transition to IFRS 9. Another large accounting firm commented that if existing hedging relationships were not allowed to be treated as continuous on transition to IFRS 9, then many of the potential benefits arising from closer alignment to an entity's risk management practices would not be achieved.

Response received from securities regulators

20. With respect to Question 1, securities regulators were of the view that hedging relationships can be treated as a continuing hedging relationship on transition to IFRS 9.

21. Securities regulators did not provide any explicit comments regarding Question 2**.**

22. With respect to Question 3, one securities regulator stated that it was possible that diversity in practice could develop, although, in their view, the likelihood of this occurring was not high.

Staff analysis

Issue 1: Can an existing hedging relationship under IAS 39 be treated as a continuing hedging relationship on transition to IFRS 9 if an entity changes the hedge designation?

23. In respect of Issue 1, on transition to IFRS 9 an entity changes the designation of the hedged item in a hedging relationship from an *entire* non-financial item (as permitted by IAS 39) to a *component* of the non-financial item (as permitted by IFRS 9) to align with its risk management objective.

24. Paragraph 88 of IAS 39 outlines the qualifying criteria for hedge accounting and paragraphs 91(b) and 101(b) note that a hedging relationship has to be discontinued if it no longer meets the criteria for hedge accounting in paragraph 88.

25. Such a change in hedge designation requires a change in the hedge documentation (to reflect the change in the hedged risk attributable to the hedged item) as well as the measurement of hedge effectiveness arising from the change in the hedged risk.

26. Since the qualifying criteria for hedge accounting in IAS 39 requires the hedged risk to be documented at inception of the hedge, a change in designation requires the entity to discontinue the original hedge designation and start a new designation on the date of the change.

27. The staff note that to treat this hedging relationship as a continuing hedging relationship implies that the change in designation occurred at the inception of the hedge instead of on the date of transition. In addition, since the measurement of hedge effectiveness or ineffectiveness also follows the hedge designation, it would also be necessary to consider a different measurement of the hedged risk for the purposes of effectiveness measurement from inception. This is tantamount to the

retrospective designation of a hedging relationship that is not permitted under IAS 39 (see Section F3.8 of the Implementation Guidance of IAS 39).

28. Paragraph 7.2.22 of IFRS 9 states [emphasis added]:

> Except as provided in paragraph 7.2.26, an entity shall apply the hedge accounting requirements of this Standard **prospectively**.

29. Consequently, the retrospective designation of a hedging relationship is also not permitted under IFRS 9.

30. As an exception, paragraph 7.2.26 of IFRS 9 outlines three specific circumstances under which the retrospective application of the hedge accounting requirements of IFRS 9 can be applied on transition. The staff note that these exceptions relate specifically to the time value of options, the forward element of forward contracts and specific scenarios in which a hedging instrument does not expire or terminate if, as a consequence or introduction of laws and regulations, the clearing counterparties to that hedging instrument are replaced.

31. Accordingly, to the extent that the exceptions outlined in paragraph 7.2.26 of IFRS 9 do not apply, on transition an entity cannot apply retrospectively the hedge accounting requirements of IFRS 9.

32. Furthermore, paragraph 7.2.24 of IFRS 9 permits a hedging relationship to continue if it would have also qualified as a hedging relationship under IAS 39; the designation of a component of a non-financial item is *prohibited* under IAS 39 and therefore would not meet the requirements in paragraph 7.2.24 of IFRS 9.

33. Based on the analysis outlined in paragraphs 23–32 regarding Issue 1, the staff agree with View B outlined in paragraph 8(b) of this paper that the existing hedging relationship under IAS 39 should be discontinued on transition to IFRS 9.

Issue 2: Can an entity continue with its original hedge designation of an entire non-financial item on transition to IFRS 9?

34. Paragraph 7.2.23 of IFRS 9 states that:

> To apply hedge accounting from the date of initial application of the hedge accounting requirements of this Standard, all qualifying criteria must be met as at that date.

35. Paragraph 7.2.24 of IFRS 9 goes on to state that:

> Hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the criteria of this Standard (see paragraph 6.4.1), after taking into account any rebalancing of the hedging relationship on transition (see paragraph 7.2.25(b), shall be regarded as continuing hedging relationships.

