

IFRS 9
CHAPTER 6
HEDGE ACCOUNTING
Basis for Conclusions

BASIS FOR CONCLUSIONS ON IFRS 9 *FINANCIAL INSTRUMENTS*

	<i>from paragraph</i>
INTRODUCTION	BCIN.1
SCOPE	BC2.1
RECOGNITION AND DERECOGNITION	BCZ3.1
Derecognition of a financial asset	BCZ3.1
Arrangements under which an entity retains the contractual rights to receive the contractual cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients	BCZ3.14
Transfers that do not qualify for derecognition	BCZ3.25
Continuing involvement in a transferred asset	BCZ3.27
Improved disclosure requirements issued in October 2010	BC3.30
CLASSIFICATION	BC4.1
Classification of financial assets	BC4.1
Classification of financial liabilities	BC4.46
Option to designate a financial asset or financial liability at fair value through profit or loss	BCZ4.54
Embedded derivatives	BC4.83
Reclassification	BC4.111
MEASUREMENT	BCZ5.1
Fair value measurement considerations	BCZ5.1
Gains and losses	BC5.21
HEDGE ACCOUNTING	BC6.1
The objective of hedge accounting	BC6.1
Hedging instruments	BC6.27
Hedged items	BC6.64
Qualifying criteria for hedge accounting	BC6.136
Accounting for qualifying hedges	BC6.178
Hedges of a group of items	BC6.304
Hedging credit risk using credit derivatives	BC6.346
EFFECTIVE DATE AND TRANSITION	BC7.1
Effective date	BC7.1
Mandatory Effective Date of IFRS 9—November 2011	BC7.9A
Requirements added to IFRS 9 in [Date] 2012	BC7.9F
Transition related to IFRS 9 as issued in November 2009	BC7.10
Transitional disclosures	BC7.24
Transition related to the requirements added to IFRS 9 in October 2010	BC7.26
Transitional insurance issues	BC7.30

Disclosures on Transition from IAS 39 to IFRS 9—November 2011	BC7.34A
Transition related to IFRS 9 as issued in [Date] 2012	BC7.35
GENERAL	BCG.1
Summary of main changes from the exposure draft issued in 2009	BCG.1
Summary of main changes from the exposure draft issued in 2010	BCG.2
Cost-benefit considerations	BCG.3
APPENDIX	
Amendments to the Basis for Conclusions on other IFRSs	
DISSENTING OPINIONS	

Basis for Conclusions on IFRS 9 *Financial Instruments*

This Basis for Conclusions accompanies, but is not part of, IFRS 9.

The Board expects that IFRS 9 will replace IAS 39 Financial Instruments: Recognition and Measurement. When revised in 2003 IAS 39 was accompanied by a Basis for Conclusions summarising the considerations of the Board, as constituted at the time, in reaching some of its conclusions in that Standard. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard. For convenience the Board has incorporated into its Basis for Conclusions on IFRS 9 material from the Basis for Conclusions on IAS 39 that discusses matters that the Board has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to the IFRS have been updated accordingly and minor necessary editorial changes have been made. In 2003 and later some Board members dissented from the issue of IAS 39 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 9. Those dissenting opinions are set out after the Basis for Conclusions on IAS 39.

Paragraphs describing the Board's considerations in reaching its own conclusions on IFRS 9 are numbered with the prefix BC.

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

Introduction

- BCIN.1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing IFRS 9 *Financial Instruments*. Individual Board members gave greater weight to some factors than to others.
- BCIN.2 The Board has long acknowledged the need to improve the requirements for financial reporting of financial instruments to enhance the relevance and understandability of information about financial instruments for users of financial statements. To meet the urgency of that need in the light of the financial crisis, the Board decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* in its entirety as expeditiously as possible. To make progress quickly the Board divided the project into several phases. In adopting this approach, the Board acknowledged the difficulties that might be created by differences in timing between this project and others, in particular phase II of the project on insurance contracts. (Paragraphs BC7.2(b), BC7.4 and BC7.30–BC7.34 discuss issues relating to insurance contracts.)

Classification and measurement

- BCIN.3 IFRS 9 is a new standard dealing with the accounting for financial instruments. In developing IFRS 9, the Board considered the responses to its exposure draft *Financial Instruments: Classification and Measurement*, published in July 2009.
- BCIN.4 That exposure draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the Board should finalise its proposals on classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the Board had more fully considered and debated the issues relating to financial liabilities. Those respondents pointed out that the Board accelerated its project on financial instruments

because of the global financial crisis, which placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the Board should consider issues related to financial liabilities more fully before finalising the requirements for classification and measurement of financial liabilities.

- BCIN.5 The Board noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with the classification and measurement of financial assets. In the Board's view, requirements on classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and the requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the Board noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement of financial assets in accordance with IAS 39.
- BCIN.6 Thus, financial liabilities, including derivative liabilities, remained within the scope of IAS 39. Taking that course enabled the Board to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.
- BCIN.7 Immediately after issuing IFRS 9, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The Board obtained information and views from its Financial Instruments Working Group (FIWG) and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the Board received were that the requirements in IAS 39 for classifying and measuring financial liabilities are generally working well but that the effects of the changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46–BC4.53).
- BCIN.8 By taking that course, the issue of credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010, the Board published an exposure draft *Fair Value Option for Financial Liabilities*, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised requirements that were added to IFRS 9 in October 2010.
- BCIN.9 The Board is committed to completing its project on financial instruments expeditiously. The Board is also committed to increasing comparability between IFRSs and US generally accepted accounting principles (GAAP) requirements for financial instruments.

Hedge accounting

- BCIN.10 In December 2010 the Board published the exposure draft Hedge Accounting. That exposure draft contained an objective for hedge accounting that aimed to align accounting more closely with risk management and to provide useful information about the purpose and effect of hedging instruments. It also proposed requirements for:

- (a) what financial instruments qualify for designation as hedging instruments;
- (b) what items (existing or expected) qualify for designation as hedged items;
- (c) an objective-based hedge effectiveness assessment;
- (d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*); and
- (e) hedge accounting presentation and disclosures.

- BCIN.11 After the publication of the exposure draft, the Board began an extensive outreach programme to gather feedback on the hedge accounting proposals. The Board obtained information and views from users, preparers, treasurers, risk management experts, auditors, standard-setters and regulators from a range of industries across different geographical regions.
- BCIN.12 The views from participants in the Board's outreach activities were largely consistent with the views in the comment letters to the exposure draft. The Board received strong support for the objective of aligning accounting more closely with risk management. However, many asked the Board for added clarification on some of the fundamental changes proposed in the exposure draft.
- BCIN.13 The Board considered the responses in the comment letters to that exposure draft and the information received during its outreach activities in finalising the requirements for hedge accounting that were added to IFRS 9 in [Date] 2012.

Hedge accounting (chapter 6)

The objective of hedge accounting

- BC6.1 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRSs. For example, the hedge accounting guidance in IAS 39 permitted:
- (a) recognition of items that would otherwise not be recognised (for example, a firm commitment);
 - (b) measurement of an item on a basis that is different from the measurement basis that is normally required (for example, adjusting the measurement of a hedged item in a fair value hedge); and
 - (c) deferral of the changes in the fair value of a hedging instrument for a cash flow hedge in other comprehensive income. These changes in fair value would otherwise have been recognised in profit or loss (for example, the hedging of a highly probable forecast transaction).
- BC6.2 The Board noted that, although hedge accounting was an exception from normal accounting requirements, in many situations the information that resulted from applying those normal requirements without using hedge accounting did not provide useful information or omitted important information. Hence, the Board concluded that hedge accounting should be retained.
- BC6.3 In the Board's view, a consistent hedge accounting model requires an objective that describes *when* and *how* an entity should:
- (a) override the general recognition and measurement requirements in IFRSs (ie when and how an entity should apply hedge accounting); and

- (b) recognise effectiveness and/or ineffectiveness of a hedging relationship (ie when and how gains and losses should be recognised).

BC6.4 The Board considered two possible objectives of hedge accounting—that hedge accounting should:

- (a) provide a link between an entity's risk management and its financial reporting. Hedge accounting would convey the context of hedging instruments, which would allow insights into their purpose and effect.
- (b) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items and manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

BC6.5 However, the Board rejected both objectives for hedge accounting. The Board thought that an objective that linked an entity's risk management and financial reporting was too broad: it was not clear enough what risk management activity was being referred to. Conversely, the Board thought that an objective that focused on the accounting anomalies was too narrow: it focused on the mechanics of hedge accounting rather than on why hedge accounting was being done.

BC6.6 Consequently, the Board decided to propose in the exposure draft an objective that combined elements of the two objectives. The Board considered that the proposed objective of hedge accounting reflected a broad articulation of a principle-based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provided for a focus on the statement of financial position and the statement of comprehensive income thus reflecting the effects of the individual assets and liabilities associated with the risk management activities on those statements. This reflected the Board's intention that entities should provide useful information about the purpose and effect of hedging instruments for which hedge accounting is applied.

BC6.7 The Board also noted that, notwithstanding that an entity's risk management activities were central to the objective of hedge accounting, an entity would only achieve hedge accounting if it met all the qualifying criteria.

BC6.8 Almost all respondents to the exposure draft as well as participants in the Board's outreach activities supported the objective of hedge accounting proposed in the exposure draft.

Open portfolios

BC6.9 In practice, risk management often assesses risk exposures on a continuous basis and at a portfolio level. Risk management strategies tend to have a time horizon (for example, two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to such hedged portfolios and other exposures are removed from them.

BC6.10 Hedges of open portfolios introduce complexity to the accounting for such hedges. Changes could be addressed by treating them like a series of closed portfolios with a short life (ie by periodic discontinuation of the hedging relationship for the previous closed portfolio of items and designation of a new hedging relationship for the revised closed portfolio of items). However, this gives rise to complexities regarding tracking, amortisation of hedge adjustments

and reclassification of gains or losses deferred in accumulated other comprehensive income. Furthermore, it may be impractical to align such an accounting treatment with the way in which the exposures are viewed from a risk management perspective, which may update hedge portfolios more frequently (for example, daily).

- BC6.11 Closed hedged portfolios are hedged portfolios in which items cannot be added, removed or replaced without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies at inception the hedged items that form that particular hedging relationship.
- BC6.12 The Board decided not to address open portfolios or 'macro' hedging (ie hedging at the level that aggregates portfolios) as part of the exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross or net position for which the items that make up that position are included in a specified overall group of items. See paragraphs BC6.305–BC6.345.
- BC6.13 Consequently, for fair value hedge accounting for a portfolio hedge of interest rate risk the exposure draft did not propose replacing the requirements in IAS 39.
- BC6.14 The Board received feedback from financial institutions as well as from entities outside the financial sector that addressing situations in which entities use a dynamic risk management strategy was important. Financial institutions also noted that this was important because some of their risk exposures might only qualify for hedge accounting in an open portfolio context (for example, non-interest bearing demand deposits).
- BC6.15 The Board noted that this is a complex topic that warrants thorough research and input from constituents. Accordingly, the Board decided to separately deliberate accounting for macro hedging as part of its active agenda with the objective of issuing a discussion paper. The Board noted that this would enable IFRS 9 to be completed more quickly and would enable the new 'general' hedge accounting requirements to be available as part of IFRS 9. The Board also noted that during the project on accounting for macro hedging the status quo of 'macro' hedge accounting under previous IFRSs would broadly be maintained so that entities would not be worse off in the meantime.

Hedge accounting for equity investments designated as at fair value through other comprehensive income

- BC6.16 In accordance with IFRS 9 an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in other comprehensive income. Amounts recognised in other comprehensive income for such instruments are not reclassified to profit or loss. However, IAS 39 defined a hedging relationship as a relationship in which the exposure to be hedged could affect profit or loss. Consequently, an entity could not apply hedge accounting if the hedged exposure affected other comprehensive income without reclassification out of other comprehensive income to profit or loss because only such a reclassification would mean that the hedged exposure could ultimately affect profit or loss.
- BC6.17 For its exposure draft, the Board considered whether it should amend the definition of a fair value hedge to state that the hedged exposure could affect either profit or loss or other comprehensive income, instead of only profit or loss. However, the Board had concerns about the mechanics of matching the changes

in the fair value of the hedging instrument with the changes in the value of the hedged item attributable to the hedged risk. Furthermore, the Board was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the Board considered alternative approaches.

- BC6.18 The Board considered whether the hedge ineffectiveness should remain in other comprehensive income when the changes in the value of the hedged item attributable to the hedged risk are bigger than the changes in the fair value of the hedging instrument. This approach would:
- (a) be consistent with the Board's decision on the classification and measurement (the first phase of the IFRS 9 project) that changes in the fair value of the equity investment designated as at fair value through other comprehensive income should not be reclassified to profit or loss; but
 - (b) contradict the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss.
- BC6.19 Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:
- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but
 - (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income.
- BC6.20 Consequently, in its exposure draft the Board proposed prohibiting hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it could not be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the Board did not want to add another exception (ie contradicting the principle in IFRS 9 of not reclassifying between other comprehensive income and profit or loss, or contradicting the principle of recognising hedge ineffectiveness in profit or loss) to the existing exception of accounting for investments in equity instruments (ie the option to account for those investments at fair value through other comprehensive income).
- BC6.21 However, the Board noted that dividends from such investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from such investments could be an eligible hedged item (if all qualifying criteria for hedge accounting are met).
- BC6.22 Almost all respondents to the exposure draft disagreed with the Board's proposal to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. Those respondents argued that hedge accounting should be available for equity investments at fair value through other comprehensive income so that hedge accounting can be more closely aligned with risk management activities. In particular, respondents commented that it was a common risk management strategy for an entity to hedge the foreign exchange risk exposure of equity investments (irrespective of the accounting designation at fair value through profit or loss or other comprehensive income). In addition, an entity might also hedge the equity price risk even though it does not intend to sell the equity investment because it might still want to protect itself against equity volatility.

- BC6.23 In the light of those concerns, the Board reconsidered whether it should allow investments in equity instruments designated as at fair value through other comprehensive income to be designated as a hedged item in a fair value hedge. Some respondents argued that the inconsistencies that the Board had discussed in its original deliberations (see paragraphs BC6.18 and BC6.19) could be overcome by using a differentiating approach, whereby if fair value changes of the hedging instrument exceeded those of the hedged item hedge ineffectiveness would be presented in profit or loss and otherwise in other comprehensive income. However, the Board noted that the cumulative ineffectiveness presented in profit or loss or other comprehensive income over the total period of the hedging relationship might still contradict the principle of not recycling to profit or loss changes in the fair value of equity investments at fair value through other comprehensive income. Hence, the Board rejected that approach.
- BC6.24 The Board noted that recognising hedge ineffectiveness always in profit or loss would be inconsistent with the irrevocable election of presenting in other comprehensive income fair value changes of investments in equity instruments (see paragraph BC6.19). The Board considered that that outcome would defeat its aim to reduce complexity in accounting for financial instruments.
- BC6.25 The Board considered that an approach that would recognise hedge ineffectiveness always in other comprehensive income (without recycling) could facilitate hedge accounting in situations in which an entity's risk management involves hedging risks of equity investments designated as at fair value through other comprehensive income without contradicting the classification and measurement requirements of IFRS 9. The Board noted that, as a consequence, hedge ineffectiveness would not always be presented in profit or loss but would always follow the presentation of the value changes of the hedged item.
- BC6.26 The Board considered that, on balance, the advantages of the approach that always recognises hedge ineffectiveness in other comprehensive income (without recycling) for these investments in equity instruments would outweigh any disadvantages and, overall, that this alternative was superior to the other alternatives that the Board had contemplated. Hence, the Board decided to include this approach in the final requirements.
- BC6.27 The Board also considered whether hedge accounting should be more generally available for exposures that only affect other comprehensive income (but not profit or loss). However, the Board was concerned that such a broad scope might result in items qualifying for hedge accounting that might not be suitable hedged items and hence have unintended consequences. Consequently, the Board decided against making hedge accounting more generally available to such exposures.

Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

- BC6.28 IAS 39 required the separation of derivatives embedded in hybrid financial assets and liabilities that are not closely related to the host contract (bifurcation). In accordance with IAS 39, the separated derivative was eligible for designation as

a hedging instrument. In accordance with IFRS 9, hybrid financial assets are measured in their entirety (ie including any embedded derivative) at either amortised cost or fair value through profit or loss. No separation of any embedded derivative is permitted.

- BC6.29 In the light of the decision that it made on IFRS 9, the Board considered whether derivatives embedded in financial assets should be eligible for designation as hedging instruments. The Board considered two alternatives:
- (a) an entity could choose to separate embedded derivatives solely for the purpose of designating the derivative component as a hedging instrument; or
 - (b) an entity could designate a risk component of the hybrid financial asset, equivalent to the embedded derivative, as the hedging instrument.
- BC6.30 The Board rejected both alternatives. Consequently, the Board proposed not to allow derivative features embedded in financial assets to be eligible hedging instruments (even though they can be an integral part of a hybrid financial asset that is measured at fair value through profit or loss and designated as the hedging instrument in its entirety—see paragraph BC6.40). The reasons for the Board’s decision are summarised below.
- BC6.31 Permitting an entity to separate embedded derivatives for the purpose of hedge accounting would retain the IAS 39 requirements in terms of their eligibility as hedging instruments. However, the Board noted that the underlying rationale for separating embedded derivatives in IAS 39 was not to reflect risk management activities, but instead to prevent an entity from circumventing the requirements for the recognition and measurement of derivatives. The Board also noted that the designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 was not very common in practice. Hence, the Board considered that reintroducing the separation of embedded derivatives for hybrid financial assets does not target hedge accounting considerations, would therefore not be an appropriate means to address any hedge accounting concerns and in addition would reintroduce complexity for situations that were not common in practice.
- BC6.32 Alternatively, permitting an entity to designate, as the hedging instrument, a risk component of a hybrid financial asset would allow that entity to show more accurately the results of its risk management activities. However, such an approach would be a significant expansion of the scope of the hedge accounting project because the Board would need to address the question of how to disaggregate a hedging instrument into components. In order to be consistent, a similar question would need to be addressed regarding non-financial items (for example, non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with currency or commodity risk elements). The Board did not want to expand the scope of the hedge accounting project beyond financial instruments because the outcome of exploring this alternative would be highly uncertain, could possibly involve a review of other standards and could significantly delay the project.
- BC6.33 The Board therefore retained its original decision during the redeliberations of its exposure draft.

Non-derivative financial instruments

- BC6.34 Hedge accounting shows how the changes in the fair value or cash flows of a hedging instrument offset the changes in the fair value or cash flows of a designated hedged item attributable to the hedged risk if it reflects an entity's risk management strategy.
- BC6.35 IAS 39 permitted non-derivative financial assets and non-derivative financial liabilities (for example, monetary items denominated in a foreign currency) to be designated as hedging instruments only for a hedge of foreign currency risk. Designating a non-derivative financial asset or liability denominated in a foreign currency as a hedge of foreign currency risk in accordance with IAS 39 was equivalent to designating a risk component of a hedging instrument in a hedging relationship. This foreign currency risk component is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because the foreign currency risk component is determined in accordance with foreign currency translation requirements in IAS 21, it is already available for incorporation by reference in the financial instruments standard. Consequently, permitting the use of a foreign currency risk component for hedge accounting purposes did not require separate, additional requirements for risk components within the hedge accounting model.
- BC6.36 Not allowing the disaggregation of a non-derivative financial instrument used as a hedge into risk components, other than foreign currency risk, has implications for the likelihood of achieving hedge accounting for those instruments. This is because the effects of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness assessment. Consequently, depending on the size of the components that are not related to the risk being hedged, in most scenarios it will be difficult to demonstrate that there is an economic relationship between the hedged item and the hedging instrument that gives rise to an expectation that their values will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged.
- BC6.37 In the light of this consequence, the Board considered whether it should permit non-derivative financial instruments to be eligible for designation as hedging instruments for risk components other than foreign currency risk. The Board noted that permitting this would require developing an approach for disaggregating non-derivative hedging instruments into components. For reasons similar to those set out in paragraph BC6.32 the Board decided not to explore such an approach.
- BC6.38 The Board also considered two alternatives to the requirements of IAS 39 (which limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk). The Board considered whether for hedges of all types of risk (ie not limited to hedges of foreign currency risk) it should extend the eligibility as hedging instruments to non-derivative financial instruments:
- (a) that are classified as at fair value through profit or loss; or (alternatively to those)
 - (b) that are part of other categories of IFRS 9.
- BC6.39 The Board noted that extending the eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give

rise to operational problems because to apply hedge accounting would require changing the measurement of non-derivative financial instruments measured at amortised cost when designated as hedging instruments. The Board considered that the only way to mitigate this issue was to allow for the designation of components of the non-derivative financial instrument. This would limit the change in measurement to a component of the instrument attributable to the hedged risk. However, the Board had already rejected that idea in its deliberations (see paragraph BC6.37).

- BC6.40 However, the Board noted that extending the eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety (rather than risk components), would not give rise to the need to change the measurement or the recognition of gains and losses of the financial instrument. The Board also noted that extending the eligibility to these financial instruments would align more closely with the classification model of IFRS 9 and make the new hedge accounting model better able to address hedging strategies that could evolve in the future. Consequently, the Board proposed in its exposure draft that non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments if they are designated in their entirety (in addition to hedges of foreign currency risk for which the hedging instrument can be designated on a risk component basis—see paragraph BC6.35).
- BC6.41 Generally, respondents to the exposure draft agreed that distinguishing between derivative and non-derivative financial instruments was not appropriate for the purpose of determining their eligibility as hedging instruments. Many respondents believed that extending the eligibility criteria to non-derivative financial instruments at fair value through profit or loss would allow better representation of an entity's risk management activities in the financial statements. The feedback highlighted that this was particularly relevant in countries that have legal and regulatory restrictions on the use and availability of derivative financial instruments.
- BC6.42 Some respondents argued that there was no conceptual basis to restrict the eligibility of non-derivative financial instruments to those that are measured at fair value through profit or loss. In their view all non-derivative financial instruments should be eligible as hedging instruments.
- BC6.43 Other respondents thought that that the proposals were not restrictive enough, particularly in relation to non-derivative financial instruments that are measured at fair value through profit or loss as a result of applying the fair value option. Those respondents thought that the Board should specifically restrict the use of non-derivative financial instruments designated under the fair value option because these have usually been elected to be measured at fair value to eliminate an accounting mismatch and hence should not qualify for hedge accounting. Some respondents also questioned whether a financial liability that is measured at fair value, with changes in the fair value attributable to changes in the liability's credit risk presented in other comprehensive income, would be an eligible hedging instrument under the proposals in the exposure draft.
- BC6.44 The Board noted that in its deliberations leading to the exposure draft it had already considered whether non-derivative financial instruments measured at amortised cost should also be eligible for designation as hedging instruments. The Board remained concerned that designating as hedging instruments those non-derivative financial instruments that were not already accounted for at fair

value through profit or loss would result in hedge accounting that would change the measurement or recognition of gains and losses of items that would otherwise result from applying IFRS 9. For example, the Board noted that it would have to determine how to account for the difference between the fair value and the amortised cost of the non-derivative financial instrument upon designation as a hedging instrument. Furthermore, upon discontinuation of the hedging relationship, the measurement of the non-derivative financial instrument would revert to amortised cost resulting in a difference between its carrying amount as of the date of discontinuation (the fair value as at the discontinuation date which becomes the new deemed cost) and its maturity amount. The Board considered that addressing those aspects would inappropriately increase complexity.

- BC6.45 The Board was also concerned that allowing non-derivative financial instruments not already accounted for at fair value through profit or loss to be designated as hedging instruments would mean that the hedge accounting model would not only change the measurement basis of the hedged item, as the existing hedge accounting model already does, but also the measurement basis of hedging instruments. Hence, it could for example result in situations where a natural hedge (ie an accounting match) is already achieved on an amortised cost basis between two non-derivative financial instruments, but hedge accounting could still be used to change the measurement basis of both those instruments to fair value (one as a hedged item and the other as the hedging instrument).
- BC6.46 Consequently, the Board decided that non-derivative financial instruments should be eligible hedging instruments only if they are already accounted for at fair value through profit or loss.
- BC6.47 The Board also discussed whether or not those non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of applying the fair value option should be eligible for designation as a hedging instrument. The Board considered that any designation as a hedging instrument should not contradict the entity's election of the fair value option (ie recreate the accounting mismatch that the election of the fair value option addressed). For example, if a non-derivative financial instrument that has previously been designated under the fair value option is included in a cash flow hedge relationship, the accounting for the non-derivative financial instrument under the fair value option would have to be overridden. This is because all (or part) of the changes in the fair value of that hedging instrument are recognised in other comprehensive income. However, recognising the changes in fair value in other comprehensive income re-introduces the mismatch that the application of the fair value option eliminated in the first instance. The Board noted that similar considerations apply to fair value hedges and hedges of net investments in foreign operations.
- BC6.48 Consequently, the Board considered whether it should introduce a general prohibition against designating, as hedging instruments, non-derivative instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option. However, such a prohibition would not necessarily be appropriate. The Board noted that one of the items underlying the fair value option might be sold or terminated at a later stage (ie the circumstances that made the fair value option available might be subject to change or later disappear). However, because the fair value option is irrevocable it would mean a non-derivative financial instrument for which the fair value option was initially elected could never qualify as a hedging instrument

even if there was no longer a conflict between the purpose of the fair value option and the purpose of hedge accounting. A general prohibition would not allow the use of hedge accounting at a later stage even when hedge accounting might then mitigate an accounting mismatch (without recreating another one).

