

STAFF PAPER

March 2018

IFRS Interpretations Committee Meeting

Project	IFRS 9 and IAS 39 — Application of the highly probable requirement when a specific derivative is designated as a hedging instrument		
Paper topic	Initial consideration		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® Update. The approval of a final Interpretation by the Board is reported in IASB® Update.

Introduction

1. The IFRS Interpretation Committee (Committee) received a request regarding the requirement in IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* that a forecast transaction must be ‘highly probable’ in order to qualify as a hedged item in a cash flow hedge relationship. The request asked how an entity applies that requirement when the notional amount of the derivative designated as a hedging instrument (‘Load Following Swap’) varies depending on the outcome of the hedged item. In addition, the request asked whether, when assessing or measuring hedge effectiveness, the hedged item must be fixed (in volume terms) at the inception of the hedging relationship, and whether the answers to these questions depend on whether the entity applies IAS 39 or IFRS 9.
2. The objective of this paper is to:
 - (a) provide the Committee with a summary of the matter;
 - (b) present our analysis; and

- (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

- 3. This paper includes:
 - (a) background information;
 - (b) staff analysis and assessment against the Committee's agenda criteria; and
 - (c) staff recommendation.
- 4. There are two appendices to this paper:
 - (a) Appendix A — Proposed wording of the tentative agenda decision; and
 - (b) Appendix B — Submission.

Background information

- 5. The submitter describes a Load Following Swap as a derivative with a variable notional, which is typically a function of actual hedged volumes. Although the terms of such instruments can vary, the submission assumes that the contract is a derivative financial instrument in the scope of IAS 39 or IFRS 9 and, as such, is an eligible hedging instrument.
- 6. The submitter describes a fact pattern in which a solar energy farm sells the energy it produces on the national energy market at the spot rate. Separately, the entity enters into a Load Following Swap with a third party to exchange variable market prices for electricity into fixed prices based on the actual volume of electricity produced by a solar energy farm. The entity designates the Load Following Swap as a hedging instrument in a cash flow hedge relationship, while designating its forecast sales of energy as the hedged items. According to the submitter, the nature of the Load Following Swap is such that the swap's notional amount will be based on the actual quantity of electricity that the entity sells on the national energy market.

7. Applying paragraph 88(c) of IAS 39, one of the criteria for a hedging relationship to qualify for hedge accounting is that, for a cash flow hedge, a forecast transaction that is the subject of the hedge must be highly probable. Applying paragraph 88(b) of IAS 39, another criterion for a hedging relationship to qualify for hedge accounting is that the hedge is expected to be highly effective 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.
8. Similarly, applying paragraph 6.3.3 of IFRS 9, a forecast transaction must be highly probably in order for it to qualify as a hedged item.
9. For cash flow hedges, applying both IAS 39 and IFRS 9, hedge ineffectiveness is measured and recognised in profit or loss.
10. The submitter noted that the following questions have arisen and are causing diverging views in practice when Load Following Swaps are designated as hedging instruments in a hedge accounting relationship:
 - (a) How should the ‘highly probable’ requirement in IAS 39 and IFRS 9 be applied in situations when the notional amount of the hedging instrument follows the actual hedged transaction?
 - (b) When assessing hedge effectiveness applying IAS 39 or IFRS 9, does the hedged item have to be fixed at the inception of the hedging relationship or can the underlying volumes vary based on expected volumes from period to period?
 - (c) Does the answer to either question differ depending on whether an entity applies the hedge accounting requirements in IAS 39 or IFRS 9?

Staff analysis and assessment against the Committee’s agenda criteria

Outreach

9. In order to gather information about the use of Load Following Swaps as hedging instruments in a hedge accounting relationship, we sent information requests to

members of the International Forum of Accounting Standard-Setters, securities regulators and the large accounting firms.

10. The request asked those participating to provide information, based on their experience, on:
 - (a) whether the particular derivative instrument described in the submission is common;
 - (b) whether the designation of Load Following Swaps in a hedge accounting relationship is common;
 - (c) if (a) and (b) are common, whether there is any concentration in particular jurisdictions, industries or types of entities; and
 - (d) to what extent those participating have observed diversity in the accounting treatment in the specific situation described in the submission.

