

STAFF PAPER

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IASB® meeting

Project	Second Comprehensive Review of the <i>IFRS for SMEs</i> ® Standard
Paper topic	Towards an Exposure Draft—IFRS 9 <i>Financial Instruments</i> (hedge accounting)
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Introduction

1. This paper discusses whether to propose amendments to the hedge accounting requirements in Section 12 *Other Financial Instrument Issues* of the *IFRS for SMEs* Standard to align with IFRS 9 *Financial Instruments*. It also considers whether Section 12 needs to continue to include hedge accounting requirements.
2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

Purpose of the paper

3. The purpose of this paper is to ask the International Accounting Standards Board (Board) to:
 - (a) consider feedback on the Request for Information *Comprehensive Review of the IFRS for SMEs Standard*, published in January 2020, and the recommendations of the SME Implementation Group (SMEIG) on possible amendments to the hedge accounting requirements in Section 12 (Question S3C of the Request for Information); and

- (b) decide whether Section 12 should continue to include hedge accounting requirements and, if so, whether to align the existing requirements with IFRS 9.

Summary of staff recommendations

- 4. The staff recommend the Board retain the existing hedge accounting requirements unchanged in Section 12 of the *IFRS for SMEs* Standard (ie the hedge accounting requirements would remain unaligned with IFRS 9).

Structure of the paper

- 5. This paper is structured as follows:
 - (a) background (paragraphs 6–11 of this paper);
 - (b) question in the Request for Information (paragraph 12 of this paper);
 - (c) feedback on the Request for Information (paragraphs 13–20 of this paper);
 - (d) SMEIG recommendations (paragraphs 21–22 of this paper);
 - (e) staff analysis (paragraphs 23–36 of this paper); and
 - (f) staff recommendation and question for the Board (paragraph 37 of this paper).

Background

Requirements in the IFRS for SMEs Standard

- 6. Section 12 of the *IFRS for SMEs* Standard focuses on the types of hedging transactions that SMEs are likely to do and only permits hedge accounting for the following risks:
 - (a) interest rate risk of a debt instrument measured at amortised cost;

- (b) foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
 - (c) price risk of a commodity held or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; and
 - (d) foreign exchange risk in a net investment in a foreign operation.¹
7. Section 12 similarly limits the type of instruments that can be used as hedging instruments.
8. Limiting the risks for which hedge accounting may be used and focussing on ‘plain vanilla’ hedging instruments enabled the requirements in Section 12 to be kept simple in comparison to IAS 39 *Financial Instruments: Recognition and Measurement* during development of the *IFRS for SMEs* Standard. The fact that Section 12 does not permit some hedge accounting strategies does not prevent SMEs from using other hedging instruments, such as purchased options, to hedge risks or from disclosing the effect of doing so. It only prohibits hedge accounting for those transactions. Furthermore, the *IFRS for SMEs* Standard includes an optional fallback to IAS 39, which could be used if an SME has more sophisticated hedging strategies.
9. IFRS 9 includes new hedge accounting requirements that represent a major overhaul of hedge accounting. It introduces improvements principally by aligning the accounting more closely with risk management.² The Project Summary for IFRS 9 states:

The hedge accounting requirements in IAS 39 were developed when hedging activities were relatively new and not as widely understood as they are today. As a result of the increased use and sophistication of hedging activities the IASB decided to undertake a fundamental overhaul of all aspects of hedge accounting.

10. IFRS 9’s hedge accounting model enables entities to better reflect their risk management activities in the financial statements and use information produced

¹ SMEs also commonly hedge foreign exchange risk of a debt instrument measured at amortised cost. This risk is not in the list because hedge accounting would not have any significant effect on an SME’s financial statements (see paragraph 12.17 of the *IFRS for SMEs* Standard).

² [IFRS 9 Project Summary: IFRS 9 *Financial Instruments*](#).

internally as a basis for hedge accounting, which, together with the improved disclosure requirements, will help investors better understand the entity's risk management activities and the effect of hedging activities on the financial statements.