- BC6.49 The Board noted that when a non-derivative financial instrument is accounted for at fair value through profit or loss as a result of electing the fair value option, the appropriateness of its use as a hedging instrument depends on the relevant facts and circumstances underlying the fair value option designation. The Board considered that if an entity designates as a hedging instrument a financial instrument for which it originally elected the fair value option, and this results in the mitigation of an accounting mismatch (without recreating another one), using hedge accounting was appropriate. However, the Board emphasised that if applying hedge accounting recreates, in the financial statements, the mismatches that electing the fair value option sought to eliminate, then designating the financial instrument for which the fair value option was elected as a hedging instrument would contradict the basis (qualifying criterion) on which the fair value option was elected. Hence, in those situations there would be a conflict between the purpose of the fair value option and the purpose of hedge accounting as they could not be achieved at the same time but instead would overall result in another accounting mismatch. Consequently, the Board emphasised that designating the non-derivative financial instrument as a hedging instrument in those situations would call into question the legitimacy of electing the fair value option and would be inappropriate. The Board considered that, to this effect, the requirements of the fair value option were sufficient and hence no additional guidance was necessary.
- BC6.50 As a result, the Board decided to not introduce a general prohibition against the eligibility of designating as hedging instruments non-derivative financial instruments accounted for at fair value through profit or loss as a result of electing the fair value option.
- BC6.51 The Board also considered whether it needed to provide more guidance on when a non-derivative financial liability designated as at fair value through profit or loss under the fair value option would qualify as a hedging instrument. The Board noted that IFRS 9 refers to liabilities for which the fair value option is elected as “liabilities designated at fair value through profit or loss”, irrespective of whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or (if that presentation would enlarge an accounting mismatch) in profit or loss. However, for the eligibility as a hedging instrument, the Board considered that it would make a difference whether the effects of changes in the liability’s credit risk are presented in other comprehensive income or profit or loss. The Board noted that if a financial liability whose credit risk related fair value changes are presented in other comprehensive income was an eligible hedging instrument there would be two alternatives for what could be designated as part of the hedging relationship:
- (a) only the part of the liability that is measured at fair value through profit or loss, in which case the hedging relationship would exclude credit risk and hence any related hedge ineffectiveness would not be recognised; or
 - (b) the entire fair value change of the liability, in which case the presentation in other comprehensive income of the changes in fair value related to changes in the credit risk of the liability would have to be overridden (ie

using reclassification to profit or loss) to comply with the hedge accounting requirements.

- BC6.52 Consequently, the Board decided to clarify its proposal by adding an explicit statement that a financial liability is not eligible for designation as a hedging instrument if under the fair value option the amount of change in the fair value attributable to changes in the liability's own credit risk is presented in other comprehensive income.

Internal derivatives as hedging instruments

- BC6.53 An entity may follow different risk management models depending on the structure of its operations and the nature of the hedges. Some use a centralised treasury or similar function that is responsible for identifying the exposures and managing the risks borne by various entities within the group. Others use a decentralised risk management approach and manage risks individually for entities in the group. Some also use a combination of these two approaches.
- BC6.54 Internal derivatives are typically used to aggregate risk exposures of a group (often on a net basis) to allow the entity to manage the resulting consolidated exposure. However, IAS 39 was primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align accounting with risk management, the Board considered whether internal derivatives should be eligible for designation as hedging instruments. However, the Board noted that the ineligibility of internal derivatives as hedging instruments was not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge was how to make hedge accounting operational for groups of items and net positions.
- BC6.55 The Board noted that, for financial reporting purposes, the mitigation or transformation of risk is generally only relevant if it results in a transfer of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity does not change the risk exposure from the perspective of that reporting entity as a whole. This is consistent with the principles of consolidated financial statements.
- BC6.56 For example, a subsidiary might transfer cash flow interest rate risk from variable rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (instead of hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's consolidated perspective, the cash flow interest rate risk has not changed but merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).
- BC6.57 Consequently, in the deliberations leading to the exposure draft, the Board decided that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting entity (for example, intragroup derivatives in the consolidated financial statements) because they do not represent an instrument that the reporting entity uses to transfer the risk to an external party (ie outside the reporting entity). This meant that the related requirements in IAS 39 would be retained.
- BC6.58 The Board retained its original decision during the redeliberations of its exposure draft.

Intragroup monetary items as hedging instruments

- BC6.59 In accordance with IAS 39, the difference arising from the translation of intragroup monetary items in the consolidated financial statements in accordance with IAS 21 was eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.
- BC6.60 The Board noted that, when translating an intragroup monetary item, IAS 21 requires the recognition of a gain or loss in the consolidated statement of profit or loss and other comprehensive income. Consequently, in the Board's view, considering intragroup monetary items for eligibility as hedging instruments would require a review of the requirements in IAS 21 at the same time as considering any hedge accounting requirements. The Board noted that it does not have a project on foreign currency translation on its agenda. Hence, it decided that it should not address this issue as part of its project on hedge accounting. Consequently, in the deliberations leading to the exposure draft, the Board decided not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).
- BC6.61 The Board retained its original decision during the redeliberations of its exposure draft.

Written options

- BC6.62 In its exposure draft, the Board retained the restriction in IAS 39 that a written option does not qualify as a hedging instrument except when it is used to hedge a purchased option or unless it is combined with a purchased option as one derivative instrument (for example, a collar) and that derivative instrument is not a net written option.
- BC6.63 However, respondents to the exposure draft commented that a stand-alone written option should not be excluded from being eligible for designation as a hedging instrument if it is jointly designated with other instruments such that in combination they do not result in a net written option. Those respondents highlighted that entities sometimes enter into two separate option contracts because of, for example, legal or regulatory considerations, and that these two separate option contracts achieve, in effect, the same economic outcome as one contract (for example, a collar contract).
- BC6.64 The Board considered that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance rather than its legal form. Consequently, the Board decided to amend the requirements such that a written and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument, provided that the combination is not a net written option. The Board also noted that by aligning the accounting for combinations of written and purchased options with that for derivative instruments that combine written and purchased options (for example, a collar contract), the assessment of what is, in effect, a net written option would be the same, ie it would follow the established practice under IAS 39. That practice considers the following cumulative factors to ascertain that an interest rate collar or other derivative instrument that includes a written option is not a net written option:

- (a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- (b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Hedged items

Qualifying items

Designation of derivatives

- BC6.65 The guidance on implementing IAS 39 stated that derivatives could be designated as hedging instruments only, not as hedged items (either individually or as part of a group of hedged items). As the sole exception, paragraph AG94 in the application guidance in IAS 39 allowed a purchased option to be designated as a hedged item. In practice, this has generally prevented derivatives from qualifying as hedged items. Similarly, positions that are a combination of an exposure and a derivative (aggregated exposures) failed to qualify as hedged items. The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives (or aggregated exposures that include a derivative) to be designated as hedged items. It stated that derivative instruments were always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.
- BC6.66 However, this rationale is difficult to justify in the light of the exception to permit some purchased options to qualify as hedged items irrespective of whether the option is a stand-alone derivative or an embedded derivative. If a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of an aggregated exposure to be part of a hedged item is arbitrary. Many raised similar concerns about the prohibition of designating derivatives as hedged items in response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*.
- BC6.67 The Board noted that an entity was sometimes economically required to enter into transactions that result in, for example, both interest rate risk and foreign currency risk. While these two exposures can be managed together at the same time and for the entire term, the Board noted that entities often use different risk management strategies for the interest rate risk and foreign currency risk. For example, for 10-year fixed rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument but require fixed rate exposure in its functional currency only for the short to medium term (say, two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates). In such a situation it is common to enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate functional currency exposure. This is then overlaid with a two-year interest rate swap that—on the

basis of the functional currency—swaps variable rate debt into fixed rate debt. In effect, the fixed rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable rate debt functional currency exposure for risk management purposes.

- BC6.68 Consequently, for the purpose of its exposure draft, the Board concluded that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that aggregated exposure as a hedged item.
- BC6.69 Most respondents to the exposure draft supported the proposal to allow aggregated exposures to be designated as hedged items. Those respondents noted that the proposal better aligns hedge accounting with an entity's risk management by allowing hedge accounting to be used for common ways in which entities manage risks. In addition, those respondents noted that the proposal removes the arbitrary restrictions that were in IAS 39 and moves closer towards a principle-based requirement. The Board therefore decided to retain the notion of an aggregated exposure as proposed in the exposure draft.
- BC6.70 The main requests that respondents made to the Board were:
- (a) to provide examples that would illustrate the accounting mechanics for aggregated exposures;
 - (b) to clarify that accounting for aggregated exposures is not tantamount to 'synthetic accounting'; and
 - (c) to clarify whether an entity would, in a first step (and as a precondition), have to achieve hedge accounting for the combination of the exposure and the derivative that together constitute the aggregated exposure so that, in a second step, the aggregated exposure itself can then be eligible as the hedged item in the other hedging relationship.
- BC6.71 In response to the request for examples of the accounting mechanics for aggregated exposures, the Board decided to provide illustrative examples to accompany IFRS 9. The Board considered that numerical examples illustrating the mechanics of the accounting for aggregated exposures would, at the same time, address other questions raised in the feedback on the proposals, such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved. Moreover, the Board noted that those examples would also demonstrate that the proposed accounting for aggregated exposures is very different from 'synthetic accounting', which would reinforce the second clarification respondents had requested.
- BC6.72 The Board thought that the confusion about 'synthetic accounting' arose from accounting debates in the past about whether two items should be treated for accounting purposes as if they were one single item. This would have had the consequence that a derivative could have assumed the accounting treatment for a non-derivative item (for example, accounting at amortised cost). The Board noted that, in contrast, under the exposure draft's proposal for aggregated exposures the accounting for derivatives would always be at fair value and hedge accounting would be applied to them. Hence, the Board emphasised that accounting for aggregated exposures does not allow 'synthetic accounting'.
- BC6.73 The Board noted that most respondents had correctly understood the exposure draft (ie that it does not allow 'synthetic accounting') but the Board was still concerned because any misconception that aggregated exposures are

tantamount to 'synthetic accounting' would result in a fundamental accounting error. Hence, the Board decided to provide, in addition to illustrative examples, an explicit statement confirming that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value.

BC6.74 The Board also discussed the request to clarify whether an entity would have to first (as a precondition) achieve hedge accounting for the combination of the underlying exposure and the derivative that constitute the aggregated exposure (first level relationship) so that the aggregated exposure itself can be eligible as the hedged item in the other hedging relationship (second level relationship). The Board noted that the effect of not achieving hedge accounting for the first level relationship depended on the circumstances (in particular the types of hedge used). In many circumstances, it would make the accounting for the aggregated exposure more complicated and the outcome inferior compared to achieving hedge accounting for the first level relationship. However, the Board considered that achieving hedge accounting for the first level relationship was not required to comply with the general hedge accounting requirements for the second level relationship (ie the hedging relationship in which the aggregated exposure is the hedged item). Consequently, the Board decided not to make achieving hedge accounting for the first level relationship a prerequisite for qualifying for hedge accounting for the second level relationship.

BC6.75 The Board also clarified two other aspects that had been raised by some respondents:

- (a) that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure, once it has occurred, is eligible as a hedged item; and
- (b) how to apply the general requirements of designating a derivative as the hedging instrument in the context of aggregated exposures. The Board noted that the way in which a derivative is included in the hedged item that is an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure (ie at the level of the first level relationship—if applicable, ie if hedge accounting is applied at that level). If the derivative is not designated as the hedging instrument at the level of the aggregated exposure, it must be designated in its entirety or as a proportion of it. The Board noted that, consistent with the general requirements of the hedge accounting model, this also ensures that including a derivative in an aggregated exposure does not allow splitting a derivative by risk, by parts of its term or by cash flows.

Designation of hedged items

Designation of a risk component

BC6.76 IAS 39 distinguished the eligibility of risk components for designation as the hedged item by the type of item that includes the component:

- (a) for financial items, an entity could designate a risk component if that risk component was separately identifiable and reliably measurable; however,
- (b) for non-financial items, an entity could only designate foreign currency risk as a risk component.

- BC6.77 Risk components of non-financial items, even when they are contractually specified, were not eligible risk components in accordance with IAS 39. So other than for foreign currency risk, a non-financial item was required to be designated as the hedged item for all risks. The rationale for including this restriction in IAS 39 was that permitting risk components (portions) of non-financial assets and non-financial liabilities to be designated as the hedged item for a risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing because the portion could be designated so that no ineffectiveness would ever arise.
- BC6.78 The hedge accounting model in IAS 39 used the entire item as the default unit of account and then provided rules to govern what risk components of that entire item were available for separate designation in hedging relationships. This has resulted in the hedge accounting requirements being misaligned with many risk management strategies. The outcome was that the normal approach for risk management purposes was treated as the exception by the hedge accounting requirements.
- BC6.79 Many of the comment letters received on the discussion paper *Reducing Complexity in Reporting Financial Instruments* criticised the prohibition on designating risk components for non-financial items. This was also the most common issue raised during the Board's outreach activities.
- BC6.80 The Board noted that the conclusion in IAS 39, that permitting, as hedged items, risk components of non-financial assets and non-financial liabilities would compromise the principles of identification of the hedged item and effectiveness testing, was not appropriate in all circumstances. As part of its deliberations, the Board considered whether risk components should be eligible for designation as hedged items when they are:
- (a) contractually specified; and
 - (b) not contractually specified.
- BC6.81 Contractually specified risk components determine a currency amount for a pricing element of a contract independently of the other pricing elements and, therefore, independently of the non-financial item as a whole. Consequently, these components are separately identifiable. The Board also noted that many pricing formulas that use a reference to, for example, benchmark commodity prices are designed in that way to ensure there is no gap or misalignment for that risk component compared with the benchmark price. Consequently, by reference to that risk component, the exposure can be economically fully hedged using a derivative with the benchmark as the underlying. This means that the hedge effectiveness assessment on a risk components basis accurately reflects the underlying economics of the transaction (ie that there is no or very little ineffectiveness).
- BC6.82 However, in many situations risk components are not an explicit part of a fair value or a cash flow. Nonetheless, many hedging strategies involve hedging of components even if they are not contractually specified. There are different reasons for using a component approach to hedging, including:
- (a) the entire item cannot be hedged because there is a lack of appropriate hedging instruments.

- (b) it is cheaper to hedge the single components individually than the entire item (for example, because an active market exists for the risk components, but not for the entire item).
- (c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (for example, because one of the risk components is particularly volatile and it therefore justifies the costs of hedging it).

- BC6.83 The Board learned from its outreach activities that there are circumstances in which entities are able to identify and measure many risk components (other than foreign currency risk) of non-financial items with sufficient reliability. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure regarding that risk. Consequently, the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances (ie careful analysis and knowledge of the relevant markets). The Board noted that as a result there is no 'bright line' to determine eligible risk components of non-financial items.
- BC6.84 Consequently, in its exposure draft, the Board proposed that risk components (both contractually specified and those not contractually specified) should be eligible for designation as hedged items as long as they are separately identifiable and reliably measurable. This proposal would align the eligibility of risk components of non-financial items with that of financial items in IAS 39.
- BC6.85 Most respondents to the exposure draft supported the Board's proposal and its rationale for allowing risk components (both contractually specified and those not contractually specified) to be eligible for designation as hedged items. Those respondents noted that the proposal on risk components was a key aspect of the new hedge accounting model because it would allow hedge accounting to reflect that, in commercial reality, hedging risk components was the norm and hedging items in their entirety was the exception.
- BC6.86 Many commentators noted that IAS 39 was biased against hedges of non-financial items such as commodity hedges. They considered the distinction between financial and non-financial items for determining which risk components would be eligible hedged items as arbitrary and without conceptual justification. The main request by respondents was for additional guidance or clarifications.
- BC6.87 Only a few respondents disagreed with the Board's proposal on risk components. Those respondents believed that, in situations in which non-contractually specified risk components of non-financial items would be designated as hedged items, no hedge ineffectiveness would be recognised.
- BC6.88 The Board noted that the debate about risk components suffered from some common misunderstandings. In the Board's opinion, the root cause of those misunderstandings is the large number of markets and circumstances in which hedging takes place. This results in an inevitable lack of familiarity with many markets. In the light of the arguments raised and to address some of the misunderstandings, the Board focused its discussions on non-contractually specified risk components of non-financial items and, in particular, on:
- (a) the effect of risk components; and
 - (b) hedge ineffectiveness when designating a risk component.
- BC6.89 The Board noted that some believe that designating a risk component as a hedged item should not be allowed if it could result in the value of that risk

component moving in an opposite direction to the value of the entire item (ie its overall price). For example, if the hedged risk component increases in value this would offset the loss on the hedging instrument, while decreases in the value of other unhedged risk components remain unrecognised.

- BC6.90 The Board noted that this was not specific to non-contractually specified risk components of non-financial items, but that it applied to risk components in general. For example, consider an entity that holds a fixed rate bond and the benchmark interest rate decreases but the bond's spread over the benchmark increases. If the entity hedges only the benchmark interest rate using a benchmark interest rate swap, the loss on the swap is offset by a fair value hedge adjustment for the benchmark interest rate component of the bond (even though the bond's fair value is lower than its carrying amount after the fair value hedge adjustment because of the increase in the spread).
- BC6.91 The Board also noted that designating a risk component was not tantamount to 'hiding losses' or avoiding their recognition by applying hedge accounting. Instead, it would help to mitigate accounting mismatches that would otherwise result from how an entity manages its risks. If hedge accounting is not applied, only the gain or loss from the change in fair value of the financial instrument that hedges the risk is recognised in profit or loss, whereas the gain or loss on the entire item that gives rise to the risk remains fully unrecognised (until it is realised in a later period) so that any offset is obscured. If designation on a risk component basis is not available, that initially creates an issue of whether the hedge qualifies at all for hedge accounting and is inconsistent with the economic decision of hedging done on a components basis. Consequently, the accounting assessment would be completely disconnected from the decision making of an entity, which is driven by risk management purposes. The Board also noted that this consequence would be amplified by the fact that the hedged component is not necessarily the main or largest component (for example, in the case of a power purchase agreement with a contractual pricing formula that includes indexations to fuel oil and inflation, only the inflation risk but not the fuel oil price risk is hedged).
- BC6.92 The Board noted that even if hedge accounting can be achieved between the hedging instrument and the item (which includes the hedged risk component) in its entirety, the accounting outcome would be more akin to a fair value option for the entire item than reflecting the effect of the economic hedge. However, because hedge accounting would be disconnected from what is economically hedged, there would also be ramifications for the hedge ratio that would have to be used for designating the hedging relationship. The hedge ratio that an entity actually uses (ie for decision making purposes driven by risk management) would be based on the economic relationship between the underlyings of the hedged risk component and the hedging instrument. This is the sensible basis for hedging decisions. However, for accounting purposes, an entity would be forced to compare changes in the value of the hedging instrument to those of the entire item. This means that, in order to improve the offset for the hedging relationship that is designated for accounting purposes, an entity would have to create a deliberate mismatch compared to the economic hedging relationship, which is tantamount to distorting the economic hedge ratio for accounting purposes. The Board noted that distorting the hedge ratio also meant that prohibiting the designation of hedged items on a risk components basis would, ultimately, not necessarily result in the financial statements reflecting the change in the value of the unhedged risk component as a gain or loss for which there is

no offset. Hence, prohibiting that kind of designation would not achieve transparency about the changes in the value of unhedged components by showing a gain or loss for which there is no offset.

- BC6.93 The Board also noted that designating risk components as hedged items would reflect the fact that risk management typically operates on a ‘by risk’ instead of a ‘by item’ basis (which is the unit of account for financial reporting purposes). Hence, the use of risk components as hedged items would reflect what in commercial reality is the norm instead of requiring that all hedged items are ‘deemed’ to be hedged in their entirety (ie for all risks).
- BC6.94 The Board also considered the effect that risk components have on the recognition of hedge ineffectiveness. A few respondents believed that if a risk component was designated as the hedged item, it would result in no hedge ineffectiveness being recognised.
- BC6.95 The Board noted that the effect of designating a risk component as the hedged item was that it became the point of reference for determining offset (ie the fair value change on the hedging instrument would be compared to the change in value of the designated risk component instead of the entire item). This would make the comparison more focused because it would exclude the effect of changes in the value of risks that are not hedged, which would also make hedge ineffectiveness a better indicator of the success of the hedge. The Board noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components. Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised. For example:
- (a) A floating rate debt instrument is hedged against the variability of cash flows using an interest rate swap. The two instruments are indexed to the same benchmark interest rate but have different reset dates for the variable payments. Even though the hedged item is designated as the benchmark interest rate related variability in cash flows (ie as a risk component), the difference in reset dates causes hedge ineffectiveness. There is no market structure that would support identifying a ‘reset date’ risk component in the variable payments on the floating rate debt that would mirror the reset dates of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto floating rate debt.
 - (b) A fixed rate debt instrument is hedged against fair value interest rate risk using an interest rate swap. The two instruments have different day count methods for the fixed rate payments. Even though the hedged item is designated as the benchmark interest rate related change in fair value (ie as a risk component), the difference in the day count methods causes hedge ineffectiveness. There is no market structure that would support identifying a ‘day count’ risk component in the payments on the debt that would mirror the day count method of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto the fixed rate debt.
 - (c) An entity purchases crude oil under a variable–price oil supply contract that is indexed to a light sweet crude oil benchmark. Because of the natural decline of the benchmark oil field the derivatives market for that benchmark

has suffered a significant decline in liquidity. In response, the entity decides to use derivatives for a different benchmark for light sweet crude oil in a different geographical area because the derivatives market is much more liquid. The changes in the crude oil price for the more liquid benchmark and the less liquid benchmark are closely correlated but vary slightly. The variation between the two oil benchmark prices causes hedge ineffectiveness. There is no market structure that would support identifying the more liquid benchmark as a component in the variable payments under the oil supply contract. In particular, the terms and conditions of the derivatives indexed to the more liquid benchmark cannot be simply imputed by projecting terms and conditions of those derivatives onto the oil supply contract.

- (d) An entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude oil benchmark for jet fuel purchases at its North American locations is WTI whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe. Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness regarding the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot be simply imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

- BC6.96 Consequently, the Board noted that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.
- BC6.97 The Board noted that the concerns about hedge ineffectiveness not being recognised related particularly to non-contractually specified risk components of non-financial items. However, the Board considered that this was not a financial versus non-financial item problem. Determining the hedge ineffectiveness, for example, for a fixed rate debt instrument when designating the benchmark interest rate component as the hedged item is no more or less troublesome than doing so for commodity price risk. In both cases the appropriate designation of a risk component depends on an appropriate analysis of the market structure. The Board noted that the derivative markets for commodity risk had evolved and had resulted in customs that helped improve the effectiveness of hedging. For example, very liquid commodity benchmarks have evolved, allowing for a market volume for derivatives that is far larger than the physical volume of the underlying commodity thus facilitating benchmarks that can be widely used.
- BC6.98 In the light of those considerations and the responses received on the exposure draft, the Board decided to retain the notion of risk components as eligible hedged items. Because of the large variety of markets and circumstances in which hedging takes place, the Board considered that, in order to avoid arbitrary discrimination against some markets, risks or geographies, there was no alternative to using a criteria-based approach to identifying eligible risk

components. Consequently, the Board decided that for risk components (of both financial and non-financial items) to qualify as eligible hedged items, they must be separately identifiable and reliably measureable. In response to requests from commentators, the Board also decided to expand the examples of how to determine eligible risk components including the role of the market structure.

- BC6.99 The Board also discussed the proposal in the exposure draft to prohibit the designation of non-contractually specified inflation risk components. That prohibition was carried over from IAS 39. The Board noted that an outright ban meant that the general criteria for the eligibility of risk components could not be applied and, as a result, would leave no room for the possibility that in some situations there might be circumstances that could support identifying a risk component for inflation risk. On the other hand, the Board was concerned that the removal of the restriction would encourage the use of inflation risk components for hedge accounting when it was not necessarily appropriate to do so. This would be the case where a risk component, instead of being supported by the market structure and independently determined for the hedged item, would for example be determined by simply projecting the terms and conditions of the inflation derivative that was actually used as the hedge onto the hedged item. In the light of this trade-off, the Board also considered that financial markets continuously evolve and that the requirements should be capable of addressing changes in the market over time.
- BC6.100 On balance, the Board decided to remove the prohibition. However, the Board was concerned its decision could be misunderstood as simply ‘rubber stamping’ the use of inflation risk components for hedge accounting without proper application of the criteria for designating risk components. The Board therefore agreed to include a caution in the final requirements that in order to determine whether inflation risk is an eligible risk component, a careful analysis of the facts and circumstances is required so that the criteria for designating risk components are properly applied. Consequently, the Board decided to add a ‘rebuttable presumption’ regarding non-contractually specified inflation risk components of financial items.

Designation of ‘one-sided’ risk components

- BC6.101 IAS 39 permitted an entity to designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a ‘one-sided’ risk). So, an entity might hedge an exposure to a specific type of risk of a financial instrument (for example, interest rates) above a predetermined level (for example, above 5 per cent) using a purchased option (for example, an interest rate cap). In this situation an entity hedged some parts of a specific type of risk (ie interest exposure above 5 per cent).
- BC6.102 Furthermore, the Board noted that hedging one-sided risk exposures is a common risk management activity. The Board also noted that the main issue that relates to the hedging of one-sided risk is the use of options as hedging instruments. Consequently, the Board decided to permit the designation of one-sided risk components as hedged items, as was the case in IAS 39 for some risk components. However, the Board decided to change the accounting for the time value of options (see paragraphs BC6.264–BC6.291).
- BC6.103 The Board retained its original decisions about the eligibility of one-sided risk components as hedged items during the redeliberations of its exposure draft.

Components of a nominal amount—designation of a component that is a proportion

- BC6.104 The Board noted that components that are some quantifiable nominal part of the total cash flows of the instrument are typically separately identifiable. For example, a proportion, such as 50 per cent, of the contractual cash flows of a loan includes all the characteristics of that loan. In other words, changes in the value and cash flows for the 50 per cent component are half of those for the entire instrument.
- BC6.105 The Board noted that a proportion of an item forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The Board concluded that if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a proportion of an item as a hedged item (as previously permitted by IAS 39).
- BC6.106 The Board retained its original decisions during the redeliberations of its exposure draft.