11. We received twelve responses – six from large accounting firms, three from national standard-setters, one from an organisation representing groups of regulators, one from a regulator and one from a Committee member. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

12. Almost all respondents said that the Load Following Swap described in the submission is not common.

13. Two respondents noted that they have observed this derivative instrument in one industry segment (energy sector) in one jurisdiction. One of these two respondents said it is aware of only a relatively small number of entities that have designated Load Following Swaps in hedge accounting relationships. The other respondent noted that some energy generators – unlisted entities in the public sector of a specific jurisdiction – currently apply hedge accounting for Load Following Swaps. In addition, the two respondents provided examples of similar swaps used in different circumstances. These examples included specific features that are unrelated to the situation described in the submission and therefore this paper does not discuss them further.

Staff analysis

14. As explained above, the responses to our outreach request indicate that the derivative instrument described in the submission is not common. In addition, the responses to our outreach indicate that the issue is not widespread since only a relatively small number of entities have designated these instruments in hedge accounting relationships.
15. For these reasons, we recommend not analysing the accounting for the derivative instrument described in the submission.

Should the Committee add this matter to its standard setting agenda?

Is the matter widespread and expected to have a material effect on those affected?¹

16. As previously explained in this paper, the outreach responses indicate that the derivative instrument described in the submission is not common and only a relatively small number of entities have designated these instruments in hedge accounting relationships. Therefore, we have not obtained evidence that the matter is widespread or is expected to have a material effect on those affected.

¹ Paragraph 5.16(a) of the Due Process Handbook.

Staff recommendation

17. Based on our assessment of the Committee’s agenda criteria in paragraphs 5.16 and 5.17 of the *Due Process Handbook*, we recommend that the Committee does not add this matter to its standard-setting agenda. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 1 and 2 for the Committee

1. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
2. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A — Proposed wording of the tentative agenda decision

IFRS 9 *Financial Instruments* and IAS 39 *Financial instruments: Recognition and Measurement* — Application of the highly probable requirement when a specific derivative is designated as a hedging instrument

The IFRS Interpretation Committee (Committee) received a request regarding the requirement in IFRS 9 and IAS 39 that a forecast transaction must be ‘highly probable’ in order to qualify as a hedged item in a cash flow hedge relationship.

The request asked how an entity applies that requirement when the notional amount of the derivative designated as a hedging instrument (‘Load Following Swap’) varies depending on the outcome of the hedged item. In addition, the request asked whether, when assessing or measuring hedge effectiveness, the hedged item must be fixed (in volume terms) at the inception of the hedging relationship, and whether the answers to these questions depend on whether the entity applies IAS 39 or IFRS 9.

On the basis of the responses to outreach performed on the request, the Committee observed that the financial instrument described in the request is not common.

Therefore, the Committee has not obtained evidence that the matter has widespread effect or is expected to have a material effect on those affected.

Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B — Submission

We have reproduced the submission below. We have deleted details that would identify the submitter of this request

Potential Interpretations Committee Agenda Item Request

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It has come to our attention that there are diverse views on the application of the ‘highly probable forecast transaction’ requirement to qualify for hedge accounting in situations where the notional amount of the hedging instrument varies depending on the outcome of the hedged transaction. We are seeking clarification by the Committee of the issue detailed below.

Background

A Load Following Swap is a contract with a variable notional, typically a function of actual hedged volumes. For example, a Load Following Swap can swap variable market prices for electricity into fixed prices based on the actual volume of electricity produced by a windfarm or solar energy farm after the inception of the swap contract.

The terms of such instruments can vary, but for the purposes of the below analysis it is assumed that the contract is a derivative financial instrument in the scope of IAS 39 *Financial instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* and, as such, is an eligible hedging instrument.

Below is an example to illustrate a typical transaction.

A solar energy farm sells all its energy produced on the national energy market at spot rate. Energy produced will be priced in half-hour blocks. The spot sales transaction on the national energy market will be settled on a weekly basis (in some jurisdictions this could be monthly or otherwise specified). The weekly settlement will be the sum of all 30 minute blocks sold on the national energy market over that specific week.