36. Consequently, for a hedging relationship to continue on transition to IFRS 9 it would have also needed to qualify as a hedging relationship under IAS 39 as well as the hedge accounting criteria in IFRS 9, as outlined in paragraph 6.4.1 of IFRS 9.

37. Accordingly, in addressing Issue 2 as outlined in paragraph 9, we need to evaluate whether the hedge accounting criteria in IFRS 9 would be met for the hedging relationship under consideration. The specific question raised by the submitter is whether a designation that is different from an entity's risk management objective would meet the qualifying criteria in IFRS 9 for hedge accounting (it is assumed that other qualifying criteria set out in paragraph 6.4.1 of IFRS 9 are met.)

38. Paragraph BC6.96 of IFRS 9 refers to these situations as proxy hedging. It states that proxy hedging is a colloquial reference to the use of designations of hedging relationships that do not exactly represent an entity's actual risk management.

39. Paragraph BC6.97 of IFRS 9 acknowledges that proxy hedging is possible for hedging relationships and states that:

> The IASB noted that its rationale for not including a scope exception from the IFRS 9 hedge accounting requirements for 'macro cash flow hedge accounting' reflected that designations of hedging relationships that represent 'proxy hedging' are possible. The IASB was aware that many

> financial institutions use 'proxy hedging' as described in paragraph BC6.96.

40. Paragraph BC6.100 of IFRS 9 outlines the challenges in achieving an exact reflection of an entity's risk management objective when designating hedging relationships and notes that under the hedge accounting model of IFRS 9 it is not always possible to reflect risk management exactly. Paragraph BC6.100 states:

> The IASB also noted that designations of hedging relationships that reflect 'proxy hedging' were not unique to hedging of interest rate risk by banks in, for example, a 'macro' context. Despite the objective of the project to represent, in the financial statements, the effect of an entity's risk management activities, the IASB considered that this would in many situations not be possible as a simple, exact '1:1 copy' of the actual risk management perspective. In the IASB's view this was already apparent from other aspects of the hedge accounting model of IFRS 9 ...

41. The staff note that even though hedge accounting designations that do not exactly reflect risk management is permissible in certain instances, there should be still be a linkage to risk management. This is supported by paragraph BC6.98 of IFRS 9, which states that:

> The IASB considered that in those situations the designation for hedge accounting purposes was inevitably not the same as the entity's risk management view of its hedging, but that the designation reflects risk management in that it relates to the same type of risk that was being managed and the instruments used for that purpose. For example, like IAS 39, IFRS 9 also does not allow cash flow hedges of interest rate risk to be designated on a net position basis but entities must instead designate gross positions. This requires so called 'proxy hedging' because the designation for hedge accounting purposes is on a gross position basis even though risk management typically manages on a net position basis. This 'proxy

hedging' also includes approaches that for risk management purposes determine the net interest rate risk position on the basis of fixed-rate items. A cash flow hedge designation can still reflect those approaches in that the net interest rate risk position can be viewed as having a dual character: the hedges bridge, for example, the economic mismatch between fixed-rate assets and variable-rate funding (existing variable-rate funding as well as funding to be obtained in the future to continue to fund the assets as existing funding matures). Such an economic mismatch can be regarded as fair value interest rate risk when looking at the assets and as cash flow interest rate risk when looking at the funding. The net position hedging combines the two aspects because both affect the net interest margin. Hence, both fair value and cash flow interest rate risk are inherent aspects of the hedged exposure. However, hedge accounting requires the designation of the hedging relationship as either a fair value hedge or as a cash flow hedge. The IASB noted that in that sense, even if a fair value hedge designation better represented a risk management perspective that considers the fixed-rate assets as the primary or leading aspect, a cash flow hedge designation would still reflect the risk management because of the dual character of the risk position. Consequently, the IASB regarded 'proxy hedging' as an eligible way of designating the hedged item under IFRS 9 as long as that still reflected risk management, which was the case in this situation.

42. Based on the above, the staff note that notwithstanding the objective to represent, in the financial statements, the effect of an entity's risk management activities, IFRS 9 contemplates situations in which it will not be possible to replicate, as a simple, exact '1:1 copy', the actual risk management perspective. Consequently, IFRS 9, in the staff's view, allows for designations for hedge accounting purposes that are not exact replicas of actual risk management, as long as the designation

relates to the same type of risk that is being managed and the same type of instruments that are being used for that purpose.