Components of a nominal amount—designation of a layer component

- BC6.107 IAS 39 required an entity to identify and document anticipated (ie forecast) transactions designated as hedged items with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. As a result, IAS 39 permitted forecast transactions to be identified as a 'layer' component of a nominal amount, for example, the first 100 barrels of the total oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item regarding the amount or timing. This uncertainty does not affect the hedging relationship to the extent that the hedged volume occurs (irrespective of which particular individual items make up that volume).
- BC6.108 The Board considered whether similar considerations should also apply to a hedge of an existing transaction or item in some situations. For example, a firm commitment or a loan might also involve some uncertainty because:
- (a) a contract might be cancelled for breach of contract (ie non-performance); or
 - (b) a contract with an early termination option (for repayment at fair value) might be terminated before maturity.
- BC6.109 Because there is uncertainty for both anticipated transactions and existing transactions and items, the Board decided not to distinguish between such transactions and items for the purposes of designating a layer component.
- BC6.110 The Board noted that designating as the hedged item a component that is a proportion of an item can give rise to a different accounting outcome when compared with designating a layer component. If the designation of those components is not aligned with the risk management strategy of the entity, it might result in profit or loss providing misleading or less useful information to users of financial statements.
- BC6.111 In the Board's view there might be circumstances when it is appropriate to designate a hedged item as a layer component. Consequently, in its exposure draft the Board proposed to permit designating a layer component as the hedged item (for anticipated and existing transactions). The Board also proposed that a

layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The Board noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how the hedge effectiveness would be measured).

- BC6.112 Most respondents to the exposure draft agreed with the proposed change for fair value hedges, which would allow designating a layer component from a defined nominal amount. They agreed that such layers would allow entities to better reflect what risk they actually hedge.
- BC6.113 However, many respondents disagreed with the Board's proposal to prohibit, in any circumstances, the designation of a layer component in a fair value hedge for all contracts that include any prepayment option whose fair value is affected by changes in the hedged risk. Those respondents' main objection was that the proposal was inconsistent with common risk management strategies and that the fair value changes of a prepayment option were irrelevant in the context of a bottom layer.
- BC6.114 In the light of the comments received, the Board discussed:
- (a) whether the prohibition to designate a layer component as the hedged item in a fair value hedge should relate to an (entire) item or contract containing a prepayment option or whether it should relate only to those situations in which the designated layer contains a prepayment option;
 - (b) whether a layer component can be designated as the hedged item in a fair value hedge if it includes the effect of a related prepayment option; and
 - (c) whether the requirement should differentiate between written and purchased prepayment options, thereby allowing a layer component to be designated for items with a purchased option, ie if the entity is the option holder (for example, a debtor's call option included in prepayable debt).
- BC6.115 The Board discussed situations in which a contract is prepayable for only a part of its entire amount, which means that the remainder is not prepayable and hence does not include a prepayment option. For example, a loan with a principal amount of CU100 and a maturity of five years that allows the debtor to repay (at par) up to CU10 at the end of each year would mean that only CU40 is prepayable (at different points in time) whereas CU60 is non-prepayable but has a five year fixed term. Because the CU60 is fixed term debt that is not affected by prepayments, its fair value does not include the effect of a prepayment option. Consequently, the changes in the fair value related to the CU60 are unrelated to the fair value changes of the prepayment option for other amounts. This means that if the CU60 were designated as a layer component, the hedge ineffectiveness would appropriately exclude the change in the fair value of the prepayment option. The Board considered that this would be consistent with its rationale for proposing prohibiting a layer component of an (entire) item or contract that contains a prepayment option (see paragraph BC6.111) to be designated. However, the Board noted that the changes in fair value of the amounts that are prepayable (ie the CU40 at inception, CU30 after one year, CU20 after two years and CU10 after three years) include a prepayment option and the designation of a layer for these amounts would therefore contradict the Board's rationale (see paragraph BC6.111). The Board noted that the layer of

CU60 in the example above should not be confused with a bottom layer of CU60 that is expected to remain at maturity from a total amount of CU100 that is prepayable in its entirety. The difference is that the expected remaining amount of a larger prepayable amount is the expected eventual outcome of a variable contractual maturity, whereas the CU60 in the example above is the definite outcome of a fixed contractual maturity.

- BC6.116 Consequently, the Board decided to:
- (a) confirm the proposals in the exposure draft to allow a layer-based designation of a hedged item (when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk); and
 - (b) to allow a layer-based designation for those amounts that are not prepayable at the time of designation of a partially prepayable item.
- BC6.117 The Board also discussed whether a layer component should be available for designation as the hedged item in a fair value hedge if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.
- BC6.118 Including the change in fair value of the prepayment option that affects a layer in determining hedge ineffectiveness has the following consequences:
- (a) The designated hedged item would include the entire effect of changes in the hedged risk on the fair value of the layer, ie including those resulting from the prepayment option.
 - (b) If the layer was hedged with a hedging instrument (or a combination of instruments that are designated jointly) that does not have option features that mirror the layer's prepayment option, hedge ineffectiveness would arise.
- BC6.119 The Board noted that a designation of a layer as the hedged item, if it included the effects of a related prepayment option when determining the change in fair value of the hedged item, would not conflict with its rationale for proposing the requirements related to the implication of prepayment options for layer designations (see paragraph BC6.111).
- BC6.120 Consequently, the Board decided that designating a layer as the hedged item should be allowed if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.
- BC6.121 The Board also considered whether it should differentiate between written and purchased prepayment options for the purpose of determining the eligibility of a layer-based designation of a hedged item in a fair value hedge. Some respondents had argued that if the entity was the option holder, the entity would control the exercise of the option and could therefore demonstrate that the option was not affected by the hedged risk.
- BC6.122 However, the Board noted that the hedged risk affects the fair value of a prepayment option irrespective of whether the particular option holder actually exercises it at that time or intends to actually exercise it in the future. The fair value of the option captures the possible outcomes and hence the risk that an amount that would be 'in the money' might be repaid at a different amount than at fair value before taking the prepayment option into account (for example, at par). Consequently, the Board noted that whether a prepayment option is a purchased or a written option does not affect the change in the option's absolute

fair value but instead determines whether it is either a gain or a loss from the entity's perspective. In other words, the Board considered that the aspect of who controls the exercise of the option relates to whether any intrinsic value would be realised (but not whether it exists).

- BC6.123 Consequently, the Board decided not to differentiate between written and purchased prepayment options for the purpose of the eligibility of a layer-based designation of hedged items.

Relationship between components and the total cash flows of an item

- BC6.124 IAS 39 allowed an entity to designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).
- BC6.125 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing a variable interest coupon at LIBOR minus a spread or an equivalent fixed rate coupon), the negative spread represents a positive margin for the borrower. This is because banks on average pay LIBOR for their funding in the interbank market. Another example where this occurs is when the reference rate is highly correlated with LIBOR and the negative spreads arise because of the better credit risk of the contributors to the reference index compared with LIBOR. When entering into hedging relationships, an entity cannot obtain (at a reasonable cost) a standardised hedging instrument for all transactions that are priced sub-LIBOR. Consequently, such an entity uses hedging instruments that have LIBOR as their underlying.
- BC6.126 In the deliberations leading to the exposure draft, the Board noted that it had received feedback on the sub-LIBOR issue from its outreach activities that accompanied those deliberations. That feedback showed that some participants believed that designating a risk component that assumes cash flows that would exceed the actual cash flows of the instrument reflected risk management in situations in which the hedged item has a negative spread to the benchmark rate. They believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argued that they were hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.
- BC6.127 In the deliberations leading to the exposure draft, the Board noted that, for risk management purposes, an entity normally does not try to hedge the effective interest rate of the instrument but rather the change in the variability of the cash flows attributable to LIBOR. By doing this, such an entity ensures that exposure to benchmark interest rate risk is managed and that the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes, provided that LIBOR is not below the absolute value of the negative spread. This risk management strategy provides offsetting changes regarding the LIBOR-related interest rate risk similar to situations where the

spread above LIBOR is zero or positive. However, if LIBOR falls below the absolute value of that negative spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The Board noted that these outcomes are inconsistent with the economic phenomenon to which they relate.

- BC6.128 To avoid these outcomes, the Board proposed retaining the restriction in IAS 39 for the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the Board emphasised that hedge accounting would still be available on the basis of designating all the cash flows of an item for a particular risk, ie a risk component for the actual cash flows of the item (see paragraph BC6.124).
- BC6.129 The Board received mixed views on its proposal to retain this restriction. Some agreed with the restriction and the Board's rationale for retaining it. Others were concerned that the restriction was inconsistent with common risk management practices. Those who disagreed believed that it should be possible to designate as the hedged item a benchmark risk component equivalent to the entire LIBOR and treat the spread between the entire LIBOR and the contractual rate as a negative residual component. Their view reflects the fact that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps (see paragraph BC6.133 for an example). In their view, the Board's proposal would not allow them to properly reflect the hedging relationship, and would force them to recognise hedge ineffectiveness that, in their view, would not reflect their risk management strategy.
- BC6.130 In response to the concerns raised, the Board considered whether it should allow designating risk components on a benchmark risk basis that assumes cash flows exceeding the total actual cash flows of the hedged item.
- BC6.131 As part of its redeliberations, the Board discussed how contractual terms and conditions that determine whether an instrument has a zero interest rate floor or 'negative' interest (ie no floor) might affect the designation of a full LIBOR component of a sub-LIBOR instrument.
- BC6.132 The Board discussed an example of an entity that has a liability that pays a fixed rate and grants a loan at a floating rate with both instruments being priced at sub-LIBOR interest rates. The entity enters into a LIBOR-based interest rate swap with the aim of locking in the margin that it will earn on the combined position. If the entity wants to designate the hedged item on the basis of the interest rate risk that results from its financial asset this would be an example of a cash flow hedge of variable rate interest cash flows from a sub-LIBOR asset.
- BC6.133 The Board noted that if the floating rate asset had a zero interest rate floor and LIBOR decreased below the absolute value of the negative spread on the asset, the return on the asset (after taking into account the effect of the swap) would increase as a result of the interest rate swap not having a floor. This means that if designated on a full LIBOR risk component basis, the hedging relationship would have outcomes that would be inconsistent with the notion of a locked margin. In this example, the margin could become variable instead of being locked. The Board was of the view that, in the context of hedge accounting, this would give rise to hedge ineffectiveness that must be recognised in profit or loss. The Board noted that this hedge ineffectiveness resulted from the absence of offsetting cash flows and hence represented a genuine economic mismatch between changes in cash flows on the floating rate asset and the swap. Hence, if a full LIBOR component was imputed for instruments that are priced sub-

LIBOR, it would inappropriately defer hedge ineffectiveness in other comprehensive income. In the Board's view this would be tantamount to accrual accounting for the interest rate swap.

- BC6.134 In contrast, the Board noted that if the floating rate asset had no floor, the sub-LIBOR instrument included in the hedging relationship would still have changes in their cash flows that would move with LIBOR even if LIBOR was below the absolute value of the spread. Consequently, the variability in cash flows of the hedging instrument that locks the margin would be offset by the variability of the cash flows of the sub-LIBOR instrument irrespective of the LIBOR level. In other words, the LIBOR-related cash flow variability when the asset had no floor would be equivalent to that of a full LIBOR component and therefore the proposed requirement would not prohibit designating the hedged item accordingly (ie as changes in cash flows of a full LIBOR risk component).
- BC6.135 As a result, the Board decided to confirm the proposal in the exposure draft that if a component of the cash flows of a financial or non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item.
- BC6.136 Furthermore, the Board noted that the examples carried over from IAS 39 to the exposure draft only included financial items because under IAS 39 the issue could only apply to that type of item. But, given that under the new hedge accounting model this issue also applies to non-financial items that are traded below their respective benchmark price, the Board decided to add an example of a hedge of commodity price risk in a situation in which the commodity is priced at a discount to the benchmark commodity price.

Qualifying criteria for hedge accounting

Effectiveness assessment

- BC6.137 To qualify for hedge accounting in accordance with IAS 39, a hedge had to be highly effective, both prospectively and retrospectively. Consequently, an entity had to perform two effectiveness assessments for each hedging relationship. The prospective assessment supported the expectation that the hedging relationship would be effective in the future. The retrospective assessment determined that the hedging relationship had been effective in the reporting period. All retrospective effectiveness assessments were required to be performed using quantitative methods. However, IAS 39 did not specify a particular method for testing hedge effectiveness.
- BC6.138 The term 'highly effective' referred to the degree to which the hedging relationship achieved offsetting between changes in the fair value or cash flows of the hedging instrument and changes in the fair value or cash flows of the hedged item attributable to the hedged risk during the hedge period. IAS 39 regarded a hedge as highly effective if the offset was within the range of 80-125 per cent (often colloquially referred to as a 'bright line' test).
- BC6.139 In the deliberations leading to the exposure draft, the Board noted that it had received feedback on the hedge effectiveness assessment under IAS 39 from its outreach activities that accompanied those deliberations. The feedback showed that:
- (a) many participants found that the hedge effectiveness assessment in IAS 39 was arbitrary, onerous and difficult to apply;

- (b) as a result, there was often little or no link between hedge accounting and the risk management strategy; and
- (c) because hedge accounting was not achieved if the hedge effectiveness was outside the 80-125 per cent range, it made hedge accounting difficult to understand in the context of the risk management strategy of the entity.

BC6.140 Consequently, in its exposure draft the Board proposed a more principle-based hedge effectiveness assessment. The Board proposed that a hedging relationship meets the hedge effectiveness requirements if it:

- (a) meets the objective of the hedge effectiveness assessment (ie that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and
- (b) is expected to achieve other than accidental offsetting.

BC6.141 Most respondents to the exposure draft supported the removal of the 80-125 per cent quantitative test. Those respondents also supported the Board in avoiding the use of bright lines in hedge accounting generally and the move towards a more principle-based effectiveness assessment.

BC6.142 Only a few respondents disagreed with the proposal, largely because they believed that the quantitative threshold in IAS 39 was appropriate. They also believed that an approach that was completely principle-based would generate operational difficulties and would have the potential to inappropriately extend the application of hedge accounting.

BC6.143 The sections below elaborate on the Board's considerations.

The objective of the hedge effectiveness assessment

BC6.144 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The Board noted that this resulted in hedge accounting that was arbitrary and onerous. Furthermore, the arbitrary 'bright line' of 80-125 per cent resulted in a disconnect between hedge accounting and risk management. Consequently, it made it difficult to explain the results of hedge accounting to users of financial statements. To address these concerns, the Board decided that it would propose an objective-based model for testing hedge effectiveness instead of the 80-125 per cent bright line test in IAS 39.

BC6.145 During its deliberations, the Board initially considered an objective-based assessment to determine which hedging relationships would qualify for hedge accounting. The Board's intention was that the assessment should not be based on a particular level of hedge effectiveness. The Board decided that, in order to avoid the arbitrary outcomes of the assessment under IAS 39, it had to remove, rather than just move, the bright line. The Board held the view that the objective of the hedge effectiveness assessment should reflect that hedge accounting was based on the notion of offset.

BC6.146 In accordance with the Board's initially considered approach, the effectiveness assessment would have aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment would have been based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it could be expected to meet the risk management objective. The Board believed that the proposed approach would therefore have

strengthened the relationship between hedge accounting and risk management practice.

- BC6.147 However, the Board was concerned that this approach might not be rigorous enough. This was because, without clear guidance, an entity might designate hedging relationships that would not be appropriate because they would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation of the hedging relationship and hence be biased. The Board noted that the bright line of 80-125 per cent in IAS 39 created a trade-off when an entity chose a hedge ratio that would have a biased result, because that result came at the expense of higher ineffectiveness and hence increased the risk of falling outside that range. However, the Board noted that the 80-125 per cent range would be eliminated by its proposals. The Board therefore decided to extend its initial objective of the effectiveness assessment so that it also included the hedge ratio. Consequently, in its exposure draft, the Board proposed that the objective of assessing the effectiveness of a hedging relationship was that the entity designated the hedging relationship so that it gave an unbiased result and minimised expected ineffectiveness.
- BC6.148 The Board noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of differences in the underlyings or other differences between the hedging instrument and the hedged item that the entity accepts in order to achieve a cost-effective hedging relationship. The Board considered that when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, the Board proposed in its exposure draft that hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument.
- BC6.149 However, many respondents to the exposure draft asked the Board to provide further guidance on the objective-based effectiveness assessment, particularly on the notions of 'unbiased result' and 'minimise expected hedge ineffectiveness'. Those respondents were concerned that the requirements, as drafted in the exposure draft, could be interpreted to be more restrictive and onerous than the bright line effectiveness test in IAS 39 and would be inconsistent with risk management practice. More specifically, those respondents were concerned that the objective of the hedge effectiveness assessment as drafted in the exposure draft could be interpreted as requiring entities to set up a hedging relationship that was 'perfectly effective'. They were concerned that this would result in an effectiveness assessment that would be based on a bright line of 100 per cent effectiveness, and that such an approach:
- (a) would not take into account that in many situations entities do not use a hedging instrument that would make the hedging relationship 'perfectly effective'. They noted that entities use hedging instruments that do not achieve perfect hedge effectiveness because the 'perfect' hedging instrument is:
 - (i) not available; or
 - (ii) not cost-effective as a hedge (compared to a standardised instrument that is cheaper and/or more liquid, but does not provide the perfect fit).

- (b) could be interpreted as a mathematical optimisation exercise. In other words, they were concerned that it would require entities to search for the perfect hedging relationship at inception (and on a continuous basis), because if they did not, the results could be considered to be biased and hedge ineffectiveness would probably not be 'minimised'.

BC6.150 In the light of the concerns regarding the use of hedging instruments that are not 'perfectly effective', the Board noted that the appropriate hedge ratio was primarily a risk management decision rather than an accounting decision. When determining the appropriate hedge ratio, risk management would take into consideration, among other things, the following factors:

- (a) the availability of hedging instruments and the underlyings of those instruments (and, as a consequence, the level of risk of differences in value changes involved between the hedged item and the hedging instrument);
- (b) the tolerance levels in relation to expected sources of hedge ineffectiveness (which determine when the hedging relationship is adjusted for risk management purposes); and
- (c) the costs of hedging (including the costs of adjusting an existing hedging relationship).

BC6.151 The Board's intention behind its proposal in the exposure draft was that entities would use the actual hedging instrument it had chosen based on commercial considerations as a starting point and, on that basis, determine the hedge ratio that would comply with the proposed requirements. In other words, the Board's intention was not that entities would have to consider the hedge effectiveness and related hedge ratio that could have been achieved with a different hedging instrument that might have been a better fit for the hedged risk but that the entity did not enter into.

BC6.152 The Board also reconsidered the proposed objective of the hedge effectiveness assessment in respect of the concerns that it might result in a mathematical optimisation exercise. In particular, the Board considered the effect of its proposal in situations in which a derivative is designated as a hedging instrument only after its inception so that it is already in or out of the money at the time of its designation (often colloquially referred to as a 'late hedge'). The Board considered whether the hedge ratio would have to be adjusted with regard to the (non-zero) fair value of the derivative at the time of its designation. This is because the fair value of the hedging instrument at the time of its designation is a present value. Over the remaining life of the hedging instrument this present value will accrete to the undiscounted amount (this is often referred to as the unwinding of the discount). The Board noted that there is no offsetting fair value change in the hedged item for this effect (unless the hedged item was also in or out of the money in an equal but opposite way). Consequently, in situations in which the derivative is designated as the hedging instrument after its inception, an entity would expect that the changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item (ie the hedge ratio would not be 'unbiased'). To meet the proposed objective of the hedge effectiveness assessment an entity would need to explore whether it could adjust the hedge ratio to avoid the systematic difference between the value changes of the hedging instrument and the hedged item over the hedging period. However, to determine the ratio that would avoid the systematic difference, an entity would need to know what the actual price or rate of the underlying will be at the end of the hedging relationship. Hence, the Board

noted that the proposed objective of the hedge effectiveness assessment could be interpreted to the effect that, in the (quite common) situations in which an entity has a 'late hedge', the proposed hedge effectiveness requirements would not be met. This is because the entity would not be able to identify a hedge ratio for the designation of the hedging relationship that would not involve an expectation that the changes in value of the hedging instrument will systematically either exceed or be less than the changes in value of the hedged item. The Board did not intend this outcome when it made its proposals in its exposure draft.

BC6.153 The Board noted that the feedback on the requirement that the hedging relationship should minimise hedge ineffectiveness suggested that identifying a 'minimum' would involve considerable effort in all situations in which the terms of the hedging instrument and the hedged item are not fully matched. Hence, the requirement to minimise hedge ineffectiveness would bring back many of the operational problems of the hedge effectiveness assessment in IAS 39. Furthermore, regardless of the effort involved, it would be difficult to demonstrate that the 'minimum' had been identified.

BC6.154 The Board noted that when it developed the exposure draft, it included the notions of 'unbiased' and 'minimise expected hedge ineffectiveness' to ensure that:

- (a) entities would not deliberately create a difference between the quantity actually hedged and the quantity designated as the hedged item in order to achieve a particular accounting outcome; and that
- (b) an entity would not inappropriately designate a hedging relationship such that it would give rise to systematic hedge ineffectiveness, which could be avoided by a more appropriate designation.

The Board noted that both aspects could result in undermining the 'lower of' test for cash flow hedges or achieving fair value hedge adjustments on a greater quantity of the hedged item than an entity actually hedged (ie fair value accounting would be disproportionately expanded compared to the actually hedged quantity).

BC6.155 Taking into account the responses to the exposure draft, the Board decided to remove the terms 'unbiased' (ie no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result) and 'minimising expected hedge ineffectiveness'. Instead the Board decided to state, more directly, that the entity's designation of the hedging relationship shall use a hedge ratio based on:

- (a) the quantity of the hedged item that it actually hedges; and
- (b) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item.

BC6.156 The Board noted that this approach has the following advantages:

- (a) The use of the hedge ratio resulting from the requirement in this IFRS provides information about the hedge ineffectiveness in situations in which an entity uses a hedging instrument that does not provide the best fit (for example, because of cost-efficiency considerations). The Board noted that the hedge ratio determined for risk management purposes has the effect of showing the characteristics of the hedging relationship and the entity's

expectations about hedge ineffectiveness. This includes hedge ineffectiveness that results from using a hedging instrument that does not provide the best fit.

- (b) It also aligns hedge accounting with risk management and hence is consistent with the overall objective of the new hedge accounting model.
- (c) It addresses the requests from respondents to the exposure draft for clarification that the relevant hedging instrument to be considered in the hedge effectiveness assessment is the actual hedging instrument the entity decided to use.
- (d) It retains the notion proposed in the exposure draft that the hedge ratio is not a free choice for accounting purposes as it was in IAS 39 (subject to passing the 80-125 per cent bright line test).

BC6.157 The Board noted that the only situation open to abuse is if the entity purposefully (for risk management purposes) used a hedge ratio that would be considered 'inappropriately loose' from an accounting perspective. For example:

- (a) If an entity uses an excess quantity of the hedging instrument it would have more costs and risks because of having more hedging instruments than needed to mitigate the risks resulting from the hedged items. However, from an accounting perspective, this would create no advantage because it would create fair value changes for the hedging instrument that affect profit or loss for both fair value hedges and cash flow hedges. The result of an entity using an excess quantity of the hedging instrument would therefore solely be the presentation of fair value changes within profit or loss as hedge ineffectiveness instead of other or trading gains or losses. This would increase the hedge ineffectiveness in an entity's financial statements while having no impact on overall profit or loss.
- (b) If an entity uses a quantity of the hedging instrument that is too small it would leave, economically, a gap in its hedging. From an accounting perspective, this might create an advantage for fair value hedges if an entity wanted to achieve fair value hedge adjustments on a greater quantity of 'hedged items' than it would achieve when using an appropriate hedge ratio. In addition, for cash flow hedges, an entity could abuse the 'lower of' test because the hedge ineffectiveness arising from the larger fair value change on the hedged item compared to that on the hedging instrument would not be recognised. Consequently, even though using a 'deficit' quantity of the hedging instrument would not be economically advantageous, from an accounting perspective it might have the desired outcome for an entity.

BC6.158 The Board noted that the potential for abuse, as illustrated above, was implicitly addressed in IAS 39 by the 80-125 per cent bright line of the retrospective hedge effectiveness assessment. Given its decision to remove that bright line (see paragraph BC6.144), the Board decided to explicitly address this potential for abuse. As a consequence, this IFRS requires that, for the purpose of hedge accounting, an entity shall not designate a hedging relationship in a manner that reflects 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.

Other than accidental offsetting

- BC6.159 IAS 39 was based on a purely accounting-driven percentage-based bright line test (the 80-125 per cent range). This disconnected accounting from risk management (see paragraph BC6.144). Consequently, the Board proposed replacing the bright line test with a notion that aims to reflect the way entities look at the design and monitoring of hedging relationships from a risk management perspective. Inherent in this was the notion of ‘other than accidental offsetting’. This linked the risk management perspective with the hedge accounting model’s general notion of offset between gains and losses on hedging instruments and hedged items. The Board also considered that this link reflected the intention that the effectiveness assessment should not be based on a particular level of effectiveness (hence avoiding a new bright line).
- BC6.160 Many respondents to the exposure draft asked the Board to provide further guidance on the notion of ‘other than accidental offsetting’. Many also suggested that the Board revise the proposed guidance by directly referring to the aspect of an economic relationship between the hedged item and the hedging instrument that was included in the application guidance proposed in the exposure draft.
- BC6.161 The Board noted that qualifying criteria that use terminology such as ‘other than accidental offsetting’ can be abstract. The feedback suggested that this makes the relevant aspects or elements of the hedge effectiveness assessment more difficult to understand. The Board considered that it could address the respondents’ request and reduce the abstractness of this proposal by avoiding the use of an ‘umbrella term’ and instead making explicit all aspects that the requirement comprises. This would provide greater clarity and facilitate a better understanding of what aspects are relevant when assessing hedge effectiveness.
- BC6.162 Consequently, the Board decided to replace the term ‘other than accidental offsetting’ with requirements that better conveyed its original notion:
- (a) an economic relationship between the hedged item and the hedging instrument, which gives rise to offset, must exist at inception and during the life of the hedging relationship; and
 - (b) the effect of credit risk does not dominate the value changes that result from that economic relationship.