Separately, the solar energy farm enters into a 15-year Load Following Swap with an independent third party. Under the load following swap the variable cash flows arising from energy sold on the national energy market at spot rates is swapped into fixed cash

flows. The nature of the Load Following Swap is such that the notional amount on which the settlements will be based is the actual quantity of electricity sold.

Economically, this arrangement results in a perfect hedge of the volumes sold for changes in the spot price as there will never be a mismatch in volumes between the actual volumes of electricity sold into the grid and the notional of the load following swap. Each week, the load following swap will result in the solar energy farm receiving or paying a net settlement amount based on the difference between the fixed price and the variable price for electricity actually produced that week.

In accordance with paragraph 88(c) of IAS 39, one of the criteria for a hedging relationship to qualify for hedge accounting is that for cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable.

In accordance with paragraph 88(b) of IAS 39, another criterion for a hedging relationship to qualify for hedge accounting is that the hedge is expected to be highly effective 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.

Similarly, in accordance with paragraph 6.3.3 of IFRS 9 for a forecast transaction to qualify as a hedged item it must be highly probable.

For cash flow hedges, both IAS 39 and IFRS 9 require that hedge ineffectiveness be measured and recognised in profit or loss.

When using Load Following Swaps and applying the hedge accounting requirements in IAS 39 or IFRS 9, the following issues have thus arisen and have caused diverging views in practice:

Question 1: How should the ‘highly probable’ requirement in IAS 39 and IFRS 9 be applied in situations when the notional amount of the hedging instrument follows the actual hedged transaction?

Question 2: When assessing hedge effectiveness (under IAS 39) or measuring hedge effectiveness (under IAS 39 or IFRS 9), does the hedged item have to be fixed at inception of the hedging relationship or can the underlying volumes vary based on expected volumes from period to period?

Question 3: Does the answer to either question differ depending on whether an entity applies the hedging accounting requirements of IAS 39 or of IFRS 9?

Question 1 – How should the ‘highly probable’ requirement in IAS 39 and IFRS 9 be applied in situations when the notional amount of the hedging instrument follows the actual hedged transaction?

View 1 – The ‘highly probable’ requirement requires an entity to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time at the inception of the hedge relationship.

Proponents of this view argue that the requirements for cash flow hedge accounting for forecast transactions are clear (albeit very prescriptive).

Both IAS 39 and IFRS 9 require a forecast transaction to be assessed as highly probable. Proponents of this view argue that hedge accounting requires an assessment and clear documentation of the forecast transaction and the timing of the forecast transaction. This is a requirement for all cash flow hedges.

Section F.3.11 of the Guidance on Implementing IAS 39 provides further guidance on the documentation of timing of forecast transactions. It states that to meet the ‘highly probable’ requirement, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, hedge documentation is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge that the hedge will be highly effective, it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the cash flows occur within close proximity to each other.

Using the example of a 15-year Load Following Swap, the forecast transaction would be the volume of electricity produced in the specified increments of time. To document the timing of the forecast electricity production an entity would need to be able to document

the time period during which each forecast cash flow is expected to occur within a specific and narrow enough range over the full 15 years.

Typically, the more distant a forecast transaction the less likely it is that the transaction would be considered highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

View 2 – The ‘highly probable’ requirement only requires an entity to demonstrate that the forecast transaction is highly probable to occur. It does not require precise timing, cash flows or volumes to be specified.

Paragraph 88(c) of IAS 39 and 6.3.3 of IFRS 9 respectively require entities to demonstrate that the forecast transactions are highly probable.

Proponents of this view argue that there is no specific requirement in IAS 39 or IFRS 9 that requires an entity to specify the exact timing and volumes of the forecast transactions and that, furthermore, Load Following Swaps differ from a more conventional derivative with a fixed notional in that the derivative follows the actual hedged transaction volume and that this feature is relevant when determining whether it reasonable to assume a forecast transaction is highly probable. Given the derivative’s notional follows the actual volumes of the hedged item the highly probable qualifying criteria should be considered as met as every hedged cash flow that arises in practice will be subject to offset from the derivative that follows it.