43. Based on the analysis in paragraphs 34–42 regarding Issue 2, the staff agree with View B outlined in paragraph 9(b) that an entity can continue with the original hedge designation of an entire non-financial item on transition to IFRS 9, assuming that the designation reflects risk management.

Assessment against agenda criteria

44. The staff's assessment of the agenda criteria is as follows:[1]

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	Entities are not required to apply IFRS 9 until annual periods beginning on or after 1 January 2018, although early adoption is permitted. On the basis of the results of the outreach, it is possible that the issue could be widespread.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No**—we think the wording in the existing Standard provides a sufficient basis for determining the appropriate treatment.
that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*.	Not applicable.

[1] These criteria can be found in the IFRS Foundation *Due Process Handbook* as indicated in the paragraphs above.

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.
The solution developed should be effective for a reasonable time period (paragraph 5.21).	Not applicable.

Staff recommendation

45. On the basis of our assessment of the Interpretations Committee's agenda criteria, the feedback received from the outreach activities and also on our analysis in this paper, we believe that the Interpretations Committee should not take the issue analysed in this paper onto its agenda. We have included proposed wording for a tentative agenda decision in Appendix A of this paper.

Questions for the Interpretations Committee

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the analysis and conclusions reached? 2. If the Interpretations Committee agrees with the staff recommendation, does it agree with the proposed wording of the tentative agenda decision as set out in Appendix A?

Appendix A

Proposed wording for final agenda decision

A1 The proposed wording for the final agenda decision is presented below (deleted text is struck through and new text is underlined).

IFRS 9 *Financial Instruments*—Transition for hedge accounting

The IFRS Interpretations Committee (the 'Interpretations Committee') received a request for guidance in respect of two related issues pertaining to hedge designation and hedge accounting in situations in which an entity makes the transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9 *Financial Instruments*.

More specifically, the Interpretations Committee has been asked to consider whether an entity can:

(a) treat a hedging relationship as a continuing hedging relationship on transition from IAS 39 to IFRS 9 if that entity changes the hedged item in a hedging relationship from an entire non-financial item (as permitted by IAS 39) to a component of the non-financial item (as permitted by IFRS 9) to align the hedge with the entity's risk management objective (Issue 1); and

(b) continue with its original hedge designation of the entire non-financial item under IFRS 9 (Issue 2).

The Interpretations Committee noted that, in relation to Issue 1, a change in the hedged item on transition to IFRS 9 is equivalent to the retrospective application of the hedge accounting requirements in IFRS 9, which is prohibited by paragraph 7.2.22 of IFRS 9 except in those circumstances outlined in paragraph 7.2.26 of IFRS 9. Consequently, the Interpretations Committee noted that unless the existing hedging relationship under IAS 39 meets the exceptions outlined in paragraph 7.2.26 of IFRS 9 it cannot be considered as a continuing hedging relationship on transition to IFRS 9.

In relation to Issue 2, the Interpretations Committee observed that paragraphs BC6.97, BC6.98 and BC6.100 of IFRS 9 supported the use of hedge designations that are not exact copies of actual risk management but nevertheless reflected risk management in that they relate to the same type of risk that is being managed and the same type of instruments that are being used for that purpose. As a result, the Interpretations Committee noted that hedge designations of an entire non-financial item could continue on transition to IFRS 9.

In the light of existing IFRS requirements, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore [decided] not to add this issue to its agenda.

Appendix B
Standard References

B1 Paragraph 82 of IAS 39 states:

> If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

B2 Paragraph 88 of IAS 39 states:

> A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all the following conditions are met.
>
> (a) At the inception of the hedge 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 or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
>
> (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105–AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
>
> (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and

must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

B3 Paragraph 91(b) of IAS 39 states:

> (b)the hedge no longer meets the criteria for hedge accounting in paragraph 88;

B4 Paragraph 101(b) of IAS 39 states:

> The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.