A ‘reasonably effective’ threshold

- BC6.163 A few respondents suggested that the Board consider using a ‘qualitative threshold’ instead of a principle-based hedge effectiveness assessment. Those respondents believed that, in order to meet the hedge effectiveness criteria, a hedging relationship should be required to be ‘reasonably effective’ in achieving offsetting changes in the fair value of the hedged item and in the fair value of the hedging instrument.
- BC6.164 The Board noted that a ‘reasonably effective’ criterion would retain the threshold design of the effectiveness assessment that was used in IAS 39. The Board considered that moving, rather than removing, the threshold would not address the root cause of the problem (see paragraph BC6.144). The suggested approach would instead only change the level of the threshold. The Board considered that, even though the threshold would be of a qualitative nature, it would still create a danger of reverting back to a quantitative measure (such as

the percentage range of IAS 39) in order for it to be operational. The Board noted that similar concerns had been raised as part of the feedback.

- BC6.165 The Board also noted that one of the major concerns that respondents had raised about the reference in the exposure draft to ‘unbiased result’ was that it could be perceived as requiring entities to identify the ‘perfect’ hedging instrument or that the entity’s commercial decision of which hedging instrument to actually use could be restricted or second guessed (see paragraph BC6.149).
- BC6.166 The Board considered that using a reference to ‘reasonably effective’ would give rise to similar concerns because it would raise the question of how much ineffectiveness that results from the choice of the actual hedging instrument is ‘reasonable’ (similar to the notion of ‘unbiased’ proposed in the exposure draft). The Board was also concerned that this might have a particular impact on emerging economies because entities in those economies often have to transact hedging instruments in more liquid markets abroad, which means it is more difficult for them to find a hedging instrument that fits their actual exposure than it is for entities in economies with those liquid markets.
- BC6.167 Furthermore, the Board was concerned that using the single term ‘reasonably effective’ would mingle different aspects, which would be tantamount to aggregating the different aspects of the effectiveness assessment that the Board had considered (ie the economic relationship, the effect of credit risk and the hedge ratio). The Board noted that it was clear from feedback received on its proposed objective of the hedge effectiveness assessment that a single term was too abstract if the notion described by that term included a number of different aspects (also see paragraph BC6.161).
- BC6.168 Consequently, the Board decided not to use a qualitative ‘reasonably effective’ threshold for assessing hedge effectiveness.

Frequency of assessing whether the hedge effectiveness requirements are met

- BC6.169 In the deliberations leading to the exposure draft, as a consequence of its proposed hedge effectiveness requirements, the Board considered how frequently an entity should assess whether the hedge effectiveness requirements were met. The Board decided that an entity should perform this assessment at the inception of the hedging relationship.
- BC6.170 Furthermore, the Board considered that an entity should assess on an ongoing basis whether the hedge effectiveness requirements are (still) met, including any adjustment (rebalancing) that might be required in order to continue to meet those requirements (see paragraphs BC6.199–BC6.212). This was because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship. The Board also decided that the assessment of those requirements should be only forward-looking (ie prospective) because it related to expectations about hedge effectiveness.
- BC6.171 Hence, in the deliberations leading to the exposure draft, the Board concluded that the reassessment of the hedge ratio should be performed at the beginning of each reporting period or upon a significant change in the circumstances underlying the effectiveness assessment, whichever comes first.
- BC6.172 Given that the changes made to the proposed hedge effectiveness requirements during the redeliberations of the exposure draft did not affect the Board’s rationale regarding the frequency of the assessment, the Board retained its original decision.

Method of assessing hedge effectiveness

- BC6.173 The method used to assess the effectiveness of the hedging relationship needs to be suitable to demonstrate that the objective of the hedge effectiveness assessment has been achieved. The Board considered whether the effectiveness of a hedging relationship should be assessed on either a qualitative or a quantitative basis.
- BC6.174 Hedging relationships have one of two characteristics that affect the complexity of the hedge effectiveness assessment:
- (a) The critical terms of the hedged item and hedging instrument match or are closely aligned. If there are no substantial changes in the critical terms or in the credit risk of the hedging instrument or hedged item, the hedge effectiveness can typically be determined using a qualitative assessment.
 - (b) The critical terms of the hedged item and hedging instrument do not match and are not closely aligned. These hedging relationships involve an increased level of uncertainty regarding the degree of offset and so the effectiveness of the hedge during its term is more difficult to evaluate.
- BC6.175 Qualitative hedge effectiveness assessments use a comparison of the terms of the hedged item and the hedging instrument (for example, the commonly termed 'critical-terms-match' approach). The Board considered that, in the context of an effectiveness assessment that does not use a threshold, it can be appropriate to assess the effectiveness qualitatively for a hedging relationship for which the terms of the hedging instrument and the hedged item match or are closely aligned.
- BC6.176 However, assessing the hedging relationship qualitatively is less effective than a quantitative assessment in other situations. For example, when analysing the possible behaviour of hedging relationships that involve a significant degree of potential ineffectiveness resulting from terms of the hedged item that are less closely aligned with the hedging instrument, the extent of future offset has a high level of uncertainty and is difficult to determine using a qualitative approach. The Board considered that a quantitative assessment would be more suitable in such situations.
- BC6.177 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The Board noted that selecting the appropriate tool or technique depends on the complexity of the hedge, the availability of data and the level of uncertainty of offset in the hedging relationship. The type of assessment and the method used to assess hedge effectiveness therefore depends on the relevant characteristics of the hedging relationship. Consequently, in the deliberations leading to the exposure draft, the Board decided that an entity should assess the effectiveness of a hedging relationship either qualitatively or quantitatively depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. However, the Board decided not to prescribe any specific method of assessing hedge effectiveness.
- BC6.178 The Board retained its original decisions during the redeliberations of its exposure draft.

Accounting for qualifying hedging relationships

Financial instruments held within a business model whose objective is to collect or pay contractual cash flows

- BC6.179 Against the background of potential interaction with the classification of financial instruments in accordance with IFRS 9, the Board, in its deliberations leading to the exposure draft, considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows. The Board focused on fair value hedges of interest rate risk because other risks (for example, foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seemed clearly appropriate. More specifically, the Board was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the entity's business model is to hold the financial instrument to collect (or pay) contractual cash flows, rather than to sell (or settle/transfer) the instrument before contractual maturity in order to realise the fair value changes. Consequently, some argue that, on the basis of the assertion underlying the business model assessment, the entity should be interested only in the contractual cash flows arising from these investments and not in changes in fair value.
- BC6.180 The Board discussed several situations in which a fair value hedge of interest rate risk does not contradict that a financial instrument is held with the objective to collect or pay contractual cash flows. One example is an entity that seeks to invest in a variable rate asset of a particular credit quality, but could only obtain a fixed rate asset of the desired credit quality. That entity could create the cash flow profile of a variable rate asset indirectly by buying both the available fixed rate investment and entering into an interest rate swap that transforms the fixed interest cash flows from that asset into variable interest cash flows. The Board noted that this and other examples demonstrated that what is a fair value hedge for accounting purposes is, from a risk management perspective, often a choice between receiving (or paying) fixed versus variable interest cash flows, rather than a strategy to protect against fair value changes. Hence, the Board considered that a fair value hedge of interest rate risk in itself would not contradict the assertion that a financial instrument is held with the objective to collect or pay contractual cash flows.
- BC6.181 The Board also noted that, under the classification model for financial instruments in IFRS 9, an entity may sell or transfer some financial instruments that qualify for amortised cost, even if they are held with the objective to collect or pay contractual cash flows. Consequently, the Board decided that fair value hedge accounting should be available for financial instruments that are held with the objective to collect or pay contractual cash flows.
- BC6.182 The Board retained its original decisions during the redeliberations of its exposure draft.

Hedge of a foreign currency risk of a firm commitment

- BC6.183 IAS 39 allowed an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. In its deliberations leading to the exposure draft, the Board considered whether it should continue to allow this choice.

- BC6.184 The Board noted that requiring an entity to apply cash flow hedge accounting for all hedges of foreign currency risk of a firm commitment could result in what some regard as 'artificial' other comprehensive income and equity volatility (see paragraphs BC6.231 and BC6.232). The Board also noted that, by requiring an entity to apply cash flow hedge accounting, the 'lower of' test would apply to transactions that already exist (ie firm commitments).
- BC6.185 However, the Board also noted that requiring an entity to apply fair value hedge accounting for all hedges of foreign currency risk of a firm commitment would require a change in the type of hedging relationship to a fair value hedge when the foreign currency cash flow hedge of a forecast transaction becomes a hedge of a firm commitment. This results in operational complexity. For example, this would require changing the measurement of ineffectiveness from a 'lower of' test to a symmetrical test.
- BC6.186 The Board also noted that for existing hedged items (such as firm commitments) foreign currency risk affects both the cash flows and the fair value of the hedged item and hence has a dual character.
- BC6.187 Consequently, the Board proposed in its exposure draft to continue to permit an entity the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge.
- BC6.188 The Board retained its original decision during the redeliberations of its exposure draft.

Measuring the ineffectiveness of a hedging relationship

- BC6.189 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the Board in its deliberations leading to the exposure draft decided that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).
- BC6.190 The Board retained its original decision during the redeliberations of its exposure draft.

Time value of money

- BC6.191 The objective of measuring hedge ineffectiveness is to recognise, in profit or loss, the extent to which the hedging relationship did not achieve offset (subject to the restrictions that apply to the recognition of hedge ineffectiveness for cash flow hedges—often referred to as the 'lower of' test).
- BC6.192 The Board noted that hedging instruments are subject to measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts that are compared with the changes in the value of the hedging instrument must also be determined on a present value basis. The Board noted that hedge accounting does not change the measurement of the hedging instrument, but that it might change only the location of where the change in its carrying amount is presented. As a result, the same basis (ie present value) for the hedged item must be used in order to avoid a mismatch when determining the amount to be recognised as hedge ineffectiveness.

- BC6.193 Consequently, in the deliberations leading to the exposure draft, the Board decided that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.
- BC6.194 The Board retained its original decision during the redeliberations of its exposure draft.

Hypothetical derivatives

- BC6.195 In its deliberations leading to the exposure draft, the Board considered the use of a 'hypothetical derivative', which is a derivative that would have critical terms that exactly match those of a hedged item. The Board considered the use of a hypothetical derivative in the context of the hedge effectiveness assessment as well as for the purpose of measuring hedge ineffectiveness.
- BC6.196 The Board noted that the purpose of a hypothetical derivative is to measure the change in the value of the hedged item. Consequently, a hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods (for example, statistical methods or dollar-offset) to assess the effectiveness of the hedging relationship or measure ineffectiveness.
- BC6.197 Consequently, in the deliberations leading to the exposure draft, the Board decided that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The Board noted that this notion of a hypothetical derivative means that using a hypothetical derivative is only one possible way of determining the change in the value of the hedged item and would result in the same outcome as if that change in the value was determined by a different approach (ie it is a mathematical expedient).
- BC6.198 The Board retained its original decision during the redeliberations of its exposure draft.

Rebalancing the hedging relationship

- BC6.199 IAS 39 did not allow adjustments that were not envisaged (documented) at the inception of the hedge to be treated as adjustments to a continuing hedging relationship. IAS 39 treated adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The Board noted that this resulted from a hedge accounting model that did not include the notion of accounting for changes to an existing hedging relationship as a continuation of that relationship.
- BC6.200 The Board noted that this is inconsistent with risk management practices. There are instances where, 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. For example, such adjustments are often required to re-align the hedging relationship with risk management policies in view of changed circumstances. Hence, these adjustments to the hedged item or hedging instrument do not change the original risk management objective but instead reflect a change in

how it is executed owing to the changes in circumstances. The Board considered that in these situations the revised hedging relationship should be accounted for as a continuation of the existing hedging relationship. The Board referred to such adjustments of hedging relationships as ‘rebalancing’.

- BC6.201 In its deliberations leading to the exposure draft, the Board also considered the ramifications of the proposed hedge effectiveness requirements, which, for some changes in circumstances, would create the need for an adjustment to the hedging relationship to ensure that those requirements would continue to be met. An example is a change in the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid a level of ineffectiveness that would fail the effectiveness requirements (which would not be met when using the original hedge ratio in the new circumstances).
- BC6.202 The Board concluded that, in such situations, if the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the Board proposed that an adjustment to a hedging relationship is treated as a rebalancing when that adjustment changes the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument but risk management otherwise continues the originally designated hedging relationship.
- BC6.203 However, if the adjustment represents an overhaul of the existing hedging relationship, the Board considered that treating the adjustment as a rebalancing would not be appropriate. Instead, the Board considered that such an adjustment should result in the discontinuation of that hedging relationship. An example is a hedging relationship with a hedging instrument that experiences a severe deterioration of its credit quality and hence is no longer used for risk management purposes.
- BC6.204 Most respondents to the exposure draft agreed that the hedge accounting model should include a notion whereby a hedging relationship can be adjusted and accounted for as the continuation of an existing hedging relationship. Respondents thought that the inclusion of the concept of rebalancing would enhance the application of hedge accounting and would be a better representation of what entities do as part of their risk management activities. However, some respondents requested that the Board clarify the circumstances in which rebalancing is required or permitted. They were unsure as to whether rebalancing has been designed in the narrower sense to only deal with adjustments to the hedge ratio in the context of the hedge effectiveness requirements, or whether in a wider sense it also relates to the adjustment of hedged volumes when the hedge ratio is still appropriate (ie when the entity simply wants to hedge more or less than originally).
- BC6.205 Even though respondents generally supported the concept of rebalancing, some were concerned that, on the basis of how the hedge effectiveness requirement was proposed in the exposure draft, it would be unclear when to rebalance and that the Board should provide more guidance to ensure consistent application. Some respondents also thought that rebalancing should be permitted but not mandatory. They argued that risk management often chose not to adjust its (economic) hedging relationships based on a mathematical optimisation exercise that was implied in the exposure draft (see paragraph BC6.149). This was because of cost-effectiveness considerations or simply because the hedge was still within the tolerance limits an entity might use for adjusting the hedging

relationship. There was concern that the wording, as proposed in the exposure draft, implied a continuous optimisation exercise (ie to always have the 'perfect' hedge ratio) and would therefore require constant rebalancing. Consequently, almost all respondents (directly or indirectly) requested that the Board clarify that rebalancing should only be required when done for risk management purposes. They believed that hedge accounting should follow and represent rebalancing based on what an entity actually did for risk management purposes but that rebalancing should not be triggered merely by accounting requirements.

BC6.206 In the light of the feedback, the Board decided to retain the notion of rebalancing but to add some clarification on:

- (a) whether rebalancing should be mandatory or voluntary; and
- (b) the notion of rebalancing.

Mandatory or voluntary rebalancing

BC6.207 The Board noted that its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft had ramifications for rebalancing. This decision resulted in designating hedging relationships using a hedge ratio based on the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item. However, this is provided that the hedge ratio would not reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs BC6.155–BC6.158). The Board considered that this decision addressed the main concerns respondents had about rebalancing (ie how rebalancing for hedge accounting purposes related to rebalancing for risk management purposes).

BC6.208 The Board's proposal in the exposure draft included the notion of proactive rebalancing as a complement to the proposed hedge effectiveness assessment in order to allow an entity to adjust hedging relationships on a timely basis and at the same time strengthen the link between hedge accounting and risk management. However, the Board considered that its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft (see paragraph BC6.155) had an effect on rebalancing that would facilitate the adjustments to a hedging relationship that the exposure draft had addressed by the proposed notion of proactive rebalancing. In other words, if an entity adjusted the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument for risk management purposes (including adjustments that the exposure draft would have considered 'proactive'), the hedging relationship for hedge accounting purposes would usually be adjusted in the same way. Consequently, the Board considered that the notion of proactive rebalancing had become obsolete.

BC6.209 The Board also noted that its decisions on the hedge effectiveness assessment during the redeliberations of the exposure draft had an effect on rebalancing that addressed respondents' concerns related to the frequency of rebalancing because that also clarified that rebalancing was not a mathematical optimisation exercise (see paragraphs BC6.155 and BC6.156).

Clarification of the term ‘rebalancing’

- BC6.210 The Board noted that it had already clarified the notion of ‘rebalancing’ as a result of its decision on the hedge effectiveness assessment during the redeliberations of the exposure draft (see paragraphs BC6.207–BC6.209). However, the Board considered whether it also needed to provide clarification on the scope of rebalancing—in other words, what adjustments to a hedging relationship constitute rebalancing.
- BC6.211 The Board noted that the notion of rebalancing, as proposed in its exposure draft, was used in the context of adjusting the designated quantities of the hedging instrument or hedged item in order to maintain a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedging instrument or of a hedged item for different purposes did not constitute the notion of ‘rebalancing’ that was proposed in the exposure draft.
- BC6.212 Consequently, the Board decided to clarify that rebalancing only covers adjustments to the designated quantities of the hedged item or of the hedging instrument for the purpose of maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment (ie not when the entity simply wants to hedge more or less than it did originally).

Discontinuation of hedge accounting

- BC6.213 In accordance with IAS 39, an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria (including when the hedging instrument no longer existed or was sold). However, in accordance with IAS 39, an entity also had a free choice to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).
- BC6.214 The Board noted that entities voluntarily discontinued hedge accounting often because of how the effectiveness assessment in IAS 39 worked. For example, entities revoked the designation of a hedging relationship and re-designated it as a new hedging relationship in order to apply a different method of assessing hedge ineffectiveness from the method originally documented (expecting that the new method would be a better fit). Another example was entities that revoked the designation of a hedging relationship because they wanted to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument (typically in response to a change in the relationship between different underlyings). The hedging relationship was then re-designated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The Board noted that in these situations the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the Board’s view, these outcomes created a disconnect between the hedge accounting model in IAS 39 and hedging from a risk management perspective and also undermined the usefulness of the information provided.
- BC6.215 In its deliberations leading to the exposure draft, the Board concluded that the proposed hedge accounting model would improve the link between hedge accounting and risk management because:
- (a) the new hedge effectiveness assessment requirements would not involve a percentage band or any other bright line criterion and would result in

changing the method for assessing hedge effectiveness in response to changes in circumstances as part of a continuing hedging relationship; and

- (b) the notion of rebalancing would allow the hedge ratio to be adjusted as part of a continuing hedging relationship.

- BC6.216 The Board also noted that sometimes a hedging relationship was discontinued because of a decrease in the hedged quantities of forecast transactions (ie the volume that remains highly probable of occurring falls or is expected to fall below the volume designated as the hedged item). Under IAS 39 this had resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the volume designated as the hedged item in its entirety. The Board considered that the quantity of forecast transactions that were still highly probable of occurring was in fact a continuation of the original hedging relationship (albeit with a lower volume). Hence, the Board decided to propose in its exposure draft that hedge accounting should be discontinued only for the volume that was no longer highly probable of occurring and that the remaining volume that was still highly probable of occurring should be accounted for as a continuation of the original hedging relationship. In the Board's view, this would more closely align hedge accounting with risk management and provide more useful information.
- BC6.217 However, the Board was concerned that this accounting might possibly undermine the requirement that forecast transactions must be highly probable in order to qualify as a hedged item. Hence, the Board decided to also propose to clarify that a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur would call into question the entity's ability to predict similar forecast transactions accurately. This would affect the assessment of whether similar forecast transactions are highly probable and hence their eligibility as hedged items.
- BC6.218 In view of its aim to better link hedge accounting to risk management and provide more useful hedge accounting information, the Board also discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship. The Board considered that the choice to revoke the designation of a hedging relationship (and hence discontinue hedge accounting) at will does not result in useful information. The Board noted that this would allow hedge accounting to be discontinued even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective that was part of the qualifying criteria that initially allowed the entity to achieve hedge accounting. The Board considered that, in such situations, voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. Hence, the Board decided to propose not to allow entities a free choice to revoke the designation of a hedging relationship in this situation. The Board also noted that if the hedging relationship no longer reflected the risk management objective for that particular hedging relationship, discontinuation of hedge accounting was not a choice but was required because the qualifying criteria would no longer be met. The Board considered that applying hedge accounting without a risk management objective would not provide useful information.
- BC6.219 In its deliberations leading to the exposure draft, the Board did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a business combination. The Board

noted that this was a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.

- BC6.220 The responses to the proposals on the discontinuation of hedge accounting in the exposure draft provided mixed views. Those who agreed thought that the proposals would strengthen the reliability of financial reporting because the ability to change accounting for no valid reason would be reduced.
- BC6.221 More specifically, those who agreed also thought that the model in IAS 39 provided an opportunity for structuring. They noted that allowing a hedging relationship to be arbitrarily discontinued at any point in time is not conceptually sound and does not result in useful information.
- BC6.222 Even though many respondents agreed with the proposals, there were also requests that the Board provide additional guidance on the meaning of 'risk management' and at what level it should be considered for the purpose of hedge accounting.
- BC6.223 Generally, those who disagreed with the proposals argued that if starting hedge accounting was voluntary, ceasing it should also be voluntary. Some respondents who disagreed did so because they believed that voluntary discontinuation was necessary in scenarios where an entity decided to terminate a hedging relationship on the basis that the hedge was no longer cost efficient (for example, a high administrative burden makes it too onerous and costly to apply hedge accounting). Some of these respondents raised the concern that voluntary discontinuation was an important tool in the current hedge accounting model for financial institutions that normally run hedging programmes based on portfolios of items on a macro basis. Those portfolios were subject to constant changes and entities removed the hedge designation with the aim of adjusting the hedging relationship for new hedged items and hedging instruments.
- BC6.224 Others who disagreed argued that not allowing voluntary discontinuation was not consistent with the mechanics of cash flow hedge accounting. For example, when an entity entered into a cash flow hedge for forecast sales in a foreign currency, the risk management strategy aimed to protect the cash flows until settlement of the invoice. However, hedge accounting was only applied until the moment when the sales invoice became an on-balance-sheet item, after which the entity obtained a natural offset in the statement of profit or loss and other comprehensive income because of the translation of the hedged item in accordance with IAS 21 and the accounting for the hedging instrument at fair value through profit or loss. Those respondents thought that voluntary discontinuation of the hedging relationship was necessary at the time the forecast transaction became an on-balance-sheet item (for example, a trade receivable).
- BC6.225 Based on this feedback, the Board in its redeliberations considered:
- (a) whether voluntary discontinuation should be allowed given that hedge accounting remained optional; and
 - (b) how the link of the proposed discontinuation requirements to the risk management objective and strategy would work.
- BC6.226 The Board noted that even though the application of hedge accounting remained optional, it facilitated the provision of useful information for financial reporting purposes (ie how hedging instruments are used to manage risk). The Board considered that this purpose could not be ignored when considering voluntary

discontinuation of hedge accounting. If an entity chose to apply hedge accounting, it did so with the aim of using that particular accounting to represent in the financial statements the effect of pursuing a particular risk management objective. If the risk management objective had not changed and the other qualifying criteria for hedge accounting were still met, the ability to discontinue hedge accounting would undermine the aspect of consistency over time in accounting for and providing information about that hedging relationship. The Board noted that a free choice to discontinue hedge accounting reflected a view that hedge accounting is a mere accounting exercise that does not have a particular meaning. Consequently, the Board considered that it was not valid to argue that because hedge accounting was voluntary, the discontinuation of hedge accounting should also be voluntary.

- BC6.227 In addition, the Board noted that other optional accounting treatments of IFRSs do not allow the entity to overturn its initial election:
- (a) the fair value option in IAS 39 and IFRS 9; and
 - (b) the lessee's option to account for a property interest held under an operating lease as an investment property, which is available (irrevocably) on a property-by-property basis.
- BC6.228 The Board also did not think that the ability to voluntarily discontinue hedge accounting was necessary for hedge accounting to work as intended in particular situations mentioned in the feedback (see paragraphs BC6.223 and BC6.224). The Board considered that the impression of some respondents that voluntary discontinuation was necessary in those situations resulted from a lack of clarity about the distinction between the notions of risk management strategy and risk management objective. The Board noted that that distinction was important for determining when the discontinuation of a hedging relationship was required (or not allowed). The Board also noted that the term 'risk management strategy' was used in the exposure draft as a reference to the highest level at which an entity determines how it manages risk. In other words, the risk management strategy typically identified the risks to which the entity was exposed and set out how the entity responded to them. Conversely, the exposure draft used the term 'risk management objective' (for a hedging relationship) to refer to the objective that applies at the level of that particular hedging relationship (instead of what the entity aims to achieve with the overall strategy). In other words, it related to how the particular designated hedging instrument is used to hedge the particular exposure designated as the hedged item.
- BC6.229 The Board noted that a risk management strategy could (and often would) involve many different hedging relationships whose risk management objectives relate to executing that risk management strategy. Hence, the risk management objective for a particular hedging relationship could change even though an entity's risk management strategy remained unchanged. The Board's intention was to prohibit voluntary discontinuation of hedge accounting when the risk management objective at the level of a particular hedging relationship (ie not only the risk management strategy) remained the same and all other qualifying criteria were still met.
- BC6.230 Consequently, the Board decided to prohibit voluntary discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same and all the other qualifying criteria are still met. However, the Board also decided to add additional guidance on how the risk

management objective and the risk management strategy relate to each other using examples contrasting these two notions.