11. IFRS 9 allows an entity to choose, as its accounting policy, to continue to apply the hedge accounting requirements of IAS 39 or the requirements in IFRS 9 pending finalisation of the Board's Dynamic Risk Management project.³ In practice, a significant number of entities applying full IFRS Standards—financial institutions in particular—have elected to continue to apply hedge accounting according to IAS 39 rather than IFRS 9.⁴

Question in the Request for Information

12. Question S3C of the Request for Information asked for views on the following options about the hedge accounting requirements in the *IFRS for SMEs* Standard:
- (a) remove the requirements on hedge accounting in Section 12;
 - (b) retain the existing requirements on hedge accounting in Section 12; and
 - (c) align the requirements on hedge accounting in Section 12 with IFRS 9.

Feedback on the Request for Information

Overall feedback

13. Feedback generally supported continuing to include hedge accounting requirements in Section 12 of the *IFRS for SMEs* Standard.
14. However, there were mixed views on whether to retain the existing requirements on hedge accounting in Section 12 unchanged or align those requirements with IFRS 9.

³ Paragraph 7.2.21 of IFRS 9.

⁴ [Snapshot](#): Exposure Draft Interest Rate Benchmark Reform, May 2019.

Feedback from comment letters

15. Many respondents said Section 12 should continue to include hedge accounting requirements because some SMEs enter into hedging transactions—for example to manage foreign exchange risk in forecast sales (or purchases) in foreign currencies or to manage interest rate risk from borrowings—and some apply hedge accounting to those transactions. Of those respondents:
- (a) many respondents support retaining the existing hedge accounting requirements in Section 12 because they are well understood and sufficient for hedging strategies typically adopted by SMEs;
 - (b) some respondents would prefer Section 12 is aligned with IFRS 9, with or without with simplifications, noting, for example, that the requirements of IFRS 9 permit the use of hedging accounting in additional circumstances as some SMEs have more sophisticated hedging transactions; and
 - (c) a small number of respondents suggested giving SMEs an option to apply only the hedge accounting requirements in IFRS 9, without requiring them to apply IFRS 9 in its entirety.
16. Many respondents observed that there was limited application of hedge accounting by SMEs. Some respondents noted that even when SMEs enter into economic hedges, they do not apply hedge accounting because of the complexity.
17. Some respondents said the hedge accounting requirements should be removed from Section 12 completely because:
- (a) they are not aware of any SMEs applying Section 12 hedge accounting;
 - (b) SMEs do not commonly enter into hedging transactions; or
 - (c) the hedge accounting requirements are perceived as too complex.

Feedback from the online survey and outreach events

18. Most respondents to the online survey and participants in outreach events said Section 12 should continue to include requirements on hedge accounting.

19. Most respondents to the online survey supported aligning Section 12 with IFRS 9. Some respondents supported retaining the existing requirements as they are sufficient for the needs of SMEs. Other respondents preferred retaining the current requirements in Section 12 but updating the fallback to IFRS 9 (currently a fallback to IAS 39).
20. The staff also met with the Emerging Economies Group (EEG), in May 2021, to seek the group’s views on hedge accounting requirements. One EEG member said Section 12 should not include hedge accounting requirements for the same reason as discussed in paragraph 17 of this paper.

SMEIG recommendations⁵

21. The SMEIG met on 4–5 February 2021 to discuss the feedback from stakeholders on the Request for Information and develop recommendations for the Board to decide on amendments to the Standard.
22. SMEIG members expressed mixed views on the alternatives about hedge accounting requirements for SMEs (that is, removing, retaining or aligning with IFRS 9 the requirements on hedge accounting in Section 12).

Staff analysis

Does Section 12 need to include requirements on hedge accounting?

23. Some respondents observed that some SMEs engage in hedging transactions. However, many respondents observed that there is limited application of hedge accounting by SMEs. Nevertheless, removing hedge accounting requirements from Section 12 would disadvantage those entities that currently apply them.
24. Furthermore, Section 12 permits but does not require an entity to apply hedge accounting to a hedging relationship. Therefore, retaining requirements in Section 12 will not disadvantage other entities that do not apply hedge accounting.

⁵ The Report on the SMEIG meeting, held via remote participation, on 4–5 February 2021 can be accessed [here](#).

25. In the staff's view, as Section 12 already includes hedge accounting requirements and feedback on the Request for Information indicates that some SMEs apply these requirements, Section 12 should continue to include requirements on hedge accounting.