B5 Section F.3.8 of the Implementation Guidance of IAS 39 states:

> F.3.8 Retrospective designation of hedges
>
> **Does IAS 39 permit an entity to designate hedge relationships retrospectively?**
>
> No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IAS 39.88 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged

item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

B6 Paragraph 6.3.7 of IFS 9 states:

> An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:
>
> (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable (see paragraphs B6.3.8–B6.3.15). Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).
>
> (b) one or more selected contractual cash flows.
>
> (c) components of a nominal amount, ie a specified part of the amount of an item (see paragraphs B6.3.16–B6.3.20).

B7 Paragraph 6.4.1 of IFS 9 states:

> 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).

B8 Paragraph 7.2.26 of IFRS 9 states:

As an exception to prospective application of the hedge accounting requirements of this Standard, an entity:

(a) shall apply the accounting for the time value of options in accordance with paragraph 6.5.15 retrospectively if, in accordance with IAS 39, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

(b) may apply the accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 retrospectively if, in accordance with IAS 39, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (ie on transition this election is not available on a hedging-relationship-by-hedging-relationship basis). The accounting for foreign currency basis spreads (see paragraph 6.5.16) may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. …

(c) shall apply retrospectively the requirement of paragraph 6.5.6 that there is not an expiration or termination of the hedging instrument if:

(i) 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; and

(ii) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty.

Appendix C
Submission

C1 We received the following request. We have deleted details that would identify the submitter of this request.

Potential Interpretations Committee Agenda Item Request

This letter describes an issue that we believe should be added to the agenda of the IFRS Interpretations Committee. We have included a summary of the issue, alternative views and an assessment of the issue against the Interpretations Committee criteria.

The issue

IFRS 9 Financial Instruments introduced hedge accounting requirements with the objective of representing an entity's risk management activities in the financial statements. One of the major changes made by IFRS 9 is allowing an entity to designate a qualifying component of a non- financial item as a hedged item. IAS 39 *Financial Instruments: Recognition and Measurement* does not permit the designation of a component of a non-financial item, unless the component is a foreign currency risk (IAS 39.82). However, IFRS 9 does not limit designating a component of a non-financial item to a foreign exchange currency risk (IFRS 9.6.3.7).

An entity that economically hedges a component (other than foreign exchange risk) of a non-financial item based on its risk management objective could, under IAS 39, only designate the entire item as a hedged item for the purposes of hedge accounting. Therefore, the ability to designate a component of a non-financial item under IFRS 9 is important to aligning hedge accounting with the underlying economics when an entity hedges a component of a non-financial item as part of its risk management activities. However, this change raises questions about hedge designation and accounting when an entity transitions to IFRS 9.

On transition, the entity would need to designate the component of the non-financial item as the hedged item for accounting purposes to align its hedge accounting with its risk management activities. This would involve changing the hedged item as designated in the hedge documentation prepared in accordance with IAS 39 – even though its risk management objective remains unchanged. On transition to IFRS 9, if an entity changes the hedged item in a hedging relationship from an entire non-financial item (permitted by

IAS 39) to a component of the non-financial item (permitted by IFRS 9) to align the hedge with the risk management objective of the entity, can the entity treat the hedging relationship as a continuing hedging relationship under IFRS 9.7.2.24? *(Question 1)*

If the hedging relationship is terminated and replaced by a new hedging relationship on transition to IFRS 9, then the hedging instrument will most likely be off-market at the beginning of the new hedging relationship. This in turn would likely lead to profit or loss volatility in subsequent periods because of the ineffectiveness caused by the off-market nature of the instrument. Reflecting this ineffectiveness in profit or loss would not represent an entity's risk management activity, which remains unchanged since the hedge designation under IAS 39.

Therefore, if an entity cannot regard the hedge relationship as a continuing one (under Question 1), can it continue with its original hedge designation of the entire non-financial item as a hedged item under IFRS 9? *(Question 2)*

See **Appendix A** for a detailed analysis of these questions.

Current practice

There is currently no established practice because IFRS 9 is not yet in effect. However, we believe that the issue is likely to establish itself in practice as entities begin to apply the new standard. We believe that the Interpretations Committee should consider these questions because the potential outcomes could have a significant effect on an entity's financial statements, and consistency in this area is desirable.