Fair value hedges

Accounting for fair value hedges

- BC6.231 In its deliberations leading to the exposure draft, the Board considered reducing the complexity of hedge accounting by replacing the fair value hedge accounting mechanics with the cash flow hedge accounting mechanics. Such an approach would recognise gains or losses on the hedging instruments outside profit or loss in other comprehensive income instead of remeasuring the hedged item. The Board considered such an approach because it would:
- (a) improve the usefulness of the reported information for users. In accordance with such an approach, all hedging activities to which hedge accounting is applied (including hedges of fair value risk) would be reflected in other comprehensive income, resulting in greater transparency and comparability. In addition, the measurement of the hedged item would not be affected.
 - (b) simplify existing requirements. Although fair value and cash flow hedge accounting are designed to address different exposures, the same mechanisms can be used to reflect how an entity manages these exposures in the financial statements. Eliminating one of two different methods (fair value hedge accounting or cash flow hedge accounting) would reduce complexity. Such an approach would align fair value hedge accounting and cash flow hedge accounting, resulting in a single method for hedge accounting.
 - (c) be an expeditious approach to finalise this phase of the project to replace IAS 39. Such an approach would draw on the existing mechanics of cash flow hedge accounting in IAS 39, and consequently such an approach would not require much further development.
- BC6.232 However, during its outreach activities before publishing the exposure draft, the Board received mixed views on this approach. Some supported the approach for the reasons the Board had considered, which was consistent with the feedback received on the discussion paper *Reducing Complexity in Reporting Financial Instruments*. However, others raised concerns that such an approach:
- (a) would not reflect the underlying economics. They argued that if an entity applies a fair value hedge, the hedged item exists and hence there is an actual gain or loss on the hedged item (not just an anticipated gain or loss on a forecast transaction that does not yet exist). Consequently, hedge accounting should not cause 'artificial' volatility in other comprehensive income and equity.
 - (b) would make the movements in other comprehensive income less understandable.
 - (c) would make it difficult to identify the type of risk management strategy that the entity employs.
 - (d) could result in scenarios in which equity would be significantly reduced or even negative because of losses on the hedging instrument deferred in

other comprehensive income. This could have serious implications in terms of solvency and regulatory requirements.

- BC6.233 In the light of the views received, the Board decided to propose a different approach in the exposure draft. The Board proposed to continue to account for fair value hedges differently from cash flow hedges. However, the Board proposed some changes to the presentation and mechanics of fair value hedge accounting:
- (a) gain or loss on remeasuring the hedging instrument—IAS 39 required the gain or loss to be recognised in profit or loss. The Board proposed to require the recognition of the gain or loss in other comprehensive income.
 - (b) gain or loss on the hedged item—IAS 39 required such a gain or loss to result in an adjustment to the carrying amount of the hedged item and to be recognised in profit or loss. The Board proposed to require the gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position and in other comprehensive income. That separate line item would have been presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).
- BC6.234 The Board noted that the separate line item represented measurement adjustments to the hedged items rather than separate assets or liabilities in their own right. The Board thought that the additional line item might be perceived to add complexity and would increase the number of line items in the statement of financial position. In addition, the Board noted that this approach is more complex than the approach initially considered, which would have eliminated fair value hedge accounting mechanics.
- BC6.235 However, the Board decided to propose these changes because they would:
- (a) eliminate the mixed measurement for the hedged item (for example, an amount that is amortised cost with a partial fair value adjustment).
 - (b) avoid volatility in other comprehensive income and equity that some consider artificial.
 - (c) present in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges).
 - (d) provide information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges.
- BC6.236 Most respondents supported providing the information proposed in the exposure draft, but many disagreed with providing this information on the face of the financial statements.
- BC6.237 With respect to recognising gains or losses on the hedging instrument and hedged item in other comprehensive income, many respondents thought that the use of other comprehensive income should be limited until the Board completed a project on what 'other comprehensive income' represents. Many respondents expressed a preference for the approach in IAS 39 (ie presenting the gain or loss on the hedging instrument and the hedged item in profit or loss). As an alternative, those respondents suggested that the gain or loss on the hedging instrument and the hedged item should be disclosed in the notes to the financial statements.

- BC6.238 With respect to presenting separate line items in the statement of financial position, many respondents expressed concern about the excessive number of additional line items in the statement of financial position that could result from the proposals in the exposure draft. Those respondents thought that the statement of financial position would appear too cluttered. As an alternative, those respondents suggested that entities disclose the accumulated adjustment made to the carrying amount of the hedged item in the notes to the financial statements.
- BC6.239 In the light of this feedback, the Board in its redeliberations decided to retain the fair value hedge accounting mechanics that were in IAS 39. However, the Board also decided that it would require information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the financial statements and that all hedge accounting disclosures are presented in a single note or separate section in the financial statements (those disclosure requirements were included in IFRS 7).

Linked presentation for fair value hedges

- BC6.240 During its outreach activities before publishing the exposure draft, the Board was alerted to the financial reporting effect that fair value hedge accounting has on hedges of the foreign currency risk of firm commitments in a specific industry. This issue is a particular concern to that industry because of the magnitude of firm commitments that are denominated in a foreign currency because of the industry's business model. In response to that concern, the Board considered whether applying linked presentation for fair value hedges of firm commitments might be appropriate. Linked presentation is a way of presenting information so that it shows how particular assets and liabilities are related. Linked presentation is not the same as offsetting, which presents a net asset or liability. Linked presentation displays the 'gross' amount of related items in the statement of financial position (while the net amount is included in the total for assets or liabilities).
- BC6.241 The industry was concerned that the presentation resulting from fair value hedge accounting would not reflect the economic effects of hedges of foreign currency risk. For example, an entity that has a large firm commitment for a sale denominated in a foreign currency enters into currency forward contracts to hedge the foreign currency risk of that firm commitment (the forward contract and the firm commitment could be considered 'linked transactions'). The fair value of the derivative liability (or asset) and the firm commitment asset (or liability) could be significant depending on the volatility of the currency being hedged. That industry was concerned that as a result, on the basis of the statement of financial position, the entity would appear to be exposed to a higher risk than it actually was. In that industry's view, confusion might arise because the statement of financial position would show large amounts for total assets and total liabilities and hence a high leverage (which typically suggests higher risk) even though the entity hedged the foreign currency risk of the firm commitment and thus sought to reduce risk.
- BC6.242 That industry argued that linked presentation of the firm commitment (recognised as a result of fair value hedge accounting) and the hedging instrument could present the effect of an entity's hedging activity and the relationship of the hedged item and the hedging instrument. Linked presentation would not require

changing the requirements of offsetting in IAS 32 *Financial Instruments: Presentation* or other requirements in IAS 39 and IFRS 9.

- BC6.243 Moreover, that industry argued that a firm commitment is recognised in the statement of financial position only when fair value hedge accounting is applied. Therefore, that industry advocated that a firm commitment and the related hedging instrument should be accounted for as two parts of a single transaction. That industry also argued that totals for assets and liabilities that include only the 'net' amount (of the linked transactions) would be most appropriate for financial analysis purposes. That industry believed that the ratios such as leverage should be calculated on the basis of the difference between the hedged item and the hedging instrument, ie the net amount rather than the gross amount of these items.
- BC6.244 The Board noted that while linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (for example, only the currency risk but not the credit risk or interest rate risk). Furthermore, the Board did not consider that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affected only one risk but not all risks. Instead, the Board believed that disclosures about hedging would be a better alternative for providing information that allows users of financial statements to assess the relevance of the information for their own analysis.
- BC6.245 Consequently, the Board decided not to propose the use of linked presentation for the purposes of hedge accounting.
- BC6.246 Most respondents to the exposure draft agreed with the Board's conclusion not to allow linked presentation. Some respondents also thought that linked presentation is not an appropriate topic for a project on hedge accounting, but rather that it should be considered either as a separate project or as part of a project on financial statement presentation or a project on the *Conceptual Framework*.
- BC6.247 However, those respondents that supported linked presentation argued that, without it, entities that use hedge accounting would be perceived to be riskier than those that do not, and that the true economic effects of hedges of foreign currency risk of firm commitments would not be reflected.
- BC6.248 The Board noted that in the absence of a clear principle for linked presentation, it should be considered in a broader context than just hedge accounting. Consequently, the Board decided not to require or allow the use of linked presentation for the purpose of hedge accounting.

Cash flow hedges

The 'lower of' test

- BC6.249 When a hedge accounting relationship is fully effective, the fair value changes of the hedging instrument perfectly offset the value changes of the hedged item. Hedge ineffectiveness arises when the value changes of the hedging instrument

exceed those of the hedged item, or when the value changes of the hedging instrument are less than those of the hedged item.

- BC6.250 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on these items in excess of the gains and losses on the hedging instrument is tantamount to recognising gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument). The Board noted that this would be conceptually questionable as well as a counter-intuitive outcome.
- BC6.251 IAS 39 required a 'lower of' test for determining the amounts that were recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. In contrast, the 'lower of' test did not apply to fair value hedges because, for that type of hedge, the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRSs, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.
- BC6.252 In its deliberations leading to the exposure draft, the Board discussed whether the requirements for measuring the hedge ineffectiveness that is recognised in profit or loss should be aligned for fair value hedges and cash flow hedges. The Board noted that the requirements could be aligned by applying the 'lower of' test also to fair value hedges or by eliminating it for cash flow hedges. In the Board's view, aligning the requirements would reduce complexity. However, the Board considered that for conceptual reasons recognising gains and losses on items that do not yet exist instead of only deferring the gain or loss on the hedging instrument was not appropriate. On the other hand, the Board considered that the nature of fair value hedges is different from that of cash flow hedges. Applying the 'lower of' test also to fair value hedges even though that test was designed to address only the specific characteristics of cash flow hedges, was not justified. Consequently, the Board decided to retain the 'lower of' test for cash flow hedges and not to introduce it for fair value hedges.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

- BC6.253 A forecast transaction could subsequently result in the recognition of a non-financial asset or a non-financial liability. Similarly, a forecast transaction for a non-financial asset or non-financial liability could subsequently result in the recognition of a firm commitment for which fair value hedge accounting is applied. In these cases IAS 39 permitted an entity an accounting policy choice:
- (a) to reclassify the associated gains or losses that were recognised in other comprehensive income to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or
 - (b) to remove the associated gains or losses that were recognised in other comprehensive income and include them in the initial cost or other carrying

amount of the asset or liability. This approach was commonly referred to as a 'basis adjustment'.

- BC6.254 In its deliberations leading to the exposure draft, the Board considered whether to continue allowing this accounting policy choice. The Board noted that if an entity was precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging relationship had ended) and to match them to the period or periods in which the non-financial item that had resulted from the hedged transaction affected profit or loss. The entity would also need to consider whether or not the remaining amount in other comprehensive income was recoverable in one or more future periods. In contrast, if an entity applied a basis adjustment, the hedging gain or loss was included in the carrying amount of the non-financial item and automatically recognised in profit or loss in the period in which the related non-financial item affected profit or loss (for example, through depreciation expense for items of property, plant and equipment or cost of sales for inventories). It would also be automatically considered when an entity tested a non-financial asset for impairment. The Board noted that for a non-financial asset that is tested for impairment as part of a cash-generating unit, tracking amounts in other comprehensive income and including them in the impairment test is difficult (even more so if the composition of cash-generating units changes over time).
- BC6.255 The Board acknowledged that there were different views on whether a basis adjustment would achieve or reduce comparability. One view was that two identical assets purchased at the same time and in the same way (except for the fact that one was hedged) should have the same initial carrying amount. From this viewpoint, basis adjustments would impair comparability.
- BC6.256 The other view was that basis adjustments allowed identical assets for which the acquisitions are subject to the same risk to be measured so that they had the same initial carrying amount. For example, Entity A and Entity B want to purchase the same asset from a supplier that has a different functional currency. Entity A is able to secure the purchase contract denominated in its functional currency. Conversely, while Entity B also wants to fix the purchase price in its functional currency, it has to accept a purchase contract denominated in the functional currency of the supplier (ie a foreign currency) and is therefore exposed to the variability in cash flows arising from movements in the exchange rate. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract which, in effect, fixes the price of the purchase in its functional currency. When taking into account the currency forward contract, Entity B has, in effect, the same foreign currency risk exposure as Entity A. From this viewpoint, basis adjustments would enhance comparability.
- BC6.257 The Board also considered the interaction between basis adjustments and the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge (see paragraphs BC6.183–BC6.188). The Board noted that for hedges of the foreign currency risk of a firm commitment the basis adjustment at the end of the cash flow hedge has the same effect on the presentation of the hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for these firm commitments was tantamount to a basis adjustment. The Board thought that, in this context, basis adjustments would also enhance comparability.
- BC6.258 Consequently, the Board decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The Board decided that when the entity

removes the associated gain or loss that was recognised in other comprehensive income in order to include it in the initial cost or other carrying amount of the asset or liability, that gain or loss should be directly applied against the carrying amount of the asset or liability. This means it would not be a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence would not affect other comprehensive income when removing it from equity and adding it to, or deducting it from, the asset or liability. The Board noted that accounting for the basis adjustment as a reclassification adjustment would distort comprehensive income because the amount would affect comprehensive income twice but in different periods:

- (a) first (in other comprehensive income) in the period in which the non-financial item is recognised; and
- (b) then again in the later periods when the non-financial item affects profit or loss (for example, through depreciation expense or cost of sales).

The Board also noted that presenting a basis adjustment as a reclassification adjustment would create the misleading impression that the basis adjustment was a performance event.

BC6.259 The Board acknowledged that the total comprehensive income across periods will be distorted because the gain or loss on the hedging instrument during the period of the cash flow hedge is recognised in other comprehensive income, whereas the cumulative hedging gain or loss that is removed from the cash flow hedge reserve (ie from equity) and directly applied to the subsequently recognised non-financial item does not affect other comprehensive income. The Board considered that one type of distortion of other comprehensive income was inevitable (ie either in the period of the basis adjustment or over the total period) and hence there was a trade-off. The Board concluded that, on balance, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect over the total period of not using a reclassification adjustment.

BC6.260 The Board retained its original decision during the redeliberations of its exposure draft.

Hedges of a net investment in a foreign operation

BC6.261 In its deliberations leading to the exposure draft, the Board decided not to address a hedge of a net investment in a foreign operation as part of its hedge accounting project. The Board noted that a net investment in a foreign operation was determined and accounted for in accordance with IAS 21. The Board also noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similar to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC6.60) the Board considered that comprehensively addressing this type of hedge would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements. The Board also noted that IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (issued in July 2008) provided further guidance on that type of hedge accounting. The Board did not think it was appropriate to change the requirements so soon after issuing the Interpretation.

BC6.262 Consequently, the Board proposed retaining the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

BC6.263 The Board retained its original decision during the redeliberations of its exposure draft.

Accounting for the time value of options

BC6.264 IAS 39 allowed an entity a choice:

- (a) to designate an option-type derivative as a hedging instrument in its entirety; or
- (b) to separate the time value of the option and designate as the hedging instrument only the intrinsic value element.

BC6.265 The Board noted that under the IAS 39 hedge accounting model entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from the risk management view, whereby entities typically consider the time value of an option (at inception, ie included in the premium paid) as a cost of hedging. It is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes.

BC6.266 Against this background, the Board, in its deliberations leading to the exposure draft, considered how best to portray the time value of options (in the context of hedging exposures only against changes to one side of a specified level—‘a one-sided risk’). The Board noted that the standard-setting debate about accounting for the time value of options had historically been focused on hedge ineffectiveness. Many typical hedged transactions (such as firm commitments, forecast transactions or existing items) do not involve a time value notion because they are not options. Hence, such hedged items do not have a change in their value that offsets the fair value change related to the time value of the option that is used as a hedging instrument. The Board concluded that, unless the time value of the option was excluded from the designation as the hedging instrument, hedge ineffectiveness would arise.

BC6.267 However, the Board noted that the time value of an option could also be considered from a different perspective—that of a premium for protection against risk (an ‘insurance premium’ view).

BC6.268 The Board noted that entities that use purchased options to hedge one-sided risks typically consider the time value that they pay as a premium to the option writer or seller as similar to an insurance premium. In order to protect themselves against the downside of an exposure (an adverse outcome) while retaining the upside, they have to compensate someone else for assuming the inverse asymmetrical position, which has only the downside but not the upside. The time value of an option is subject to ‘time decay’. This means that it loses its value over time as the option approaches expiry, which occurs at an increasingly rapid rate. At expiry the option’s time value reaches zero. Hence, entities that use purchased options to hedge one-sided risks know that over the life of the option they will lose the time value that they paid. This explains why entities typically view the premium paid as being similar to an insurance premium and hence as a cost of using this hedging strategy.

BC6.269 The Board considered that by taking an insurance premium view, the accounting for the time value of options could be aligned with the risk management

perspective as well as with other areas of accounting. The Board noted that under IFRSs some costs of insuring risks were treated as transaction costs that were capitalised into the costs of the insured asset (for example, freight insurance paid by the buyer in accordance with IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*), whereas costs of insuring some other risks were recognised as expenses over the period for which the entity was insured (for example, fire insurance for a building). Hence, the Board considered that aligning the accounting for the time value of options with such other areas would provide more comparable results that would also be more aligned with how preparers and users think about the issue.

- BC6.270 The Board took the view that, like the distinction of the different types of costs of insuring risk, the time value of options should be distinguished by the type of hedged item that the option hedges, into time value that is:
- (a) transaction related (for example, the forecast purchase of a commodity); or
 - (b) time-period related (for example, hedging an existing commodity inventory for commodity price changes).
- BC6.271 The Board considered that for transaction related hedged items the cumulative change in fair value of the option's time value should be accumulated in other comprehensive income and be reclassified in a way similar to that for cash flow hedges. In the Board's view, this would best reflect the character of transaction costs (like those capitalised for inventory or property, plant and equipment).
- BC6.272 In contrast, the Board considered that for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the Board considered that the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis. The Board noted that this would require accumulating the cumulative change in fair value of the option's time value in other comprehensive income and amortising the original time value by transferring each period an amount to profit or loss. The Board considered that the amortisation pattern should be determined on a systematic and rational basis, which would best reflect principle-based standard-setting.
- BC6.273 The Board also considered situations in which the option used has critical terms (such as the nominal amount, life and underlying) that do not match the hedged item. This raises the following questions:
- (a) How much of the time value included in the premium relates to the hedged item (and therefore should be treated as costs of hedging) and which part does not?
 - (b) How should any part of the time value that does not relate to the hedged item be accounted for?
- BC6.274 The Board proposed in the exposure draft that the part of the time value of the option that relates to the hedged item should be determined as the time value that would have been paid for an option that perfectly matches the hedged item (for example, with the same underlying, maturity and notional amount). The Board noted that this would require an option pricing exercise using the terms of the hedged item as well as other relevant information about the hedged item (in particular, the volatility of its price or cash flow, which is a driver of an option's time value).

- BC6.275 The Board noted that the accounting for the time value of the option would need to differentiate whether the initial time value of the purchased option (actual time value) is higher or lower than the time value that would have been paid for an option that perfectly matches the hedged item (aligned time value). The Board noted that if, at inception of the hedging relationship, the actual time value is higher than the aligned time value, the entity pays a higher premium than that which reflects the costs of hedging. Hence, the Board considered that the amount that is recognised in accumulated other comprehensive income should be determined only on the basis of the aligned time value, whereas the remainder of the actual time value should be accounted for as a derivative.
- BC6.276 Conversely, the Board noted that if, at inception of the hedging relationship, the actual time value is lower than the aligned time value, the entity actually pays a lower premium than it would have to pay to cover the risk fully. The Board considered that in this situation, in order to avoid accounting for more time value of an option than was actually paid, the amount that is recognised in accumulated other comprehensive income would have to be determined by reference to the lower of the cumulative fair value change of:
- (a) the actual time value; and
 - (b) the aligned time value.
- BC6.277 The Board also considered whether the balances accumulated in other comprehensive income would require an impairment test. The Board decided that because the accounting for the time value of the option was closely linked to hedge accounting, an impairment test that uses features of the hedge accounting model would be appropriate. Hence, for transaction related hedged items the impairment test would be similar to that for the cash flow hedge reserve. For time-period related hedged items the Board considered that the part of the option's time value that remains in accumulated other comprehensive income should be immediately recognised in profit or loss when the hedging relationship is discontinued. That would reflect that the reason for amortising the amount would no longer apply after the insured risk (ie the hedged item) no longer qualifies for hedge accounting. The Board noted that impairment of the hedged item affects the criteria for qualifying hedges and if those are no longer met it would result in an impairment loss for the remaining unamortised balance of the time value of the option.
- BC6.278 Most of the respondents to the exposure draft agreed with the 'insurance premium' view. They thought that the proposal provided a better representation of the performance and effect of the entity's risk management strategy than under IAS 39. In their view, the proposals alleviated undue profit or loss volatility and reflected the economic substance of the transaction. They also thought that the costs of hedging should be associated with the hedged item rather than being mischaracterised as hedge ineffectiveness.
- BC6.279 However, there were mixed views regarding the complexity of the proposals. Some respondents had concerns about the complexity related to:
- (a) the requirement to differentiate between transaction related and time-period related hedged items; and
 - (b) the requirement to measure the fair value of the aligned time value. Those concerns included that the costs of implementing the proposals could outweigh the benefits, for instance, for less sophisticated (for example, smaller) entities.

- BC6.280 Some respondents did not agree with the proposed accounting for transaction related hedged items. Some argued that time value should always be expensed over the option period.
- BC6.281 In the light of this feedback the Board considered in its redeliberations:
- (a) whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the exposure draft;
 - (b) whether it should remove the differentiation between transaction related and time-period related hedged items and replace it with a single accounting treatment; and
 - (c) whether it should simplify the requirement to account for the fair value of the aligned time value.
- BC6.282 The Board discussed whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the exposure draft. The Board noted that such an accounting treatment would have outcomes that would be inconsistent with the notion of the time value being regarded as costs of hedging. This is because it could result in recognising an expense in periods that are unrelated to how the hedged exposure affects profit or loss.
- BC6.283 The Board also reconsidered whether it was appropriate to defer in accumulated other comprehensive income the time value of options for transaction related hedged items. The Board noted that the deferred time value does not represent an asset in itself, but that it was an ancillary cost that is capitalised as part of the measurement of the asset acquired or liability assumed. This is consistent with how other IFRSs treat ancillary costs. The Board also noted that the exposure draft included an impairment test to ensure that amounts that are not expected to be recoverable are not deferred.
- BC6.284 The Board also discussed whether the proposals in the exposure draft could be simplified by removing the differentiation between transaction related and time-period related hedged items. However, the Board noted that a single accounting treatment would be inconsistent with other IFRSs because it would not distinguish situations in a similar way (see paragraphs BC6.269 and BC6.270). Hence, the Board considered that the suggested single accounting treatment would essentially treat unlike situations as alike. The Board noted that this would actually diminish comparability and hence not be an improvement to financial reporting.
- BC6.285 The Board also considered whether it should paraphrase the requirements as a single general principle to clarify the accounting for transaction related and time-period related hedged items, rather than having requirements that distinguish by those two types of hedged items. However, on balance the Board decided that this approach risked creating confusion, in particular because it would still involve the two different types of accounting treatments.
- BC6.286 The Board also discussed possible ways to simplify the requirements to account for the fair value of the aligned time value. As part of those discussions the Board considered:
- (a) Applying the proposed accounting treatment for the time value of options to the entire amount of the time value paid even if it differs from the aligned time value. This means that entities would not need to compute a separate

valuation for the fair value of the aligned time value. However, the Board considered that only the time value that relates to the hedged item should be treated as a cost of hedging. Hence, any additional time value paid should be accounted for as a derivative at fair value through profit or loss.

- (b) Providing entities with a choice (for each hedging relationship or alternatively as an accounting policy choice) to account for the time value of options either as proposed in the exposure draft or in accordance with the treatment in IAS 39. In the latter case, the amount recognised in profit or loss as a 'trading instrument' is the difference between the change in the fair value of the option in its entirety and the change in fair value of the intrinsic value. In contrast, the proposals in the exposure draft would require two option valuations (ie the change in fair value of the actual time value of the option and the aligned time value of the option). However, the Board noted that the accounting treatment in accordance with IAS 39 would, in effect, present the change in fair value of the time value as a trading profit or loss. This accounting treatment would not be consistent with the character of the changes in the time value that the Board is seeking to portray, ie that of costs of hedging. In addition, the Board noted that providing a choice would reduce comparability between entities and it would make financial statements more difficult to understand.

BC6.287 Consequently, the Board decided to retain the accounting requirements related to the time value of options proposed in the exposure draft (ie that the accounting would depend on the nature of the hedged item and that the new accounting treatment only applied to the aligned time value).

Zero cost collars

BC6.288 The proposed accounting treatment for the time value of options in the exposure draft only addressed situations in which the option had a time value (other than nil) at inception. That proposed accounting would not have applied to situations in which there was a combination of a purchased and a written option (one being a put option and one being a call option) that at inception of the hedging relationship had a net time value of nil (colloquially often referred to as 'zero-cost collars' or 'zero premium collars').

BC6.289 Many respondents to the exposure draft commented that the proposed accounting for purchased options should also apply to all zero-cost collars. They thought that without generally aligning the accounting treatment for time value of zero-cost collars and options, it would encourage entities to undertake particular types of transactions and replace zero-cost collars with collars with a nominal cost only to achieve a desired accounting outcome.

BC6.290 Furthermore, those respondents noted that even though the zero-cost collar had no net time value at inception, the time value of the collar would fluctuate during the life of the hedge. They noted that time value was subject to 'time decay' and that both the purchased and the written option would lose their time value over time as the collar approaches expiry. They argued that the time value of zero-cost collars should also be recognised in other comprehensive income during the life of the hedging relationship. They considered it unjustified to limit the proposed accounting to options that have an initial time value of greater than nil, given that one of the main concerns being addressed by the proposal was the volatility resulting from changes in time value over the life of the hedge.

BC6.291 In the light of those arguments, the Board decided to align the accounting treatment for changes in the time value of options and zero-cost collars.

