IFRS® Interpretations Committee meeting

Date	**November 2022**
Project	**Potential annual improvements—IFRS 1 terminology update**
Topic	**Initial consideration**
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Introduction

1. We have been informed about potential confusion arising from an inconsistency in wording between paragraph B6 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* and requirements for hedge accounting in IFRS 9 *Financial Instruments*.

2. This paper:

   (a) provides the Interpretations Committee (Committee) with a summary of the matter;

   (b) presents our research and analysis; and

   (c) asks the Committee whether it agrees with our preliminary views to include proposed amendments to paragraphs B5–B6 of IFRS 1 in the next *Annual Improvements to IFRS Accounting Standards Cycle* (annual improvements).

Structure of this paper

3. This paper includes:

   (a) background information (paragraphs 4–9);

   (b) staff analysis and preliminary views (paragraphs 10–21);

   (c) question for the Committee; and

   (d) Appendix A—recommended proposed amendment to paragraphs B5–B6 of IFRS 1.

Background information

4. Paragraph 13 of IFRS 1 prohibits a first-time adopter's retrospective application of some aspects of other IFRS Accounting Standards (Accounting Standards). These exceptions are set out in paragraphs 14–17 and Appendix B of IFRS 1.

5. Paragraph B5 of IFRS 1 states:

> An entity shall not reflect in its opening IFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IFRS 9 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate as a hedged item in accordance with IFRSs an individual item within that net position, or a net position if that meets the requirements in paragraph 6.6.1 of IFRS 9, provided that it does so no later than the date of transition to IFRSs.

6. Paragraph B6 of IFRS 1 states:

> If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IFRS 9, the entity shall apply paragraphs 6.5.6 and 6.5.7 of IFRS 9 to discontinue hedge accounting. Transactions entered into before the date of transition to IFRSs shall not be retrospectively designated as hedges.

7. Paragraph 6.4.1 of IFRS 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).

8. Paragraph 88 of IAS 39 states [emphasis added]:

> A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of 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–AG113A) 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.

Question raised

9. The question raised is whether the reference in paragraph B6 of IFRS 1 to the 'conditions' for hedge accounting in IFRS 9 should be updated to be consistent with the wording in paragraph 6.4.1 of IFRS 9 that refers to 'qualifying criteria' for hedge accounting.

Staff analysis and preliminary views

Interaction between IFRS 1 and IAS 39 *Financial instruments: Recognition and Measurement*

10. Paragraphs B5–B6 of IFRS 1 were originally written to be consistent with the requirements for hedge accounting in IAS 39. On transition, an entity applied what some in practice refer to as a 'two-step approach' to hedge accounting—that is:

    (a) applying paragraph B5 of IFRS 1, an entity did not reflect in its statement of financial position at the date of transition to IFRS Accounting Standards a hedging relationship of a type that did not qualify for hedge accounting in IAS 39. Paragraphs 72–84 of IAS 39 provide requirements for eligible hedging instruments and eligible hedged items.

    (b) applying paragraph B6 of IFRS 1, if a hedging relationship was of a type that qualified for hedge accounting in IAS 39, but an entity did not meet the conditions for a hedging relationship to apply hedge accounting, the entity discontinued hedge accounting immediately after the transition. The *conditions* in paragraph 88 of IAS 39 include:

        (i) formal designation and documentation; and

        (ii) hedge effectiveness.

Interaction between IFRS 1 and IFRS 9

11. IFRS 9, as issued in July 2014, amended paragraphs B1–B6 of IFRS 1.[1] These amendments, among others, replaced references to IAS 39 with references to IFRS 9 and, in paragraph B5 of IFRS 1,

[1] Paragraph 7.2.21 of IFRS 9 permits an entity, when first applying IFRS 9, to choose as its accounting policy either to apply the hedge accounting requirements in IFRS 9 or to *continue* to apply the hedge accounting requirements in IAS 39. Consequently, although IFRS 9 is effective—with limited exceptions for entities that issue insurance contracts and entities applying the IFRS for SMEs Accounting Standard—IAS 39, which now contains only its requirements for hedge accounting, also remains effective.

updated examples of hedging relationships that do not qualify for hedge accounting applying IFRS 9. Paragraphs 6.2.1–6.3.7 of IFRS 9 provide requirements for eligible hedging instruments and eligible hedged items; paragraph 6.4.1 of IFRS 9 sets out *qualifying criteria* for hedge accounting, including:

(a) eligibility;

(b) formal designation and documentation; and

(c) hedge effectiveness.

'Conditions' and 'qualifying criteria'

12. If read literally, there is an inconsistency between the requirements in paragraph B6 of IFRS 1 and the requirements in paragraph 6.4.1 of IFRS 9; IFRS 9 sets out 'qualifying criteria' rather than 'conditions' for hedge accounting.