Assessment against agenda criteria

(a) *Is the issue widespread and has, or is expected to have, a material effect on those affected?* Yes. Hedging of a specific component of a non-financial item in accordance with an entity's risk management policies and objectives and designating the entire non-financial item as a hedged item for the purposes of hedge accounting under IAS 39 is common. Therefore, the issue will affect the reporting of many entities on transition to IFRS 9 and in subsequent periods.

Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods? Yes. Application of the different views of this issue could result in significantly different accounting outcomes. Clarifying an acceptable approach would eliminate this possibility.

(b) *Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?* Yes. The issue relates to the interpretation of specific aspects of IFRS 9's hedge accounting requirements and therefore we believe that it can be resolved within the confines of IFRSs and the Conceptual Framework.

(c) *Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?* Yes. Many entities' reporting will be affected because the issue relates to hedging a component of a non-financial item. However, we believe that the issue can be resolved efficiently within the confines of IFRS 9.

(d) *Will the solution developed by the Interpretations Committee be effective for a reasonable time period?* The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified. Yes. Although the issue relates to transition to IFRS 9, it affects not only the period of initial application of IFRS 9 but also subsequent periods. The issue is not currently in the scope of any of the Board's current or planned project

Appendix A

Consider the following fact pattern:

An entity hedges a specific (non-foreign exchange rate) component of a non-financial item as per its risk management objective. However, because IAS 39 does not permit the designation of a non-foreign exchange rate component of a non-financial item, the entity designates the entire non- financial item – instead of the specific component – as a hedged item for accounting purposes under IAS 39. Subsequently, the entity transitions to IFRS 9.

The issue

Question 1: On transition to IFRS 9, if an entity changes the hedged item in a hedging relationship from an entire non-financial item (permitted by IAS 39) to a component of the non-financial item (permitted by IFRS 9) to align the hedge with the entity's risk management objective, can the entity treat the hedging relationship as a continuing hedging relationship under IFRS 9.7.2.24?

View 1: Yes, the hedging relationship can be treated as a continuing hedging relationship on transition to IFRS 9.

When the entity transitions to IFRS 9, it applies the guidance in IFRS 9.7.2.22–7.2.25 related to hedge accounting. Reading this guidance, along with paragraphs BC7.44–BC7.47 of the basis for conclusions, it appears that the intention was to permit qualifying hedging relationships to be moved from the IAS 39 model to the IFRS 9 model. This is also consistent with the principle in IFRS 9.BCE.200, which suggests that a hedging relationship is not discontinued if a hedged item and a hedging instrument exist and the original risk management objective is unaltered.

On transition, the entity needs to change the way that it describes the hedged item in the hedge documentation to reflect its risk management objective of hedging only the specific component of a non-financial item. However, this does not reflect the cessation of one hedging relationship and the creation of a new one – because the risk management objective is entirely unchanged. Also, there is no use of hindsight.

View 2: No, the existing hedging relationship under IAS 39 should be discontinued.

The guidance noted in View 1, in IFRS 9.7.2.22–7.2.25 and BC7.44–BC7.47, merely explains the IASB's logic regarding the dedesignation of old relationships under IAS 39 and their replacement by new relationships that are better aligned with the requirements of IFRS 9.

Further, IFRS 9.BCE.200 merely refers to the ongoing application of rebalancing under the IFRS 9 model following adoption and does not relate to situations in which the hedged item identified in the hedge documentation is changed.

Allowing a change to the hedged item on transition to IFRS 9 without treating it as the termination of the original hedging relationship and the inception of a new hedging relationship would be equivalent to allowing retrospective application of IFRS 9, which is not permitted (except for 'costs of hedging' as described in 7.2.26). Accordingly, changing the description of how the hedged item is designated on transition to IFRS 9 cannot be regarded as a continuation of the original hedging relationship.

Question 2: If the answer to Question 1 is no, then can an entity continue with its original hedge designation of the entire non-financial item as a hedged item under IFRS 9?

View 1: No, the entity cannot continue with the original hedge designation under IFRS 9.

IFRS 9.6.1.1 states that the objective of hedge accounting is to represent an entity's risk management activities in the financial statements. Therefore, when the entity transitions to IFRS 9 it is only appropriate for the entity to dedesignate the hedge designation of the entire non-financial item and to redesignate only the component of the non-financial item that it has hedged as part of its actual risk management activities.