Accounting for the forward element of forward contracts

BC6.292 IAS 39 allowed an entity a choice between:

- (a) designating a forward contract as a hedging instrument in its entirety; or
- (b) separating the forward element and designating as the hedging instrument only the spot element.

BC6.293 If not designated, the forward element was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss.

BC6.294 The Board noted that the characteristics of forward elements depended on the underlying item, for example:

- (a) For foreign exchange rate risk, the forward element represents the interest differential between the two currencies.
- (b) For interest rate risk, the forward element reflects the term structure of interest rates.
- (c) For commodity risk, the forward element represents what is called the 'cost of carry' (for example, it includes costs such as storage costs).

BC6.295 Respondents to the exposure draft as well as participants in the Board's outreach activities requested that the Board consider extending the proposal on the accounting for time value of options (see paragraphs BC6.264-BC6.291) to forward elements.

BC6.296 The Board noted that even though under IAS 39 the hedge accounting requirements were identical for forward elements and options, the actual accounting implications were different. In contrast to many typical situations in which options were used to hedge transactions that did not involve a time value notion because they were not options (see paragraph BC6.266), in situations in which forward contracts were used the value of hedged items typically did have a forward element that corresponded to that of the hedge. The Board noted that this meant that an entity could choose to designate the forward contract in its entirety and use the 'forward rate method' to measure the hedged item.

BC6.297 Using the forward rate method, the forward element is essentially included in the hedging relationship by measuring the change in the value of the hedged item on the basis of forward prices or rates. An entity can then recognise the forward element as costs of hedging by using the forward rate method for example resulting in:

- (a) capitalising the forward element into the cost of the acquired asset or liability assumed; or
- (b) reclassifying the forward element into profit or loss when the hedged item (for example, hedged sales denominated in a foreign currency) affects profit or loss.

BC6.298 Consequently, changes in forward elements are not recognised in profit or loss until the hedged item affects profit or loss. The Board noted that this outcome was equivalent to what it had proposed in its exposure draft for accounting for the time value of options that hedge transaction related hedged items. Hence,

the Board considered that, for situations similar to hedges of transaction related hedged items using options, applying the forward rate method would, in effect, achieve an accounting outcome that treated the forward element like costs of hedging. This would be consistent with the Board's overall approach to accounting for the costs of hedging and therefore not require any amendments to its exposure draft.

BC6.299 However, the Board acknowledged that in situations that were equivalent to those addressed by its decision on the accounting for time-period related hedged items that were hedged using options, its proposals in the exposure draft (like IAS 39) would prevent an entity from achieving an equivalent accounting outcome for the forward element of a forward contract. The reason was that, like IAS 39, the proposals in the exposure draft did not allow the forward element to be amortised. For example, if an entity hedged the fair value changes resulting from price changes of its existing commodity inventory (ie a time-period related hedged item) it could, under the proposals in the exposure draft (like IAS 39), either:

- (a) use the forward rate method (ie forward elements are capitalised into the cost of inventory, rather than accounted for as at fair value through profit or loss over the time of the hedge); or
- (b) designate as the hedging instrument only changes in the spot element (ie fair value changes in the forward element of the forward contract are recognised in profit or loss).

Neither of the above accounting outcomes are aligned with the treatment for the time value of options for time-period related hedged items that requires that the time value is amortised on a systematic and rational basis.

BC6.300 The Board also noted that the accounting for monetary financial assets and liabilities denominated in a foreign currency had an important consequence. Like IAS 39, IFRS 9 (see paragraph B5.7.2) requires an entity to apply IAS 21 to those instruments, which means they are translated into the entity's functional currency by using the spot exchange rate. Hence, the forward rate method does not provide a solution when entities hedge monetary financial assets and liabilities denominated in a foreign currency.

BC6.301 Consequently, the Board acknowledged that aligning the accounting for forward elements with the accounting for time value of options was a particular concern to entities that, for example, had more funding in their functional currency than they could invest in financial assets in their functional currency. To generate an economic return on their surplus funds, such entities exchange these funds into a foreign currency and invest in assets denominated in that foreign currency. To manage their exposure to foreign exchange risk (and to stabilise their net interest margin), such entities commonly enter into foreign exchange derivatives. Such transactions usually involve the following simultaneously:

- (a) swapping the functional currency surplus funds into a foreign currency;
- (b) investing the funds in a foreign currency financial asset for a period of time; and
- (c) entering into a foreign exchange derivative to convert the foreign currency funds back into the functional currency at the end of the investment period. This amount typically covers the principal plus interest at maturity.

- BC6.302 The difference between the forward rate and the spot rate (ie the forward element) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency by the forward points (ie the forward element of the foreign exchange derivative) and then deducting the interest expense. The combination of the three transactions described above allows the entity to, in effect, 'lock in' a net interest margin and generate a fixed economic return over the investment period.
- BC6.303 Respondents argued that risk management viewed the forward elements as an adjustment of the investment yield on foreign currency denominated assets. They believed that, as in the case of the accounting for time value of options, it gave rise to a similar need for adjusting profit or loss against other comprehensive income to represent the cost of achieving a fixed economic return in a way that is consistent with the accounting for that return.
- BC6.304 In the light of the arguments raised by respondents, the Board decided to permit forward points that exist at inception of the hedging relationship to be recognised in profit or loss over time on a systematic and rational basis and to accumulate subsequent fair value changes through other comprehensive income. The Board considered that this accounting treatment would provide a better representation of the economic substance of the transaction and the performance of the net interest margin.

Hedges of a group of items

- BC6.305 IAS 39 restricted the application of hedge accounting for groups of items. For example, hedged items that together constitute an overall net position of assets and liabilities could not be designated into a hedging relationship with that net position as the hedged item. Other groups were eligible if the individual items within that group had similar risk characteristics and shared the risk exposure that was designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group had to be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of these restrictions was that a group would generally qualify as a hedged item only if all the items in that group would qualify for hedge accounting for the same hedged risk on an individual basis (ie each as an individual hedged item).
- BC6.306 In response to the discussion paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to achieve hedge accounting for groups of items, including net positions, had resulted in a hedge accounting model that was inconsistent with the way in which an entity actually hedges (ie for risk management purposes). Similar concerns about the restrictions of IAS 39 for applying hedge accounting to groups of items were raised as part of the Board's outreach activities for its hedge accounting project.
- BC6.307 In practice, most entities hedge their risk exposures using different approaches. These approaches result in hedges of:
- (a) individual items;
 - (b) groups of items that form a gross position; or
 - (c) groups of (partially) offsetting items or risks that result in a net position.

- BC6.308 The group hedging approach involves identifying the risk from particular groups of items (including a net position), and then hedging some or all of that risk with one or more hedging instruments. The group hedging approach views the risk at a higher aggregated level. The reasons for taking this approach include:
- (a) items in the group have some offsetting risk positions that provide a natural hedge for some of those risks and therefore those offsetting risks do not need to be separately hedged;
 - (b) hedging derivatives that hedge different risks together can be more readily available than individual derivatives that each hedge a different risk;
 - (c) it is more expedient (cost, practicality, etc) to enter into fewer derivatives to hedge a group rather than hedging individual exposures;
 - (d) the minimisation of counterparty credit risk exposure, because offsetting risk positions are hedged on a net basis (this aspect is particularly important for an entity that has regulatory capital requirements); and
 - (e) the reduction of gross assets/liabilities in the statement of financial position, because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.
- BC6.309 The restrictions in IAS 39 prevented an entity that hedges on a group or net basis from presenting its activities in a manner that is consistent with its risk management practice. For example, an entity may hedge the net (ie residual) foreign currency risk from a sequence of sales and expenses that arise over several reporting periods (say two years) using a single foreign currency derivative. Such an entity could not designate the net position of sales and expenses as the hedged item. Instead, if it wanted to apply hedge accounting it had to designate a gross position that best matched its hedging instrument. However, the Board noted there were a number of reasons why this would not give rise to useful information. For example:
- (a) A matching hedged item might not exist, in which case hedge accounting cannot be applied.
 - (b) If the entity did identify and designate a matching gross exposure from the sequence of sales and expenses, that item would be portrayed as the only hedged item and would be presented at the hedged rate. All other transactions (for instance, in earlier reporting periods) would appear unhedged and would be recognised at the prevailing spot rates, which would give rise to volatility in some reporting periods.
 - (c) If the designated hedged transaction did not arise, but the net position remained the same, hedge ineffectiveness would be recognised for accounting purposes even though it does not exist from an economic perspective.
- BC6.310 Consequently, in its exposure draft, the Board proposed that groups of items (including net positions) should be eligible for hedge accounting. However, the Board also proposed limiting the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC6.320–BC6.325).
- BC6.311 Respondents to the exposure draft supported the proposal to allow hedge accounting for groups and net positions and most supported the Board's rationale for doing so. However, some disagreed with specific aspects of the

Board's proposals in the exposure draft. Their concerns focused on the proposals related to cash flow hedges of net positions.

BC6.312 The following subsections set out the Board's considerations regarding the application of hedge accounting in the context of groups of items.

Criteria for the eligibility of a group of items as a hedged item

BC6.313 An individual hedge approach involves an entity entering into one or more hedging instruments to manage a risk exposure from an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, for a group hedge approach an entity seeks to manage the risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument.

BC6.314 An individual hedge approach and a group hedge approach are similar in concept. Hence, the Board decided that the requirements for qualifying for hedge accounting should also be similar. Consequently, the Board proposed that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions were retained for cash flow hedges of net positions.

BC6.315 The Board retained its original decision during the redeliberations of its exposure draft.

Designation of a layer component of a nominal amount for hedges of a group of items

BC6.316 The Board proposed in its exposure draft that an entity could designate a layer component of a nominal amount (a layer) of a single item in a hedging relationship. The Board also considered whether it would be appropriate to extend that decision on single items to groups of multiple items and hence allow the designation of a layer of a group in a hedging relationship.

BC6.317 The Board considered that the benefits of identifying a layer component of a nominal amount of a group of items are similar to the benefits it considered for layer components of single items (see paragraphs BC6.107–BC6.111). In addition, the Board also noted other reasons that support the use of components for groups of items:

- (a) uncertainties such as a breach (or cancellation) of contracts, or prepayment, can be better modelled when considering a group of items;
- (b) in practice, hedging layers of groups of items (for example, a bottom layer) is a common risk management strategy; and
- (c) arbitrarily identifying and designating (as hedged items) specific items from a group of items that are exposed to the same hedged risk can:
 - (i) give rise to arbitrary accounting results if the designated items do not behave as originally expected (while other items, sufficient to cover the hedged amount, do behave as originally expected); and
 - (ii) can provide opportunities for earnings management (for example, by choosing to transfer and derecognise particular items from a group of homogeneous items when only some were specifically designated into

a fair value hedge and therefore have fair value hedge adjustments attached to them).

- BC6.318 The Board noted that, in practice, groups of items hedged together are not likely to be groups of identical items. Given the different types of groups that could exist in practice, in some cases it could be easy to satisfy the proposed conditions and in some cases it could be more challenging or even impossible. The Board considered that it is not appropriate to define the cases in which the proposed conditions were satisfied because it would depend on the specific facts and circumstances. The Board considered a criteria-based approach would be more operational and appropriate. That would allow hedge accounting to be applied in situations in which the criteria are easy to meet as well as in cases in which, although the criteria are more challenging to meet, an entity is prepared to undertake the necessary efforts (for example to invest in systems in order to achieve compliance with the hedge accounting requirements).
- BC6.319 The Board retained its original decision during the redeliberations of its exposure draft.

Cash flow hedges of a group of items that constitutes a net position that qualifies for hedge accounting

- BC6.320 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred in other comprehensive income to be reclassified later from accumulated other comprehensive income to profit or loss when the hedged item affects profit or loss. For hedges of net positions, items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group (ie the gains on some items offset the losses on others). Hence, for a cash flow hedge of a net position that is a group of forecast transactions, the cumulative change in value (from the inception of the hedge) that arises on some forecast transactions (to the extent that it is effective in achieving offset) must be deferred in other comprehensive income. This is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss in the later phase until the last hedged item in the net position affects profit or loss.
- BC6.321 However, forecast transactions that constitute a hedged net position might affect profit or loss in different accounting periods. For example, sales and unrelated expenditure hedged for foreign currency risk might affect profit or loss in different reporting periods. When the hedged items affect profit or loss in different periods, the cumulative change in value of the designated sales (to be reclassified later when the expenditure is recognised as an expense) needs to be excluded from profit or loss and instead be deferred in other comprehensive income. This is required in order to ensure that the effect of the sales on profit or loss is based on the hedged exchange rate.
- BC6.322 Hence, in its deliberations leading to the exposure draft, the Board noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in accumulated other comprehensive income of cumulative gains and losses on some forecast transactions, from the time they occurred until some other forecast transactions would affect profit or loss in later periods. The Board considered that this would be tantamount to measuring the transactions that occurred first at a different amount from the transaction amount (or other amount that would be required under general IFRS requirements) in contemplation of other forecast transactions that were expected to occur in the

future and that would have an offsetting gain or loss. When those other transactions occurred, their measurement would be adjusted for the amounts deferred in accumulated other comprehensive income on forecast transactions that had occurred earlier.

- BC6.323 The Board acknowledged that this approach would not result in recognising gains and losses on items that do not yet exist but instead defer gains and losses on some forecast transactions as they occurred. However, the Board considered that this approach would be a significant departure from general IFRSs regarding the items that resulted from the forecast transactions. The Board noted that this departure would affect the forecast transactions:
- (a) that occurred in the early phases of the hedging relationship, ie those for which gains and losses were deferred when the transaction occurred; and
 - (b) those that occurred in the later phases of the hedging relationship and were adjusted for the gains or losses that had been deferred on the forecast transactions as they had occurred in the early phases of the hedging relationship.
- BC6.324 The Board noted that the accounting for the forecast transactions that occurred in the later phases of the hedging relationship was comparable to that of forecast transactions that were hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occurred in the early phases of the hedging relationship would be more similar to that of a hedging instrument than a hedged item. The Board concluded that this would be a significant departure from general IFRS requirements and the requirements of the hedge accounting model for hedging instruments.
- BC6.325 Consequently, in its exposure draft, the Board proposed that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting risk positions would affect profit or loss in different periods. The Board noted that when the offsetting risk positions affected profit or loss in the same period those concerns would not apply in the same way as no deferral in accumulated other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the Board proposed that such net positions should be eligible as hedged items.
- BC6.326 Some respondents to the exposure draft agreed with the Board's rationale for not allowing the application of cash flow hedge accounting to net positions that consist of forecast transactions that would affect profit or loss in different reporting periods. They believed that without this restriction the potential for earnings management would arise. Despite agreeing with the proposals, some respondents asked the Board to provide additional guidance on the treatment of the amounts deferred in accumulated other comprehensive income if, in a cash flow hedge of a net position, the offsetting risk positions that were initially expected to affect profit or loss in the same reporting period subsequently changed and as a result were expected to affect profit or loss in different periods.
- BC6.327 Others requested the Board to reconsider the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. These respondents believed that this restriction would not allow entities to properly reflect their risk management activities. In addition, some respondents requested that the Board consider the annual reporting period as the basis for this restriction (if retained) instead of any reporting period (ie including an interim

reporting period) noting that the frequency of reporting would otherwise affect the eligibility for this form of hedge accounting.

BC6.328 The Board noted that the feedback on its proposals in the exposure draft reflected two different perspectives.

- (a) A treasury perspective—this is a cash flow perspective. The respondents who provided comments from this perspective typically look at cash inflows and outflows arising from both sides of the net position. The treasury view stops at the level of the cash flows and does not take into account the time lag that might exist between the cash flow and the recognition of related income or expense in profit or loss. From this perspective, once the first forecast transaction is recognised, the natural hedge lapses and the remainder of the net position will be hedged by entering into an additional derivative (or alternatively by using, for example, the foreign currency denominated cash instrument that arises as a result of the occurrence of the first forecast transaction). Subsequently (ie at the time of settlement of the second forecast transaction), the cash flows from the financial instrument being used as a hedging instrument will be used to settle the payments resulting from the forecast transaction.
- (b) An accounting perspective—this perspective focuses on how to present the effect of the two forecast transactions in profit or loss and in which accounting period. This goes beyond the cash flow view of the treasury perspective. This is because the way in which the item affects profit or loss can be different, while the cash flow is a point-in-time event. For example, while the purchase of services and sales of goods can be designated as part of a net position in a way that they will affect profit or loss in one reporting period, purchases of property, plant and equipment affect profit or loss over several different reporting periods through the depreciation pattern. Similarly, if inventory is sold in the period after it was purchased, the cash flow and the related effect on profit or loss occur in different periods.

BC6.329 In the light of the comments received, the Board reconsidered the restriction on cash flow hedges of net positions with offsetting risk positions that affect profit or loss in different reporting periods, as proposed in the exposure draft. The Board did not think that it was appropriate to completely remove the restriction. However, the Board considered whether there was an alternative approach that could better reflect an entity's risk management activities but that would also address the earnings management concerns that had been raised.

BC6.330 The Board noted that entities would only be able to reflect their risk management activities if it removed the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. However, the Board noted that it could address the concerns about earnings management by introducing some requirements for documenting the hedging relationship instead of prohibiting the designation altogether.

BC6.331 The Board noted that the potential for earnings management could be addressed if the recognition pattern for profit or loss arising from the hedged net position for all periods affected was set at the inception of the hedge, in such a way that it was clear what amounts would affect profit or loss, when they would affect profit or loss and to which hedged volumes and types of items they related.

- BC6.332 However, the Board had concerns about applying cash flow hedges for net positions to many different types of risks because it might have unintended consequences for some risks. The Board noted that foreign currency risk was the risk most commented on by respondents and the risk that the Board intended to address by this type of hedge.
- BC6.333 Consequently, the Board decided that cash flow hedges of net positions would only be available for hedges of foreign currency risk (but no other risks). In addition, the Board decided to remove the restriction that the offsetting risk positions in a net position must affect profit or loss in the same reporting period. However, the Board was concerned that without sufficiently specific documentation of the items within the designated net position, an entity could use hindsight to allocate the hedging gains or losses to those items so as to achieve a particular result in profit or loss (selection effect). Consequently, the Board decided that for all items within the designated net position for which there could be a selection effect, an entity must specify each period in which the transactions are expected to affect profit or loss as well as the nature and volume of each type of forecast transaction in such a way that it eliminates the selection effect. For example, depending on the circumstances, eliminating a selection effect could require that specifying the nature of a forecast purchase of items of property, plant and equipment includes aspects such as the depreciation pattern for items of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items (eg different useful lives because of being used in different production processes). The Board noted that this would also address the issue that some respondents had raised regarding changes in the original expectations of when the risk positions would affect profit or loss resulting in items affecting profit or loss in different periods (see paragraph BC6.326).

Presentation for groups of items that are a net position

- BC6.334 For cash flow hedges of groups of items with offsetting risk positions (ie net positions) the hedged items might affect different line items in the statement of profit or loss and other comprehensive income. Consequently, for a cash flow hedge of such a group, that raises the question of how hedging gains or losses should be presented. In its deliberations leading to the exposure draft, the Board noted that hedging gains or losses would need to be grossed up to offset each of the hedged items individually.
- BC6.335 The Board noted that if it proposed to adjust (gross up) all the affected line items in the statement of profit or loss and other comprehensive income it would result in the recognition of gross (partially offsetting) gains or losses that did not exist, and that this would not be consistent with general accounting principles. Consequently, in its exposure draft, the Board decided not to propose adjusting (grossing up) all affected line items in the statement of profit or loss and other comprehensive income.
- BC6.336 Instead, the Board proposed in its exposure draft that in the statement of profit or loss or other comprehensive income hedging gains or losses for cash flow hedges of a net position should be presented in a separate line item. This would avoid the problem of distorting gains or losses with amounts that did not exist. However, the Board acknowledged that this results in additional disaggregation of information in the statement of profit or loss and other comprehensive income.

This would also result in hedges of net positions being presented differently from hedges of gross positions.

- BC6.337 In a fair value hedge, changes in the fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in the statement of profit or loss and other comprehensive income. Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the Board did not believe any changes to the fair value hedge accounting mechanics were necessary to accommodate net positions. However, in situations where some hedging gains or losses are considered a modification of revenue or an expense (for example, when the net interest accrual on an interest rate swap is considered a modification of the interest revenue or expense on the hedged item), those gains or losses should be presented in a separate line when the hedged item is a net position. In the Board's view, in those situations the same reasons applied that it had considered for cash flow hedges in relation to their presentation in the statement of profit or loss and other comprehensive income.
- BC6.338 Most of the respondents to the exposure draft supported the Board's proposal to require the hedging gains or losses to be presented in a separate line item for a hedging relationship that includes a group of items with offsetting risks that affect different line items in the statement of profit or loss and other comprehensive income.
- BC6.339 The Board decided to retain the proposal in the exposure draft, as it would make transparent that an entity is hedging on a net basis and would clearly present the effect of those hedges of net positions on the face of the statement of profit or loss and other comprehensive income.

Identifying the hedged item for hedges of a group of items that constitutes a net position

- BC6.340 The Board considered in its deliberations leading to the exposure draft how an entity that applies hedge accounting to net positions should identify the hedged item. The Board concluded that an entity would need to designate a combination of gross positions if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the Board proposed that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item.
- BC6.341 The Board retained its original decision during the redeliberations of its exposure draft.

Hedges of a group of items that results in a net position of nil

- BC6.342 In its deliberations leading to the exposure draft, the Board noted that when an entity managed and hedged risks on a net basis, the proposals would allow the entity to designate the net risk from hedged items into a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the Board acknowledged that there might be circumstances in which, by coincidence, the net position of hedged items for a particular period was nil.
- BC6.343 The Board considered whether, when an entity hedges risk on a net basis, a nil net position should be eligible for hedge accounting. Such a hedging relationship could be, in its entirety, outside the scope of hedge accounting if it did not include any financial instruments. Furthermore, eligibility for hedge

accounting would be inconsistent with the general requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.

- BC6.344 However, the Board noted that the accounting result of prohibiting the application of hedge accounting to nil net positions could distort the financial reporting of an entity that otherwise hedged (with eligible hedging instruments) and applied hedge accounting on a net basis. For example:
- (a) in periods in which hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument), the transactions would affect profit or loss at an overall hedged rate or price; whereas
 - (b) in periods in which hedge accounting would not be permitted (because the net position is nil), transactions would affect profit or loss at prevailing spot rates or prices.
- BC6.345 Consequently, the Board proposed that nil net positions should qualify for hedge accounting. However, the Board noted that such situations would be coincidental and hence it expected that nil net positions would be rare in practice.
- BC6.346 The Board retained its original decision during the redeliberations of its exposure draft.

Hedging credit risk using credit derivatives

The Board's deliberations leading to the exposure draft

The issue

- BC6.347 Many financial institutions frequently use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This might also reduce the regulatory capital requirement for the loan or loan commitment while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (for example, a facility for a particular client) or the bank's overall lending portfolio.
- BC6.348 However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, the credit risk cannot be isolated in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable (see also paragraph BC6.381).
- BC6.349 As an alternative to hedge accounting, IFRS 9 permits an entity to designate, as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of the standard if doing so eliminates or significantly reduces an 'accounting mismatch'. However, the fair value option is only available at initial recognition, is irrevocable and an entity must designate the financial item in its entirety (ie for its full nominal amount). Because of the various optional features and the drawdown behavioural pattern of the loans and loan

commitments, credit portfolio managers engage in a flexible and active risk management strategy. Credit portfolio managers most often hedge less than 100 per cent of a loan or loan commitment. They might also hedge longer periods than the contractual maturity of the loan or the loan commitment. Furthermore, the fair value option is available only for instruments that are within the scope of IFRS 9. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37, not IFRS 9. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of its restrictions and scope.

- BC6.350 As a result, financial institutions that use credit default swaps to hedge credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments (ie those that meet the scope exception of IFRS 9). The changes in fair value of the credit default swaps are recognised in profit or loss every period (as for a trading book). The accounting outcome is a 'mismatch' of gains and losses of the loans and loan commitments versus those of the credit default swaps, which creates volatility in profit or loss. During the Board's outreach programme, many users pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.
- BC6.351 In the exposure draft, the Board proposed that a risk component should be separately identifiable and reliably measurable in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate an equivalent to hedge accounting when entities hedge credit risk, a different accounting requirement would have to be developed specifically for this type of risk, or the proposed hedge accounting requirements would have to be significantly modified (for example, in relation to eligible hedged items and effectiveness testing).

Alternatives considered by the Board in its deliberations leading to the exposure draft

- BC6.352 In its deliberations leading to the exposure draft, the Board considered three alternative approaches to hedge accounting in order to address situations in which credit risk is hedged by credit derivatives. These alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (for example, a bond, loan or loan commitment):
- (a) Alternative 1:
 - (i) to elect fair value through profit or loss only at initial recognition;
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.
 - (b) Alternative 2:
 - (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is recognised immediately in profit or loss);
 - (ii) to designate a component of nominal amounts; and
 - (iii) to discontinue fair value through profit or loss accounting.
 - (c) Alternative 3:

- (i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is amortised or deferred);
- (ii) to designate a component of nominal amounts; and
- (iii) to discontinue fair value through profit or loss accounting.

BC6.353 The election of fair value through profit or loss would be available for a financial instrument (or a proportion of it) that is managed in such a way that an economic relationship on the basis of the same credit risk exists with credit derivatives (measured at fair value through profit or loss) that causes offset between changes in fair value of the financial instrument and the credit derivatives. This would also apply to financial instruments that fall outside the scope of IFRS 9, for example, loan commitments. Instead of the qualifying criteria for hedge accounting (see paragraphs BC6.137–BC6.178), the Board considered the following qualifying criteria for electing fair value through profit or loss:

- (a) the name of the credit exposure matches the reference entity of the credit derivative (name matching); and
- (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

BC6.354 The qualification criteria above are set with a view to accommodating economic hedges of credit risk that would otherwise qualify for hedge accounting, but for the fact that the credit risk component within the hedged exposure cannot be separately identified and hence is not a risk component that meets the eligibility criteria for hedged items. The qualification criteria above are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions. However, using name matching as a qualifying criterion means that index-based credit default swaps would not meet that criterion.

