Staff paper

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Project	**Hedge accounting by a first-time adopter (IFRS 1)**
Topic	**Potential annual improvement**
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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. The IFRS Interpretations Committee (Committee) discussed this matter at its meeting in November 2022—see Agenda Paper 3A for that meeting.

3. The objective of this paper is:

   (a) to provide the International Accounting Standards Board (IASB) with background on the matter and staff analysis, including consideration of the Committee's discussion; and

   (b) to ask the IASB whether it agrees with our recommendation to include proposed amendments to paragraphs B5–B6 of IFRS 1 in its next *Annual Improvements to IFRS Accounting Standards Cycle* (annual improvements).

Structure of this paper

4. This paper includes:

   (a) Background information;

   (b) Staff analysis, including consideration of the Committee's discussion and transition requirements;

   (c) Staff recommendations and question for the IASB; and

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

Summary of staff recommendations

5. We recommend that the IASB:

   (a) propose amendments to paragraphs B5–B6 of IFRS 1, as set out in Appendix A to this agenda paper;

   (b) develop no specific transition requirements for these proposed amendments; and

   (c) include these proposed amendments in its next annual improvements cycle.

Background information

6. 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.

7. 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.

8. 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.

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

9. 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 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.

10. 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. […]
>
> (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.

Interaction between IFRS 1 and IFRS 9

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

12. Paragraph 6.4.1 of IFRS 9 states [emphasis added]:

> 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. […]
>
> (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. […]

Question raised

13. 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 Section 6.4 of IFRS 9 that sets out 'qualifying criteria for hedge accounting'.

Staff analysis

'Conditions' and 'qualifying criteria'

14. 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.

15. 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.

16. 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 9(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?

17. We have been informed that it is unclear whether the 'two-step approach' in IFRS 1—described in paragraph 9 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'.

18. 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'.

19. 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.

20. As we noted in paragraph 11 of this agenda paper, qualifying criteria for hedge accounting in paragraph 6.4.1(a) of IFRS 9 include the requirement for a hedging relationship to consist only of eligible hedging instruments and eligible hedge items. Paragraph 88 of IAS 39 (which sets out conditions for hedge accounting) does not include such a requirement. Therefore, to maintain the application of the requirements in paragraph B6 of IFRS 1 unchanged, we think it is necessary to add in paragraph B6 of IFRS 1 a cross-reference to paragraph 6.4.1(b)–(c). Our recommended cross-reference helps to ensure that by replacing 'conditions' with 'qualifying criteria', we avoid unintended consequences and do not change existing requirements.

21. In addition, we recommend including in paragraph B5 of IFRS 1 a cross-reference to paragraph 6.4.1(a) of IFRS 9. We recommend this change to improve understandability of the requirements and avoid potential misperception that the requirements in paragraphs B5–B6 of IFRS 1 are incomplete or override some qualifying criteria for hedge accounting in IFRS 9.

22. 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?

23. 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.

24. We think our proposed solution regarding paragraphs B5–B6 of IFRS 1, as set out in Appendix A to this agenda paper, meets these criteria. As we explained earlier, we think that replacing ‘conditions’ with ‘qualifying criteria’ and adding cross-references to the requirements in IFRS 9 would efficiently resolve the matter. 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.

The Committee's discussion

25. The Committee discussed this potential annual improvement at its November 2022 meeting. Most Committee members agreed, or did not disagree, with our analysis and preliminary views.

26. A few Committee members suggested alternative approaches to cross-referencing:

    (a) one Committee member suggested including a cross-reference to paragraph 6.4.1(a)–(c) of IFRS 9 only in paragraph B5 of IFRS 1, but not in paragraph B6 of IFRS 1. We think this would go beyond what paragraph B5 of IFRS 1 requires. Applying this paragraph, an entity does not reflect in its statement of financial position at the date of transition to Accounting Standards a hedging relationship of a type that does not qualify for hedge accounting. Paragraph B5 of IFRS 1 does not refer to formal designation, documentation or hedge effectiveness requirements in paragraph 6.4.1(b)–(c); this is what paragraph B6 of IFRS 1 does.

    (b) one Committee member suggested adding in paragraph B5 of IFRS 1 a cross-reference to paragraph 6.5.2 of IFRS 9[1]. In our view this is unnecessary. Before IFRS 9 amended paragraph B5 of IFRS 1, this paragraph did not include a cross-reference to paragraph 86 of IAS 39, which includes similar requirements to these in paragraph 6.5.2 of IFRS 9.

27. Based on the Committee's discussion we continue to think that replacing 'conditions' with 'qualifying criteria' would clarify the wording in paragraph B6 of IFRS 1 and adding to paragraphs B5–B6 of IFRS 1 cross-references to the requirements in IFRS 9 (as set out in Appendix A to this agenda paper) would improve navigability and accessibility of Accounting Standards.

[1] Paragraph 6.5.2 of IFRS 9 and paragraph 86 of IAS 39 set out three types of hedging relationships.

Transition requirements

28. IFRS 1 applies to entities that present their first IFRS financial statements (that is, first-time adopters) and specifies how an entity transitions from its previous GAAP to Accounting Standards. First-time adopters have not previously applied Accounting Standards. Those entities would apply the applicable requirements in IFRS 1 when transitioning to Accounting Standards, and any transition requirements for the proposed amendments to IFRS 1 would not be relevant for those entities. Accordingly, in our view, transition requirements are not relevant for first-time adopters.

29. We have identified one instance[2] in which the IASB permitted, but did not require, retrospective application of an amendment to IFRS 1 by entities that applied IFRS 1 in a previous period. We considered whether the IASB should develop similar requirements for our proposed amendments. However, in our view, entities that applied IFRS 1 in a previous period are not first-time adopters, and they are outside the scope of IFRS 1. Accordingly, transition requirements are not relevant for companies that applied IFRS 1 in a previous period.

Staff recommendations and question for the IASB

30. Based on our analysis in paragraphs 14–27 of this agenda paper, we recommend the IASB, as part of its next annual improvements cycle, amend paragraphs B5–B6 of IFRS 1, as set out in Appendix A to this agenda paper.

31. Based on our analysis in paragraphs 28–29 of this agenda paper, we think that transition requirements are not relevant for first-time adopters or for companies that applied IFRS 1 in a previous period.

[2] See paragraph 39E of IFRS 1.

Question for the IASB
Does the IASB agree with our recommendations: a. to propose amendments to paragraphs B5–B6 of IFRS 1, as set out in Appendix A to this agenda paper; b. to develop no specific transition requirements for these proposed amendments; and c. to include these proposed amendments in its next annual improvements cycle?

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

A1. Our proposed amendments would:

(a) add a cross-reference to paragraph 6.4.1(a) of IFRS 9 in paragraph B5 of IFRS 1;

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

(c) replace the word 'conditions' 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 (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) (see paragraph 6.4.1(a) of IFRS 9). 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.