13. Both IFRS 9 and IAS 39 remain in effect for hedge accounting, depending on an entity's accounting policy choice when first applying IFRS 9. However, first-time adopters of Accounting Standards applying IFRS 1 and IFRS 9 do not have an option to apply the hedge accounting requirements in IAS 39 and therefore apply IFRS 9—which calls into question the use of the term 'conditions' in paragraph B6 of IFRS 1.[2]

14. The *qualifying criteria* for hedge accounting in paragraph 6.4.1(a) of IFRS 9 require the hedging relationship to consist only of eligible hedging instruments and eligible hedged items. As set forth in paragraph 10(b) of this paper, *conditions* in paragraph 88 of IAS 39 do not refer to eligibility of hedging instruments or hedged items.

Is there still a two-step approach in IFRS 1?

15. We have been informed that it is unclear whether the 'two-step approach' in IFRS 1—described in paragraph 10 of this paper—still applies after the issuance of IFRS 9. When paragraphs B5–B6 of IFRS 1 included references to IAS 39, paragraph B5 focused on 'eligibility' of hedging instruments or hedged items, while paragraph B6 focused on 'conditions'—formal designation and documentation, and hedge effectiveness. IFRS 9 includes all three of these—eligibility, formal designation and documentation and hedge effectiveness—as part of 'qualifying criteria'.

16. In our view, when issuing IFRS 9, the IASB did not intend to change the requirements—or the two-step approach—in paragraph B5 or B6 of IFRS 1. Paragraph B5 remains focused on 'eligibility' of a hedging relationship, and paragraph B6 remains focused on the other aspects of 'qualifying criteria'.

[2] We are aware that paragraph 6.1.3 of IFRS 9 permits an entity—including a first-time adopter—to apply the hedge accounting requirements in IAS 39 for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities.

17. In our view, the IASB retained the existing reference to 'conditions' for hedge accounting in paragraph B6 of IFRS 1 but did not intend to do so—this was a minor oversight when IFRS 1 was amended by IFRS 9. We therefore recommend replacing 'conditions' with 'qualifying criteria' in paragraph B6 of IFRS 1 and adding in paragraphs B5–B6 of IFRS 1 cross-references to the requirements in IFRS 9.

18. We think that updating terminology in paragraph B6 of IFRS 1 to reflect the requirements in IFRS 9 would be a minor correction to IFRS 1. It would help maintain consistent terminology between existing requirements and improve the understandability of Accounting Standards. In addition, in our view, adding cross-references to the requirements in IFRS 9 would improve navigability and accessibility of Accounting Standards.

Does this matter meet the annual improvements criteria?

19. Paragraphs 6.10–6.13 of the *Due Process Handbook* include the criteria for annual improvements. To meet these criteria, the proposed solution would need to be limited to:

    (a) clarifying the wording in an Accounting Standard, which involves either replacing unclear wording in existing Accounting Standards or providing requirements where an absence of requirements is causing concern; or

    (b) correcting relatively minor unintended consequences, oversights or conflicts between existing requirements.

20. We think our proposed solution regarding paragraphs B5–B6 of IFRS 1 (see Appendix A) meets both of these criteria. As explained earlier, we think that replacing 'conditions' with 'qualifying criteria' would clarify the wording in paragraph B6 of IFRS 1 and correct a prior minor oversight and adding cross-references to the requirements in IFRS 9 would improve navigability and accessibility of Accounting Standards. Such amendments would maintain consistency with the principles and requirements in IFRS 1 and IFRS 9 and would not propose a new (or change an existing) principle or requirement.

Summary of staff preliminary views

21. Based on our analysis in paragraphs 10–20, our preliminary views are to:

    (a) propose that the IASB amend paragraph B6 of IFRS 1 to replace 'conditions' with 'qualifying criteria' (see Appendix A) and amend paragraphs B5–B6 of IFRS 1 to add cross-references to requirements in IFRS 9; and

    (b) include these proposed amendments in the next annual improvements cycle.

Question for the Committee

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Do Committee members agree with our preliminary views as summarised in paragraph 21 of this paper? If 'no', do you have any other suggestions?

Appendix A—recommended proposed amendments to paragraphs B5–B6 of IFRS 1

A1. Our proposed amendment would:

a. add a cross-reference to paragraph 6.4.1(a) of IFRS 9 in paragraph B5 of IFRS 9;

b. add a cross-reference to paragraph 6.4.1(b)–(c) in paragraph B6 of IFRS 1; and

c. replace the word ‘condition’ with ‘qualifying criteria’ in paragraph B6 of IFRS 1.

A2. New text is underlined and deleted text is struck through.

> B5 An entity shall not reflect in its opening IFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IFRS 9 (see paragraph 6.4.1(a) of IFRS 9) (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate as a hedged item in accordance with IFRSs an individual item within that net position, or a net position if that meets the requirements in paragraph 6.6.1 of IFRS 9, provided that it does so no later than the date of transition to IFRSs.
>
> B6 If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the ~~conditions~~ qualifying criteria for hedge accounting in paragraph 6.4.1(b)–(c) of IFRS 9, the entity shall apply paragraphs 6.5.6 and 6.5.7 of IFRS 9 to discontinue hedge accounting. Transactions entered into before the date of transition to IFRSs shall not be retrospectively designated as hedges.