Should Section 12 be aligned with IFRS 9 for hedge accounting?

26. If the Board agrees that Section 12 should continue to include requirements on hedge accounting, the Board will need to consider whether and, if so, how Section 12 should be aligned with IFRS 9.
27. At its March 2021 meeting, the Board confirmed its alignment principles (see paragraph 5 of Agenda Paper 30). The staff have considered these principles.

Relevance to SMEs

28. Relevance to SMEs is determined by assessing whether the issues addressed by IFRS 9's hedge accounting requirements would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard (ref to paragraph 33 of the Request for Information). Paragraphs 9-11 of this paper provide a high-level summary of the issues addressed by IFRS 9's hedge accounting requirements.
29. The Board's primary aim when developing the *IFRS for SMEs* Standard was to provide a stand-alone, simplified set of accounting principles for entities that do not have public accountability and that typically have less complex transactions, limited resources to apply full IFRS Standards and that operate in circumstances in which comparability with their listed peers is not an important consideration (see paragraph BC187 of the Basis for Conclusions on the *IFRS for SMEs* Standard). Feedback indicates that such entities are unlikely to have sophisticated risk management and hedging strategies, and therefore the need to explain them to users of their financial statements. They are also likely to have simpler financial reporting needs and favour simplified accounting, so some entities will choose not to apply hedge accounting even if they engage in basic hedging transactions. Consistent with this view, the staff

observe that during the development of the *IFRS for SMEs* Standard the Board did not incorporate the disclosures in IFRS 7 *Financial Instruments: Disclosures* about the nature and extent of risks from financial instruments and how those risks are managed, and so these disclosures are not required even if an SME uses the fallback to IAS 39.⁶

30. Section 12 focuses on the types of hedging transactions typically undertaken by SMEs to keep the accounting and disclosures simple. Feedback indicates that the requirements are well understood by, and sufficient for the needs of, SMEs and users of their financial statements.
31. The staff observe that some respondents have said that some SMEs have more sophisticated hedging strategies and would benefit from the improvements introduced by IFRS 9. Nevertheless, the staff think that aligning Section 12 with IFRS 9 to address more sophisticated hedging strategies would move away from the Board's primary aim, and could add cost and complexity for all SMEs applying hedge accounting without significant benefits for users of their financial statements.
32. For the above reasons, the staff think that the issues addressed by IFRS 9 (ie reducing complexity in IAS 39, better reflect risk management activities) are not relevant for 'typical' SMEs (those that the Standard is intended for) applying Section 12 and users of their financial statements. The staff therefore do not think that the 'Relevance for SMEs' condition is met for alignment with IFRS 9's hedging requirements.

Other alignment principles

33. If the Board agrees that the issues addressed by IFRS 9's hedging requirements do not meet the relevance condition, analysis of the other two alignment principles 'simplicity' and 'faithful representation' is not necessary (see explanation in paragraph 5 of Agenda Paper 30).

Assessment of costs and benefits

34. The staff think that alignment with IFRS 9 would involve costs for all SMEs applying or considering applying hedge accounting under the *IFRS for SMEs* Standard to cater

⁶ See paragraphs 31–42 of IFRS 7. These disclosures were in IFRS 7 before IFRS 9 was issued.

for the few SMEs with sophisticated hedging strategies, and users of their financial statements, that may benefit from the improvements introduced by IFRS 9.

Consequently, considering alignment of Section 12 with IFRS 9 for hedge accounting, the staff do not think that the benefits of the reported information for users would be supported by the costs of providing that information.

- 35. Section 12 focuses on the types of risks that SMEs are likely to hedge, and feedback indicates that the requirements are well understood and sufficient for typical SMEs and users of their financial statements. The feedback has not indicated that the existing hedge accounting requirements in Section 12 are ‘broken’.
- 36. The staff’s view is the existing requirements on hedge accounting are adequate for SMEs.

Staff recommendation and question for the Board

- 37. The staff recommend the Board retain the existing hedge accounting requirements unchanged in Section 12 of the *IFRS for SMEs* Standard (ie the hedge accounting requirements would remain unaligned with IFRS 9).

Question for the Board

Does the Board agree with staff recommendation to retain the existing hedge accounting requirements unchanged in Section 12 of the *IFRS for SMEs* Standard?