BC6.355 For discontinuation, the Board considered the following criteria:

- (a) the qualifying criteria are no longer met; and
- (b) retaining the measurement at fair value through profit or loss is not needed because of any other requirements.

BC6.356 Given the rationale for electing fair value through profit or loss, an entity would typically discontinue accounting at fair value through profit or loss if the discontinuation criteria above are met, because that would ensure alignment with how the exposure is managed (ie the credit risk is no longer managed using credit derivatives). The Board noted that in circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the Board considered that it would be logical to make the discontinuation of fair value through profit or loss accounting mandatory (rather than optional) if the discontinuation criteria are fulfilled.

BC6.357 Alternative 1 permits electing fair value through profit or loss for a component of the nominal amount of the financial instrument if qualifying criteria are met. This is available only at initial recognition. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with alternative 1, at the date of discontinuation of fair value through profit or loss accounting the fair

value of the financial instrument will be its deemed cost. For loan commitments outside the scope of IFRS 9 the measurement and recognition criteria of IAS 37 would apply.

- BC6.358 The Board noted that a significant disadvantage of alternative 1 is that in many situations in practice (when a financial institution obtains credit protection for an exposure after the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and therefore would not reflect its effect. An advantage of alternative 1 is that it is less complex than the other alternatives that the Board considered. By not permitting the election of fair value through profit or loss after initial recognition (or inception of a loan commitment), the difference at later points in time between the carrying amount and the fair value of the financial instrument will not arise.
- BC6.359 In addition to the election of fair value through profit or loss at initial recognition in accordance with alternative 1, alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was previously deteriorating and was then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.
- BC6.360 The Board noted that when the financial instrument is elected for measurement as at fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and its fair value. This difference is a result of the change in the measurement basis (for example, from amortised cost to fair value for a loan). The Board considers this type of difference a measurement change adjustment. Alternative 2 proposes to recognise the measurement change adjustment in profit or loss immediately. At the date of discontinuation of fair value through profit or loss accounting, the fair value will be the deemed cost (as in alternative 1). If the financial instrument is elected again after a previous discontinuation, the measurement change adjustment at that date is also recognised immediately in profit or loss.
- BC6.361 A significant advantage of alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.
- BC6.362 A disadvantage of alternative 2 is that it is more complex than alternative 1. Furthermore, it might appear susceptible to earnings management. An entity can decide at what time to elect fair value through profit or loss accounting for the financial instrument and thus when the difference between the carrying amount and fair value at that date would be recognised in profit or loss. The accounting impact of immediately recognising the measurement change adjustment in profit or loss may also deter an entity from electing fair value through profit or loss accounting. For example, when an entity decides to take out credit protection at a time when the fair value has already moved below the carrying amount of the

loan because of credit concerns in the market, it will immediately recognise a loss if it elects fair value through profit or loss accounting.

- BC6.363 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as alternative 2. Consequently, it also allows to achieve an accounting outcome that reflects the credit risk management strategy of financial institutions.
- BC6.364 An important difference between alternatives 2 and 3 is the treatment of the measurement change adjustment (ie the difference that could arise between the carrying amount and fair value of the financial instrument when fair value through profit or loss accounting is elected after initial recognition of the credit exposure). Alternative 3 proposes that the measurement change adjustment should be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37.
- BC6.365 As in alternative 2, a significant advantage of alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives. An advantage of alternative 3 over alternative 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.
- BC6.366 However, a disadvantage of alternative 3 is that it is the most complex of the alternatives. The Board noted that the measurement change adjustment in accordance with alternative 3 would have presentation implications. The measurement change adjustment could be presented in the statement of financial position in the following ways:
- (a) as an integral part of the carrying amount of the exposure (ie it could be added to the fair value of the loan): this results in a mixed amount that is neither fair value nor amortised cost;
 - (b) presentation as a separate line item next to the line item that includes the credit exposure: this results in additional line items in the balance sheet (statement of financial position) and may easily be confused as a hedging adjustment; or
 - (c) in other comprehensive income.
- BC6.367 The Board noted that disclosures could provide transparency on the measurement change adjustment.
- BC6.368 However, in the light of the complexities that these three alternatives would introduce, the Board decided that the exposure draft should not propose allowing elective fair value accounting for hedged credit exposures (such as loans and loan commitments).

The feedback received on the exposure draft

- BC6.369 Many respondents to the exposure draft were of the view that the Board should consider how to accommodate hedges of credit risk using credit derivatives under IFRSs. Respondents commented that hedges of credit risk using credit

derivatives are becoming an increasingly significant practice issue in the application of IFRSs. They noted that this issue is just as significant as other issues that had been addressed in the exposure draft (for example, the time value of options, hedges of aggregated exposures and risk components of non-financial items). They also noted that financial reporting under IFRSs should allow entities to reflect the effects of such activities in the financial statements consistently with the overall hedge accounting objective to better reflect risk management activities.

- BC6.370 Respondents also commented that IFRSs today fail to represent the effect of credit risk management activities and distort the financial performance of financial institutions. They noted that, because of the accounting mismatch between loans and loan commitments on the one hand and the related credit derivatives on the other hand, the profit or loss under IFRSs is significantly more volatile for financial institutions that hedge their credit risk exposures than for financial institutions that do not hedge.
- BC6.371 Many respondents noted that the objective of hedge accounting would not be met if IFRSs would not provide a way to account for hedges of credit risk so that financial statements can reflect the credit risk management activities of financial institutions.
- BC6.372 Most users commented that the Board should address this issue. Many users also noted that the financial statements currently reflect accounting-driven volatility when credit risk is hedged and that those financial statements do not align with those risk management activities.
- BC6.373 Participants in the outreach provided the same feedback. Most of them were also of the view that this is an important practice issue that the Board should address.
- BC6.374 However, the feedback was mixed on how the Board should address or resolve this issue. Many respondents were of the view that it was difficult to reliably measure credit risk as a risk component for the purposes of hedge accounting. However, some respondents suggested that for some types of instruments the credit risk component of financial instruments could be reliably measured on the basis of credit default swap (CDS) prices, subject to some adjustments.
- BC6.375 Many agreed that the alternatives set out in the Basis for Conclusions of the exposure draft (see paragraph BC6.352) were too complex, although some respondents supported elective fair value through profit or loss accounting as an alternative to hedge accounting. Of the three fair value through profit or loss alternatives, most respondents supported alternative 3.
- BC6.376 Respondents who supported elective fair value through profit or loss accounting thought that it would be operational and believed that it would be no more complex than the other possible approaches, for example, identifying risk components. Most preferred alternative 3 of the three alternatives as it would align most closely with the dynamic credit risk management approach of many financial institutions. Some users supported elective fair value through profit or loss accounting because they thought that the benefits of providing a better depiction of the economics of the risk management activities would outweigh the complexity.

The Board's redeliberations of the exposure draft

BC6.377 In the light of the feedback received on its exposure draft, the Board decided to specifically address the accounting for hedges of credit risk using credit derivatives. In its redeliberations the Board explored various accounting alternatives.

Treating credit risk as a risk component

BC6.378 The Board noted that for credit risk there are unique differences between how the relevant risk might affect the hedging instrument and the hedged risk exposure when compared to other risk components.

BC6.379 The Board noted that there is sometimes uncertainty about whether voluntary debt restructurings constitute a credit event under a standard credit default swap contract. Whether an event constitutes a credit event is determined by a committee consisting of representatives of banks and fund entities. This can (and in practice did) result in situations in which the fair value of a debt instrument has decreased reflecting the market view of credit losses on those instruments while any payout on credit default swaps for those instruments depends on how the difficulties of the debtor will be resolved and what related measures might be considered a credit event. This is a factor that affects credit default swaps in a different way than the actual underlying debt. It is an additional factor inherent in credit default swaps that is not inherent in the debt as such. Hence, there could be scenarios in which, for example, an impairment loss on a loan might not be compensated by a payout from a credit default swap that is linked to the obligor of that debt. Also, market liquidity and the behaviour of speculators trying to close positions and taking gains affect the credit default swap and the debt market in different ways.

BC6.380 The Board also noted that when a financial institution enters into a credit default swap to hedge the credit exposure from a loan commitment it might result in a situation in which the reference entity defaults while the loan commitment remains undrawn or partly undrawn. In such situations the financial institution receives compensation from the payout on the credit default swaps without actually incurring a credit loss.

BC6.381 Furthermore, the Board considered the implications of the fact that, upon a credit event, the protection buyer receives the notional principal less the fair value of the reference entity's obligation. Hence the compensation received for credit risk depends on the fair value of the reference instrument. The Board noted that, for a fixed rate loan, the fair value of the reference instrument is also affected by changes in market interest rates. In other words, on settlement of the credit default swap, the entity also settles the fair value changes attributable to interest rate risk—and not solely fair value changes attributable to the credit risk of the reference entity. Hence, the way credit default swaps are settled reflects that credit risk inextricably depends on interest rate risk. This in turn reflects that credit risk is an 'overlay' risk that is affected by all other value changes of the hedged exposure because they determine the value of what is lost in case of a default.

BC6.382 Hence, the Board considered that credit risk is not a separately identifiable risk component and thus does not qualify for designation as a hedged item on a risk component basis.

Exception to the general risk component criteria

- BC6.383 The Board then considered whether it should provide an exception to the general risk component criteria specifically for credit risk.
- BC6.384 Some respondents suggested that, as an exception to the general risk component criteria, the Board should consider an approach that would provide a reasonable approximation of the credit risk. This approach could be based on the guidance in IFRS 7 and IFRS 9 for measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss. Those respondents noted that if this method of determining own credit risk for such liabilities is acceptable in IFRS 7 and IFRS 9, the Board should provide the same 'relief' for measuring the credit risk component for the purposes of hedge accounting.
- BC6.385 The Board noted that, in finalising the requirement for the fair value option for financial liabilities in IFRS 9, it retained the default method in the application guidance in IFRS 7 to determine the effects of changes in the liability's credit risk. The Board received comments on its exposure draft *Fair Value Option for Financial Liabilities* that determining the effects of changes in a liability's credit risk can be complex, and that it was therefore necessary to allow some flexibility in how a liability's credit risk could be measured. Respondents to that exposure draft, like the Board, acknowledged that the default method was imprecise but considered the result a reasonable proxy in many cases. Moreover, the Board noted that respondents to that exposure draft did acknowledge that the 'IFRS 7 method' did not isolate changes in a liability's credit risk from other changes in fair value (for example, general changes in the price of credit or changes in liquidity risk). Those respondents said that it was often very difficult or impossible to separate those items.
- BC6.386 The Board noted that the 'IFRS 7 method' (which was incorporated into IFRS 9) involves the use of an observed market price at the beginning and end of the period to determine the change in the effects of credit. That method requires entities to deduct any changes in market conditions from changes in the fair value of the instrument. Any residual amount is deemed to be attributable to changes in credit. The Board noted that the loans and loan commitments for which the credit risk is hedged very often have no observable market price and that, in order to achieve a close approximation of the credit risk, complex modelling would be involved to arrive at a 'market price'. Applying the 'IFRS 7 method' would then require deducting valuations for parts of the instrument and analysing them for changes in market conditions to arrive at a credit risk component. This would also be complex when trying to achieve a close approximation of the credit risk.
- BC6.387 Furthermore, the Board noted that the loans and loan commitments for which the credit exposure is hedged often have embedded options whose fair value depends on both market and non-market conditions. For example, the exercise of prepayment options could be because of changes in general interest rates (a market condition) while loans are typically refinanced (exercise of the prepayment option) well in advance of the scheduled maturity, irrespective of movements in general interest rates. Hence, in order to achieve a close approximation of the credit risk isolating the changes for market conditions on these embedded options could involve significant judgement and could become extremely complex.

- BC6.388 The Board also considered that applying the 'IFRS 7 method' in a way that was operational (ie so that the approximation would provide relief) would mean using many of the same simplifications that some commentators had suggested for applying the general risk component criteria to credit risk (for example, using a standardised haircut for prepayment and term out options, and ignoring immaterial options).
- BC6.389 The Board considered that for exchange traded bonds without embedded options for which market prices are readily observable and that do not have embedded options, the 'IFRS 7 method' might result in an approximation or proxy for the credit risk component in some circumstances. However, the Board was concerned that for loans and loan commitments that are not actively traded, the 'IFRS 7 method' could become a complicated 'circular' pricing exercise and in any case it would very likely result in only a rough approximation or imprecise measurement of the credit risk component.
- BC6.390 The Board further noted that it had acknowledged the shortcomings of the approach used for IFRS 7 and IFRS 9 and that the approach was only a proxy for measuring credit risk. Hence, the Board had actively sought to limit the application of this approach by retaining the bifurcation requirement for hybrid financial liabilities, even though bifurcation of financial assets was eliminated. Hence, the approach was only applied to financial liabilities designated as at fair value through profit or loss.
- BC6.391 The Board acknowledged that in order to ensure that hedge ineffectiveness is recognised the qualifying criteria for risk components use a higher degree of precision than a mere proxy. Also, for classification and measurement of financial liabilities the Board sought to minimise the application of this proxy by retaining the separation of embedded derivatives. Consequently, the Board decided that using the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss also for the purpose of measuring credit risk as a hedged item would be inappropriate.
- BC6.392 The Board also considered whether it should permit 'residual risks' as an eligible hedged item. Such an approach would allow designating as the hedged item those changes in cash flows or fair value of an item that are not attributable to a specific risk or risks that meet the separately identifiable and reliably measurable criteria for risk components. For example, an entity could designate the fair value changes of a loan that are attributable to all risks other than interest rate risk.
- BC6.393 The Board noted that that approach would have the advantage of not requiring an entity to directly measure credit risk. However, the Board noted that this approach would entail similar complexity as the IFRS 7 method for financial instruments with multiple embedded options. Hence, determining the part of fair value changes that is attributable to a specific risk (for example, interest rate risk) could be complex.
- BC6.394 The Board also noted that that approach had other disadvantages:
- (a) the problem that credit risk inextricably depends on interest rate risk because of the nature of credit risk as an 'overlay' risk (see paragraphs BC6.381 and BC6.382) would remain; and
 - (b) entities would struggle with the hedge effectiveness assessment of the new hedge accounting model as it would be difficult to establish and

demonstrate a direct economic relationship between the ‘residual’ risk and the hedging instrument (ie the credit default swap), which gives rise to offset—a requirement to qualify for hedge accounting.

BC6.395 Consequently, the Board decided against permitting ‘residual risks’ as an eligible hedged item.

Applying financial guarantee contract accounting

BC6.396 The Board considered whether the accounting for financial guarantee contracts in IFRS 9 could be applied to credit derivatives.

BC6.397 The Board noted that credit derivatives, such as credit default swaps, typically do not meet the definition of a financial guarantee contract in IFRS 9 because:

- (a) the credit events that trigger payment on a standardised credit default swap (for example, bankruptcy, repudiation, moratorium or restructuring) might not directly relate to the failure to pay on the particular debt instrument held by an entity; and
- (b) in order to meet the definition of a financial guarantee contract, it must be a precondition for payment that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. However, it is not a precondition for entering into a credit default swap that the holder is exposed to the underlying reference financial instrument (ie an entity can hold a ‘naked’ position).

BC6.398 The Board noted that it would have to broaden the definition of a financial guarantee contract in order to include such credit derivatives. The Board also noted that accounting for credit default swaps as financial guarantee contracts would mean that credit default swaps would not be measured at fair value but at ‘cost’, ie it would result in applying accrual accounting to a derivative financial instrument.

BC6.399 The Board therefore rejected this alternative.

Applying the accounting for the time value of options

BC6.400 Some respondents to the exposure draft suggested that the premium paid on credit default swaps is similar to buying protection under an insurance contract and, accordingly, the premium should be amortised to profit or loss. Those respondents supported applying to credit default swaps the accounting treatment for the time value of options that was proposed in the exposure draft. They argued that, from a risk management perspective, changes in the fair value of the derivative during the period were irrelevant, as long as the issuer (of the debt) was solvent because if there was no credit event the fair value of the credit default swap on maturity would be zero. Hence, those respondents believed that ‘interim’ fair value changes could be recognised in other comprehensive income similar to the accounting treatment proposed in the exposure draft for the time value of options.

BC6.401 The Board noted that in contrast to (‘normal’) options for which the time value paid is known from the beginning (hence the amount to be amortised or deferred is known), for a credit default swap the premium is contingent on the occurrence of a credit event and hence the total premium that is ultimately paid is not known at the outset. This is because the premium for a credit default swap, or at least a large part of the premium, is paid over time—but only until a credit event occurs.

The Board noted that in order to apply the same accounting as for the time value of options, the contingent nature of the credit default swap premium would have to be ignored so that the amortisation of the premium to profit or loss could be based on the assumption that no credit event occurs—even though that risk is reflected in the fair value of the credit default swap. The Board also noted that in substance this would be ‘as-you-go’ accounting for the credit default swap premium (ie recognising it in profit or loss on an accrual basis).

- BC6.402 The Board also noted that applying to credit default swaps the same accounting treatment as for the time value of options would require splitting the fair value of the credit default swap into an intrinsic value and a time value. This raises the question whether the credit default swap would only have time value (and hence no intrinsic value) until a credit event occurs, ie whether before a credit event occurs the entire fair value of the credit default swap should be deemed to be its time value.
- BC6.403 The Board considered that it would be inappropriate to simply attribute the entire fair value of the credit default swap before a credit event to time value. The Board noted that hedged items such as bonds or loans have ‘intrinsic’ value but not an equivalent to time value. In an effective economic hedge, the changes in the ‘intrinsic’ value in the hedged item would offset the changes in the intrinsic value of the hedging instrument. During times of financial difficulty (but before a credit event, for example, before an actual default) the fair value of the loan would have decreased because of credit deterioration. Also, the fair value of the related credit default swap would increase because of the higher risk of default. Hence, the Board considered that the increase in fair value of the credit default swap includes some intrinsic value element even though it would be difficult to isolate and separately quantify it.
- BC6.404 The Board also noted that if the entire fair value on a credit default swap was treated as time value before default, there could be a mismatch when an entity recognised an impairment loss on the loan or loan commitment before default. This is because all fair value changes from the credit default swap would still be recognised in other comprehensive income. One solution might be to recycle the amount recognised as an impairment loss on the loan or loan commitment from other comprehensive income to profit or loss and hence to simply deem the amount of the impairment loss to be the intrinsic value of the credit default swap. The Board considered that this would give rise to the same problems as other approximations it had discussed when it rejected an exception to the general risk component criteria, namely that any mismatch of economic gains or losses from the hedge would not be recognised as hedge ineffectiveness. Instead, under this approach profit or loss recognition for the credit default swap would be the same as accrual accounting while assuming perfect hedge effectiveness.
- BC6.405 The Board therefore rejected this alternative.

Applying an ‘insurance approach’

- BC6.406 Some respondents to the exposure draft supported an ‘insurance approach’ or accrual accounting for credit derivatives. They argued that such an approach would best address the accounting mismatch between loans and loan commitments versus credit derivatives and would reflect the risk management of financial institutions.

- BC6.407 The Board considered that under an insurance approach the following accounting could be applied to a credit default swap that is used to manage credit exposures:
- (a) any premium paid at inception of the credit default swap (or its fair value if an existing contract is used) would be amortised over the life of that contract;
 - (b) the periodic premium would be expensed as paid each period (including adjustments for premium accruals);
 - (c) the fair value of the credit default swap would be disclosed in the notes; and
 - (d) in the assessment of impairment, the cash flow that might result from the credit default swap in case of a credit event is treated in the same way as cash flows that might result from the collateral or guarantee of a collateralised or guaranteed financial asset. In other words, the loan or loan commitment for which credit risk is managed using the credit default swap is treated like a collateralised or guaranteed financial asset with the credit default swap accounted for like collateral or a guarantee.
- BC6.408 The Board noted that the insurance approach is a simple and straightforward solution if a credit default swap is used as credit protection for one particular credit exposure with a matching (remaining) maturity. Also, situations in which the maturity of the credit default swap exceeds that of the credit exposure could be addressed by using an 'aligned' credit default swap (similar to the notion of 'aligned' time value that is used for the new accounting treatment for the time value of options—see paragraphs BC6.264–BC6.287). However, the aligned credit default swap would only address maturity mismatches. It would not capture other differences between the actual credit default swap and the hedged credit exposure (for example, that a loan might be prepayable) because the insurance approach only intends to change the accounting for the credit default swap instead of adjusting the credit exposure for value changes that reflect all of its characteristics.
- BC6.409 The Board considered that the insurance approach would have a simple interaction with an impairment model as a result of treating the credit default swap like collateral or a guarantee, which means it would affect the estimate of the recoverable cash flows. Hence, this interaction would be at the most basic level of the information that any impairment model uses so that the effect would not differ by type of impairment model (assuming only credit derivatives with a remaining life equal to, or longer than, the remaining exposure period would qualify for the insurance approach).
- BC6.410 However, the Board noted that difficulties would arise when the insurance approach was discontinued before maturity of the credit exposure. In such a situation the consequences of using accrual (or 'as-you-go') accounting for the credit default swap would become obvious, ie it would be necessary to revert from off-balance-sheet accounting to measurement at fair value.
- BC6.411 The Board also noted that under the insurance approach neither the credit derivative nor the loan or loan commitment would be recognised in the balance sheet at fair value. Hence, any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between the loan or loan commitment versus the credit derivative would not be recognised in profit or loss. In addition, it would result in omitting the fair value of the credit default swap from the balance

sheet even though fair value provides important and relevant information about derivative financial instruments.

BC6.412 The Board therefore rejected this alternative.

Applying a ‘deemed credit adjustment approach’

BC6.413 The Board also considered an approach that would adjust the carrying amount of the hedged credit exposure against profit or loss. The adjustment would be the change in the fair value of a credit default swap that matches the maturity of the hedged credit exposure (‘aligned’ credit default swap value). The mechanics of this would be similar to how, in a fair value hedge, the gain or loss on the hedged item attributable to a risk component adjusts the carrying amount of the hedged item and is recognised in profit or loss. Essentially, the cumulative change in fair value of the aligned credit default swap would be deemed to be the credit risk component of the exposure in a fair value hedge of credit risk (ie act as a proxy for credit risk—‘deemed credit adjustment’). When the deemed credit adjustment approach is discontinued before the credit exposure matures an accounting treatment that is similar to that used for discontinued fair value hedges could be used.

BC6.414 The Board noted that the deemed credit adjustment approach would retain the measurement of credit default swaps at fair value through profit or loss. Hence, in contrast to the insurance approach (see paragraphs BC6.406–BC6.412), an advantage of this approach would be that the accounting for the credit default swap would not be affected by any switches between periods for which the credit derivative is used and those for which it is not used to manage a particular credit exposure.

BC6.415 However, the Board was concerned that the interaction of the deemed credit adjustment approach with impairment accounting would be significantly more complex than under the insurance approach because the deemed credit adjustment and the impairment allowance would be ‘competing mechanisms’ in accounting for impairment losses. This would also involve the danger of double counting for credit losses. The interaction would depend on the type of impairment model and would be more difficult in conjunction with an expected loss model.

BC6.416 The Board therefore rejected this alternative.

Allowing entities to elect fair value accounting for the hedged credit exposure

BC6.417 Because the discussions of those various alternatives did not identify an appropriate solution, the Board reconsidered the alternatives it had contemplated in its original deliberations leading to the exposure draft (see paragraph BC6.352).

BC6.418 The Board considered that only alternatives 2 and 3 of allowing an entity to elect fair value through profit or loss accounting for the hedged credit exposure would be viable. Given that alternative 1 would be limited to an election only on initial recognition of the credit exposure (or when entering into a loan commitment), the Board was concerned that, in many situations in practice (when an entity obtains credit protection for an exposure after the initial recognition of that exposure or entering into the loan commitment), this alternative would not be aligned with the credit risk management strategy and would therefore fail to resolve the problem (ie that no useful information is provided).

- BC6.419 The Board noted that alternative 3 would involve amortising the measurement change adjustment (ie the difference between the carrying amount, or nil for an unrecognised loan commitment, and the fair value of the financial instrument when it is elected for measurement at fair value through profit or loss after initial recognition or after entering into a loan commitment) over the life of the financial instrument hedged for credit risk. As a consequence, to ensure that the measurement change adjustment is not inappropriately deferred but recognised immediately in profit or loss when impaired, the measurement change adjustment would require an impairment test. This would result in interaction with the impairment model.
- BC6.420 The Board was concerned that the interaction of alternative 3 with the impairment model could create a compatibility problem and might be a potential restriction regarding the impairment phase of its project to replace IAS 39.
- BC6.421 Hence, the Board reconsidered alternative 2. The Board noted that:
- (a) the status quo under IAS 39, in which credit default swaps are accounted for at fair value through profit or loss while credit exposures are at amortised cost or unrecognised (eg loan commitments in many cases), is clearly misleading. It results in recognising gains on credit default swaps while the impairment is recognised on a different measurement basis and with a time lag because of the impairment models. Hence, in a situation in which the situation of a lender deteriorates but it has protected itself, gains are shown even though the protection keeps the situation 'neutral' at best.
 - (b) Alternative 2 would use fair value accounting for both the credit default swap and the credit exposure. This would best capture all economic mismatches but would come at the expense of inevitably including in the remeasurement interest rate risk in addition to credit risk. Alternative 2 would have the clearest objective of all approaches considered (fair value measurement) and, as a result, it would require the least guidance. The Board noted that under alternative 2 there could be concerns about earnings management because on electing fair value accounting the difference to the previous carrying amount of the credit exposure would be immediately recognised in profit or loss. However, the Board also noted that some would consider that outcome as relevant because it would signal a different approach to managing credit risk and this difference would often be a loss that is a reflection of any lag in the impairment model behind the 'market view'. To be consistent, this should be removed by changing the measurement basis when switching to a fair value based credit risk management.
 - (c) The accounting under alternative 2 is completely de-linked from the impairment model and has therefore the least interaction with impairment of all approaches considered.
 - (d) Alternative 2 is operationally the least complex of all approaches considered.
- BC6.422 The Board considered that, on balance, the advantages of alternative 2 outweighed its disadvantages and, overall, that this alternative was superior to all other approaches. Hence, the Board decided to include alternative 2 in the final requirements.
- BC6.423 In response to feedback received on the exposure draft, the Board also decided to align the accounting on discontinuation of fair value through profit or loss

accounting for loan commitments with that for loans (ie use amortisation unless a higher liability is required by IAS 37, instead of simply reverting to that standard as contemplated during the Board's initial deliberations—see paragraphs BC6.360 and BC6.357). The Board's reasons for using an amortisation approach also for loan commitments were:

- (a) It would prevent an immediate gain from derecognising the loan commitment under IAS 37 if the probable threshold is not met when discontinuing fair value through profit or loss accounting. This would reduce concerns about earnings management.
- (b) The amortisation of the carrying amount when discontinuing fair value through profit or loss accounting would use the effective interest method. This would require assuming that a loan had been drawn under the loan commitment in order to determine an amortisation profile. The rationale for this alternative is that a credit loss only results from a loan commitment if that commitment gets drawn and the resulting loan is not repaid. Hence, an amortisation on an 'as if drawn' basis would be appropriate to amortise the carrying amount.
- (c) This accounting also provides operational relief for loan commitments that allow repayments and redraws (for example, a revolving facility). It would avoid the need to capitalise any remaining carrying amount into individual drawings to ensure its amortisation, which would be operationally complex.