View 2: Yes, the entity can continue with the original hedge designation under IFRS 9.

IFRS 9 (as discussed in BC6.96–BC6.100) permits the use of 'proxy hedging' in situations where an exact '1:1 copy' of the actual risk management perspective is not possible due to limitations of the hedge accounting guidance under IFRS 9.

If the original hedging relationship needs to be dedesignated, then the hedging instrument in the original hedging relationship would be redesignated at its fair value on the date of the new designation. This instrument would probably be off-market – meaning that it would have a non- zero fair value – because the underlyings to which it is indexed would have changed between the dates of the original and the new hedge designation. An instrument that is off-market will not generally give rise to fair value changes that perfectly offset those of the hedged item during the period of the hedging relationship. Therefore, redesignating it as a hedging instrument would create artificial hedge ineffectiveness that was not present in the original hedging relationship and would not be reflective of the entity's risk management activity, which has not changed since the inception of the original hedge. This represents a limitation of the hedge accounting guidance in IFRS 9. Therefore, even though it does not represent an exact '1:1 copy' of the entity's risk management perspective, continuing the original hedge designation of the entire non-financial item should be permissible.

Appendix B: Requirements in IAS 39 and IFRS 9

IAS 39.82

If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

IFRS 9.6.3.7

An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

(a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable (see paragraphs B6.3.8–B6.3.15). Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).

(b) one or more selected contractual cash flows.

(c) components of a nominal amount, i.e. a specified part of the amount of an item (see paragraphs B6.3.16–B6.3.20).

IFRS 9.7.2.22

Except as provided in paragraph 7.2.26, an entity shall apply the hedge accounting requirements of this Standard prospectively.

IFRS 9.7.2.24

Hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the criteria of this Standard (see paragraph 6.4.1), after taking into account any rebalancing of the hedging relationship *on transition (see paragraph 7.2.25(b)), shall be regarded as continuing hedging relationships.*

IFRS 9.7.2.25

On initial application of the hedge accounting requirements of this Standard, an entity:

(a) may start to apply those requirements from the same point in time as it ceases to apply the hedge accounting requirements of IAS 39; and

(b) shall consider the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from such a rebalancing shall be recognised in profit or loss.

IFRS 9.BC7.44

The IASB rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would have required 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 co-exist for a potentially long period. This would make it difficult for users to compare the financial statements of different entities. Comparability would also be difficult when entities apply the old and the new model in the same financial statements, as well as for information provided over time.

IFRS 9.BC7.45

Consequently, the IASB proposed prospective application of the proposed hedge accounting requirements for all hedging relationships, while ensuring that 'qualifying' hedging relationships could be moved from the existing model to the proposed model on the adoption date.

IFRS 9.BC7.46

Almost all respondents agreed with prospective application of the new hedge accounting requirements to all hedging relationships because that would avoid the administrative *burden of maintaining both the IAS 39 model and the new hedge accounting model and would also mitigate the risk of hindsight arising from retrospective designation of hedging relationships. Respondents also noted that prospective application is consistent with hedge accounting transition requirements that were used for previous amendments to IAS 39.*

IFRS 9.BC7.47

The IASB also received feedback that suggested a general provision, whereby hedging relationships designated under IAS 39 would be automatically 'grandfathered', ie entities could continue applying the requirements of IAS 39 to these hedging relationships. However, consistent with its proposal in the 2010 Hedge Accounting Exposure Draft (see paragraph BC7.44), the IASB decided not to allow the grandfathering of the application of IAS 39. Instead, the IASB retained its original decision that the new hedge accounting requirements are applied to hedging relationships that qualify for hedge accounting in accordance with IAS 39 and this Standard and that those are treated as continuing hedging relationships.

IFRS 9.BCE.200

In addition, IAS 39 did not allow adjustments in the hedging relationship subsequent to designation, except for rollover strategies documented at contract inception, to be treated as adjustments to a continuing hedging relationship. Consequently, IAS 39 treated such adjustments to an existing hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The IASB, in its deliberations, noted that this was inconsistent with risk management practices and did not represent the economic phenomenon in practice. There are instances when, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. The IASB concluded that, in situations in which the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. This will have the effect of enabling changes in risk management to be properly portrayed in hedge accounting.