Question 2 – When assessing hedge effectiveness (under IAS 39) or measuring hedge effectiveness (under IAS 39 or IFRS 9), does the hedged item have to be fixed (in volume terms) at inception of the hedging relationship or can the underlying volumes vary based on expected volumes from period to period?

View 1 – Assessment and measurement of hedge effectiveness must be based on a fixed (in volume terms) hedged item determined and documented at the date of hedge designation.

Proponents of this view argue that, consistent with View 1 to Question 1, the purpose of documenting the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range is because it forms the basis for

assessing hedge effectiveness (per F.3.11 of the Guidance on Implementing IAS 39). Once the forecast transaction is documented at the inception of the hedging relationship it cannot be varied. Any differences in timing or cash flows from those documented will result in hedge ineffectiveness whether or not those differences are mirrored by changes in the cash flows on the hedging instrument.

Proponents of this view also point to guidance in IFRS 9 related to the measurement of hedge ineffectiveness when using the hypothetical derivative method. Paragraph B6.5.5 of IFRS 9 only permits the hypothetical derivative to be used to calculate the value of the hedged item. In other words, the hypothetical derivative cannot be used to include features that only exist in the hedging instrument but not in the hedged item.

Consequently, for cash flow hedges, the ‘highly probable’ forecast transaction volumes cannot be variable at each reporting period and cannot mirror the expected volumes used in measuring the fair value of the hedging instrument for the purposes of assessing hedge effectiveness (under IAS 39) and measuring hedge effectiveness (under both IAS 39 and IFRS 9). Neither standard provides a mechanism for identification of a hypothetical derivative whose terms are a function of the hedged item itself.

View 2 – Underlying volumes can vary based on expected volumes from period to period.

Proponents of this view argue that the method and information used to satisfy the ‘highly probable’ criteria does not have to be reflected in the method and information used to assess or measure hedge effectiveness and that the documented forecast transaction should be based on the same expected electricity volume over the life of the derivative used in measuring the fair value of the Load Following Swap at each reporting date for the purposes of hedge effectiveness (referring to both assessment and measurement of hedge effectiveness). This is because, due to the dependency of the cash flows on the Load Following Swap on the volume of electricity generated by the solar energy farm and, there can never be a mismatch between the notional amount of the derivative and the hedged item. As such, proponents of this view believe that identification of a hypothetical derivative with a notional varying depending on the volume of the hedged item should be permitted.

Question 3 – Does the answer to either question differ depending on whether an entity applies the hedging accounting requirements of IAS 39 or of IFRS 9?

View 1 – Yes, a different answer is possible under IAS 39 compared to IFRS 9

Proponents of this view argue that the objective of and guidance to IAS 39 and IFRS 9 are different and that, consequently, a different answer could be possible for the same fact pattern under the two standards.

IAS 39 and IFRS 9 do not share the same objective. Paragraph 6.1.1 of IFRS 9 makes it clear that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks.

Furthermore, proponents of this view note that View 1 on Question 1 depends, in part, on the basis of the guidance in section F.3.11 of the Guidance on Implementing IAS 39. This guidance is not replicated in IFRS 9.

View 2 – No, there should not be a different answer under IAS 39 compared to IFRS 9

Proponents of this view argue that the omission of the guidance in section F.3.11 from IFRS 9 is not sufficient to determine a difference between IAS 39 and IFRS 9 given that both standards require forecast transactions to be highly probable in order to qualify as hedged items when applying hedge accounting and that the requirements for measurement of ineffectiveness do not differ between the two standards. Given the requirement for a transaction to be highly probable to be eligible for hedge accounting is the same then the answer should also be the same.

Reasons for the Committee to address the issue

Currently, we are aware of divergent views on this matter in a number of different jurisdictions. The issue is not related to a Board project that is expected to be completed in the near future. Also, entities applying IFRS 9 can continue to apply the hedge accounting requirements of IAS 39 so the accounting treatment under both standards will continue to be relevant.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.

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