Effective date and transition (chapter 7)

After paragraph BC7.9E of IFRS 9 (2010), as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011, the heading and paragraph BC7.9F are added.

Requirements added to IFRS 9 in [Date] 2012

BC7.9F The Board decided that the hedge accounting requirements should become effective for annual periods beginning on or after 1 January 2015. This aligns the effective date of the hedge accounting requirements with the effective date for the classification and measurement phase of IFRS 9, as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011. It also addresses feedback on the request for views *Effective Dates and Transition Methods* regarding the expected time and effort involved in properly adapting to the new financial reporting requirements of the major projects on the Board's agenda at the time. The Board decided that earlier application is permitted to ensure consistency with previous phases of IFRS 9. However, in conformity with earlier decisions, an entity can apply the proposed hedge accounting requirements only if it has adopted all of the existing IFRS 9 requirements, or adopts them at the same time as the proposed hedge accounting requirements are adopted.

After paragraph BC7.34M of IFRS 9 (2010), as amended by *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011, the heading and paragraphs BC7.35–BC7.46 are added.

Transition related to the hedge accounting requirements added to IFRS 9 in [Date] 2012

- BC7.35 IAS 8 states that retrospective application results in the most useful information to users. IAS 8 also states that retrospective application is the preferred approach to transition, unless such retrospective application is impracticable. In such a scenario the entity adjusts the comparative information from the earliest date practicable. In conformity with these requirements, the classification and measurement chapters of IFRS 9 require retrospective application (with some relief in particular circumstances).
- BC7.36 The proposals in the exposure draft were a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship could be designated only prospectively. Consequently, retrospective application was not applicable. This reflects that retrospective application gives rise to similar concerns about using hindsight as retrospective designation of hedging relationships, which is prohibited.
- BC7.37 In developing the transition requirements proposed in the exposure draft, the Board considered two alternative approaches:
- (a) prospective application only for new hedging relationships; or
 - (b) prospective application for all hedging relationships.
- BC7.38 The Board 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.
- BC7.39 Consequently, the Board 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.
- BC7.40 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.

- BC7.41 The Board 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 exposure draft (see paragraph BC7.38), the Board decided not to allow the grandfathering of the application of IAS 39. Instead, the Board 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 IFRS and that those are treated as continuing hedging relationships.
- BC7.42 Some respondents supported varying forms of retrospective application. However, consistent with previous hedge accounting transition requirements in IAS 39 and the exposure draft, the Board decided not to allow retrospective application in situations that would require retrospective designation because that would involve hindsight.
- BC7.43 Some responses to the exposure draft suggested using retrospective application in two particular situations in which the outcomes under IAS 39 and the new hedge accounting model significantly differ but retrospective designation would not be necessary. The particular situations are when an entity under IAS 39 designated as the hedging instrument only changes in the intrinsic value (but not the time value) of an option or changes in the spot element (but not the forward element) of a forward contract. The Board noted that in both circumstances applying the new requirements for accounting for the time value of options or the forward element of forward contracts would not involve hindsight from retrospective designation but instead use the designation that was previously made under IAS 39. The Board also noted that in situations in which mismatches between the terms of the hedging instrument and the hedged item exist there might still be some risk of hindsight related to Level 3 fair value measurements when calculating the 'aligned' time value of an option and the 'aligned' forward element of a forward contract. However, the Board concluded that such hindsight would be limited because hedge accounting was applied to these hedging relationships under IAS 39, meaning that the changes in the intrinsic value of an option or the changes in the value of the spot element of a forward contract had to have a high degree of offset with the changes in value of the hedged risks. Hence, the valuation inputs used for the calculation of the aligned values could not significantly differ from the valuation inputs for the overall fair value of the hedging instruments, which were known from previously applying IAS 39. The Board also noted that retrospective application in these cases would significantly improve the usefulness of the information for the reasons that underpinned the Board's decisions on accounting for the time value of options and the forward element of forward contracts (see paragraphs BC6.264–BC6.304). Consequently, the Board decided to provide for those two particular situations an exception to prospective application of the hedge accounting requirements of this IFRS but only for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. For the forward element of forward contracts retrospective application is permitted but not required because unlike the new treatment for time value of options the new treatment for the forward element of forward contracts is an election. However, in order to address the risk of using

hindsight, the Board decided that on transition this election is only available on an 'all-or-nothing' basis (ie not a hedge-by-hedge basis).

- BC7.44 Some respondents asked the Board to consider allowing discontinuing at the date of initial application of the new hedge accounting requirements hedging relationships designated under IAS 39 and then designating new hedging relationships in a way that is better aligned with the new hedge accounting requirements.
- BC7.45 The Board noted that an entity could revoke designations of hedging relationships without any restriction until the last day of applying IAS 39 in accordance with the requirements in that standard. Hence, the Board considered that any specific transition requirements to address this request were unnecessary. However, in order to address some concerns over potential practical transition issues in the context of prospective application, the Board decided:
- (a) to allow an entity to consider the moment it initially applies the new hedge accounting requirements and the moment it ceases to apply the hedge accounting requirements of IAS 39 as the same point in time. The Board noted that this would avoid any time lag between starting the use of the new hedge accounting model and discontinuing the old hedge accounting model (because the end of the last business day of the previous reporting period often does not coincide with the beginning of the first business day of the next reporting period), which otherwise might involve significant changes in fair values between those points in time and as a result could cause difficulties in applying hedge accounting under the new hedge accounting model for hedging relationships that would otherwise qualify.
 - (b) to require that an entity uses the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship (if applicable) and to recognise any related gain or loss in profit or loss. The Board considered that any change to the hedge ratio that might be required on transition so that a hedging relationship designated under IAS 39 continues to qualify for hedge accounting should not result in an entity having to discontinue that hedging relationship on transition and then newly designating it. The Board decided to require the recognition of any gain or loss on rebalancing in profit or loss in a broadly similar manner for ongoing hedge accounting under the new model to address any concerns that hedge ineffectiveness might otherwise be recognised as a direct adjustment to retained earnings on transition. The accounting is broadly similar to that for ongoing hedge accounting under the new model in that the hedge ineffectiveness in the context of rebalancing is recognised in profit or loss. However, in contrast to ongoing hedge accounting under the new model, rebalancing on transition applies because a different hedge ratio has already been used for risk management purposes (but did not coincide with the designation of the hedging relationship under IAS 39). In other words, rebalancing does not reflect a concurrent adjustment for risk management purposes but results in aligning the hedge ratio for accounting purposes with a hedge ratio that was already in place for risk management purposes.
- BC7.46 The Board decided not to change the requirements of IFRS 1 for hedging accounting. The Board noted that a first-time adopter would need to look at the entire population of possible hedging relationships and assess which ones would

meet the qualifying criteria of the new hedge accounting model. To the extent that an entity wants to apply hedge accounting, those hedging relationships should be documented on or before the transition date. This is consistent with the transition requirements for existing users of IFRSs and the existing transition requirements of IFRS 1, which state that an entity shall discontinue hedge accounting if it had designated a hedging relationship but that hedging relationship does not meet the qualifying criteria in IAS 39.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 9 and the related amendments to other IFRSs.

IFRS 1 First-time Adoption of International Financial Reporting Standards

- BCA1 The footnotes to the reference to 'IAS 39' in paragraphs BC58A, BC63A, BC65, BC66, BC74, BC89 and BC89A and to the heading 'Available-for-sale financial assets' above paragraph BC81 are deleted.
- BCA2 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17(a), and the first references to 'IAS 39' in paragraphs BC20–BC23, BC58A, BC63A, BC74, BC81, BC89 and BC89A are footnoted appropriately as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA3 The first references to 'IAS 39' in paragraphs BC65 and BC66 are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.
- BCA4 The term 'available for sale' in paragraph BC63A, the term 'available-for-sale financial assets' in paragraph BC74(b) and the heading 'Available-for-sale financial assets' above paragraph BC81 are footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, with requirements added in October 2010, eliminated the category of available-for-sale financial assets.
- BCA5 The heading 'Hedge accounting' above paragraph BC75 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39.
- BCA6 Paragraph BC80A is added:
- BC80A In [Date] 2012 the Board amended the examples in the guidance on hedge accounting so that they conformed to IFRS 9, issued in [Date] 2012, which replaced the hedge accounting requirements in IAS 39.

IFRS 2 Share-based Payment

- BCA7 The footnote to the reference to 'IAS 39' in the heading above paragraph BC25 is replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. Paragraphs BC25–BC28 refer to matters relevant when IFRS 2 was issued.

IFRS 3 Business Combinations

- BCA8 The footnote to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC185 and the first references to ‘IAS 39’ in paragraphs BC244, BC256 and BC437(c) are deleted.
- BCA9 The reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC185 and the first references to ‘IAS 39’ in paragraphs BC246–BC251, BC256, BC354, BC434A and BC437(c) are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA10 The reference to ‘IAS 39’ in paragraph BC244 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.
- BCA11 The first reference to ‘available-for-sale securities’ in paragraph BC389 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA12 The second reference to ‘IAS 39’ in paragraph BC185 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39.

IFRS 4 Insurance Contracts

- BCA13 The footnotes to the reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC11(a), the first references to ‘IAS 39’ in paragraphs BC22(c), BC28(b), BC41(b), BC47, BC55, BC73(d), BC82 and BC161, the reference to ‘available for sale’ in paragraph BC145(b) and the heading above paragraph BC166 are deleted.
- BCA14 The reference to ‘IAS 39 *Financial Instruments: Recognition and Measurement*’ in paragraph BC11(a), the first references to ‘IAS 39’ in paragraphs BC21, BC22(c), BC28(b), BC40–BC54, BC55–BC60, BC62, BC73(d), BC82, BC117, BC146 and BC154–BC165 and the heading ‘Issues related to IAS 39’ above paragraph BC166 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA15 The references to 'IAS 39' in paragraphs BC47 and BC161 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

BCA16 The term 'available for sale' in paragraph BC145(b) and the heading 'Issues related to IAS 39' above paragraph BC166 are footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA17 The footnotes to the headings above paragraphs DO7, DO9 and DO18 are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

BCA18 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8(b), the first references to 'IAS 39' in paragraphs BC13(a) and BC54(b) and the reference to 'available-for-sale assets' in paragraph BC58 are deleted.

BCA19 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8(b) and the reference to 'IAS 39' in paragraphs BC13(a), BC54(a) and BC81 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

BCA20 The term 'held-for-trading financial asset' in paragraph BC54(b) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-for-trading financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

BCA21 The term 'available-for-sale assets' in paragraph BC58 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-

sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

IFRS 7 Financial Instruments: Disclosures

BCA22 In the rubric below the title a paragraph is added as follows [amendment previously made by IFRS 9 2010]:

In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments, and IFRS 7 was amended accordingly. The text of this Basis for Conclusions has been amended for consistency with those changes.

BCA23 Paragraphs BC14–BC16 are amended to read as follows [amendment previously made by IFRS 9 2010]:

BC14 Paragraph 8 requires entities to disclose financial assets and financial liabilities by the measurement categories in IFRS 9 *Financial Instruments*. The Board concluded that disclosures for each measurement category would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognised.

BC15 The Board also concluded that separate disclosure of the carrying amounts of financial assets and financial liabilities that are designated upon initial recognition as financial assets and financial liabilities at fair value through profit or loss and those mandatorily measured at fair value is useful because such designation is at the discretion of the entity.

Financial assets or financial liabilities at fair value through profit or loss (paragraphs 9–11, B4 and B5)

BC16 IFRS 9 permits entities to designate a non-derivative financial liability as at fair value through profit or loss, if specified conditions are met. If entities do so, they are required to provide the disclosures in paragraphs 10 and 11. The Board's reasons for these disclosures are set out in the Basis for Conclusions on IFRS 9, paragraphs BCZ5.29–BCZ5.34.

BCA24 The heading above paragraph BC23 is amended to read as follows and paragraph BC23B is added [amendment previously made by IFRS 9 2010]:

Reclassification (paragraphs 12B–12D)

BC23B In November 2009 the Board issued the requirements relating to the reclassification of financial assets in IFRS 9 *Financial Instruments* and revised accordingly the disclosure requirements relating to the reclassification of financial assets.

BCA25 Paragraphs BC33 and BC34 are amended to read as follows [amendment previously made by IFRS 9 2010]:

BC33 Paragraph 20(a) requires disclosure of income statement gains and losses by the measurement classifications in IFRS 9 (which

complement the balance sheet disclosure requirement described in paragraph BC14). The Board concluded that the disclosure is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in IFRS 9.

BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities measured at fair value through profit or loss and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities measured at fair value through profit or loss include interest and dividend income (see Appendix B, paragraph B5(e)).

BCA26 Paragraphs BC35A-BC35QQ and related headings are added as follows:

Other Disclosures—Hedge Accounting

BC35A The Board divided its project to replace IAS 39 into three phases. As the Board completed each phase, it deleted the relevant portions in IAS 39 and replaced it with chapters in IFRS 9. The third phase of the project to replace IAS 39 related to hedge accounting. As a consequence of the decisions the Board made when it replaced the hedge accounting guidance in IAS 39, the Board also considered changes to the disclosure requirements related to hedge accounting contained in IFRS 7.

BC35B During its deliberations, the Board engaged in outreach activities with users of financial statements. This outreach included soliciting views on presentation and disclosures. The Board used the responses received from those outreach activities to develop the proposed hedge accounting disclosures.

BC35C The Board was told that many users did not find the hedge accounting disclosures in financial statements helpful. Many also think that the hedge accounting disclosures that were originally in IFRS 7 did not provide transparency on an entity's hedging activities.

BC35D To provide relevant information that enhances the transparency on an entity's hedging activities, the Board proposes hedge accounting disclosures that meet particular objectives. Clear disclosure objectives allow an entity to apply its judgement when it provides information that is useful and relevant to users of financial statements.

BC35E The following sub-sections set out the Board's considerations regarding the proposed hedge accounting disclosures.

General considerations

Scope of the hedge accounting disclosures

BC35F An entity might enter into a transaction to manage an exposure to a particular risk that might not qualify for hedge accounting (for various reasons), for example, an item that is not eligible to be designated as a hedged item or hedging instrument. Information on such transactions might enable users to understand why an entity has entered into a transaction and how it manages the particular risk, even though those transactions do not qualify for hedge accounting.

BC35G However, the Board thought that mandating such disclosures would require it to determine the part of an entity's risk management that was relevant for the purpose of this disclosure and then define that part to make the disclosure requirement operational. The Board did not believe that this would be feasible as part of its hedge accounting project as it requires a much wider scope because the disclosures would not depend on the accounting treatment.

BC35H Furthermore, users of financial statements can often obtain information on an entity's hedging activities from information in management reports and sources outside the financial reporting context. That often gives a reasonable overview of why hedge accounting might be difficult to achieve. Consequently, the Board decided not to propose in its exposure draft *Hedge Accounting* disclosures about hedging when hedge accounting does not apply.

BC35I Most respondents to the exposure draft agreed with the Board's proposed scope for hedge accounting disclosures (ie to provide information about risk exposures that an entity hedges and for which hedge accounting is applied). However, some did raise concerns about the potential lack of information that will be available to users of financial statements about those risk exposures an entity hedges but for which hedge accounting is not applied.

BC35J The Board noted that IFRS 7 requires entities to provide qualitative and quantitative disclosure about the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period and how those risks are being managed. The Board believes that, as part of these disclosures, entities would provide information for users of financial statements to understand how it manages risk exposures for which hedge accounting is not applied.

BC35K Consequently, the Board decided to retain the scope of the hedge accounting disclosures as proposed in the exposure draft, that is, to provide information to users of financial statements on exposures that an entity hedges and for which hedge accounting is applied.

Location of disclosures

BC35L The Board decided that all hedge accounting disclosures should be presented in one location within an entity's financial statements. However, if such information is already presented elsewhere the Board decided that, in order to avoid duplication, an entity should be allowed to incorporate that information by cross-reference, which is similar to the approach used by IFRS 7 for some disclosures that can be incorporated by reference. The Board thinks that the information will be more transparent and easier to understand if it is presented in one location within the entity's financial statements.

Disclosures by risk category

BC35M The Board noted that recognition and measurement requirements allow for only a partial reflection of the economic hedging activities in the financial statements, which results in a limitation of an entity's reporting of its hedging activities. Hence, the Board considered that the transparency of an entity's hedging activities could be enhanced by an approach that considers:

- (a) information that provides a clear picture of those risk management activities of an entity that are captured by hedge accounting (this information is not necessarily provided in the primary financial statements); and
- (b) information that is included in the primary financial statements.

BC35N To provide information that is useful to users of financial statements, there should be a clear link between the hedge accounting information that is outside the primary financial statements and the hedge accounting within those. To provide such a link, the Board decided that an entity should provide hedge accounting disclosures by risk category. Consequently, an entity should disclose by risk category:

- (a) information that is not included in the primary financial statements (see paragraphs BC35P–BC35BB); and
- (b) information that is included in the primary financial statements (see paragraphs BC35CC–BC35QQ).

BC35O The Board decided not to prescribe the risk categories by which the disclosures need to be disaggregated. In the Board's view an entity should apply judgement and categorise risks on the basis of how it manages its risks through hedging. For example, an entity manages its floating interest rate risk using interest rate swaps (to change it to a fixed interest rate) for some hedging relationships (cash flow hedges), while it also uses cross-currency interest rate swaps to manage both the floating interest rate and foreign exchange risk of other hedging relationships (cash flow hedges). Consequently, the entity would have one risk category for floating interest rate risk and another risk

category for foreign exchange risk combined with floating interest rate risk. However, an entity should apply its risk categories consistently throughout all the proposed hedge accounting disclosures.

The risk management strategy

BC35P Users of financial statements need to understand how an entity's risk management strategy is applied. Understanding an entity's risk management strategy for each risk helps users to understand the accounting information disclosed.

BC35Q Consequently, in its exposure draft, the Board proposed that an entity should provide an explanation of its risk management strategy for each category of risk.

BC35R Most respondents to the exposure draft agreed with this proposal. However, some raised concerns that the exposure draft was not clear enough on how much detail should be provided by entities to comply with the disclosure requirement.

BC35S The Board noted that an entity will identify and ultimately describe their risk management strategies based on how it manages risk. Because entities manage risk in different ways, the Board did not think that users of financial statements would necessarily understand an entity's risk management strategy if it required a specific list of information to be disclosed. Instead, the Board decided to add additional guidance on the type of information that should be included in a risk management description.

The amount, timing and uncertainty of future cash flows

BC35T The Board decided that, in order to meet the objectives of hedge accounting disclosures, an entity would have to provide sufficient quantitative information to help users of financial statements understand how its risk management strategy for each particular risk affects the amount, timing and uncertainty of future cash flows. In this context, risk exposure refers only to risks that the entity has decided to hedge and for which hedge accounting is applied.

BC35U Consequently, in its exposure draft, the Board proposed that an entity should provide:

- (a) quantitative information on the risk exposure that the entity manages and the extent to which the entity hedges that exposure; and
- (b) a breakdown of that information for each future period that a hedging relationship (which exists at the reporting date) covers.

BC35V The Board also proposed that an entity should disclose information about the sources of hedge ineffectiveness of hedging relationships for each particular risk category. In the Board's view this would assist users in identifying the reasons for

hedge ineffectiveness that is recognised in profit or loss. It would also help users to determine how hedging relationships will affect profit or loss.

BC35W Most respondents disagreed with the Board's proposal to require entities to disclose information on the risk exposure and the hedged rate. They commented that this would result in the disclosure of commercially sensitive information (ie the risk exposure and the hedged rate). They believed that those who do not elect to apply hedge accounting would potentially have an unfair advantage because although they do not have to disclose anything, they could nonetheless gain insight into their competitor's hedge positions. Commercial sensitivity was also of concern to those entities whose competitors are not listed companies or who do not report under IFRSs.

BC35X The Board noted that the proposal in the exposure draft focused on the hedged risk (ie the hedged item). Consequently, it would result in disclosures about forward looking information and the rates at which future transactions are hedged. The Board acknowledged that this would potentially provide competitors with insight into an entity's costing structure. Consequently, the Board decided not to require information to be disclosed about the total risk exposure because of the potential forward looking nature of this information. The Board also decided to change the focus of the proposed disclosure from the hedged item to the hedging instrument. In other words, the disclosure would require information on some of the terms and conditions of the hedging instrument to be provided. The Board believes that that this information will still be relevant and useful for users of financial statements in inferring the exposure that an entity is exposed to and what the effects will be on future cash flows as a result of how the entity manages the particular risk.

BC35Y The Board also discussed situations in which an entity uses a 'dynamic' hedging process, ie a situation in which entities assess their overall exposure to a particular risk and then designate hedging relationships for constantly evolving exposures that require frequent discontinuations and restarts of hedging relationships. This is particularly the case for hedges of open portfolios. The Board noted that, because the general hedge accounting model allows hedge accounting for hedges of groups and net positions in relation to closed portfolios, entities need to use a 'dynamic' hedging process for an open portfolio. This means that entities designate hedging relationships for an open portfolio as if it were a closed portfolio for a short period and at the end of that period look at the open portfolio as the next closed portfolio for another short period. The dynamic nature of this process involves frequent discontinuations and restarts of hedging relationships.

BC35Z The Board considered that, in those circumstances, providing information about the terms and conditions of the hedging instruments would not be useful given that the hedging instruments are part of a particular hedging relationship for only

a short period at a time and are then designated into a new hedging relationship or left undesignated. In contrast, the disclosure requirement related to the terms and conditions of the hedging instrument was designed to provide information for situations in which an entity hedges a risk that remains broadly the same over the entire hedged period. Consequently, the Board decided to exempt entities from the requirement to disclose the terms and conditions of the hedging instruments in situations in which they use a 'dynamic' hedging process that involves frequent discontinuations and restarts of hedging relationships.

BC35AA The Board was of the view that it was more important for users to understand why entities use hedge accounting in the context of 'dynamic' hedging processes than to provide users with information about the terms and conditions of a hedging instrument that is part of a hedging relationship for only a short period at a time (and the designation of which changes frequently). Consequently, the Board decided that, in such circumstances, an entity should expand its discussion of the risk management strategy by providing the following information about how the entity uses hedge accounting to reflect its risk management strategy:

- (a) information about what the ultimate risk management strategy is (for the dynamic hedging process);
- (b) a description of how it reflects its risk management strategy by using hedge accounting and designating the particular hedging relationships; and
- (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic hedging process.

BC35BB The Board also noted that, because the designated hedging relationships change frequently, the specific relationships at the reporting date might not be representative of the normal volumes during the period. The Board therefore decided to require entities to disclose when the volumes at the reporting date are unrepresentative of normal volumes during the period (similar to the disclosure requirement on sensitivity analyses for market risk in paragraph 42).

The effects of hedge accounting on financial position and performance

BC35CC One function of hedge accounting is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures should therefore increase the transparency of how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the entity's statement of profit or loss and other comprehensive income and statement of financial position.

BC35DD To provide information on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the Board proposed disclosures that should be presented in a tabular format that separates the information by risk category and by type of hedge. Providing disclosures in a tabular format allows users to identify clearly the relevant numbers and their effects on the entity's statement of profit or loss and other comprehensive income and statement of financial position.

BC35EE During the Board's initial outreach, users said that they do not analyse an entity's hedging activities by type of hedging relationship (for example, a cash flow hedge or a fair value hedge). They said that it is more important to understand the risks that the entity manages and the results after hedging. However, to provide information effectively on the effects of hedge accounting on the statement of profit or loss and other comprehensive income and the statement of financial position, the information should reflect the accounting that was applied (for example, cash flow hedge accounting or fair value hedge accounting). The Board believed that if the proposed table is prepared by risk category and by type of hedge, the table would provide sufficient links between the accounting information and the risk management information.

BC35DD The Board did not propose prescribing levels of aggregation or disaggregation for the information that should be disclosed in a tabular format. An entity should apply judgement when it determines the appropriate level of aggregation or disaggregation. However, the Board proposed that an entity should consider other disclosure requirements in IFRS 7 when it considers the appropriate level of aggregation or disaggregation. For example, users should be able to take amounts that are disclosed and measured at fair value and make comparisons between the fair value disclosures and the proposed hedge accounting disclosures.

BC35EE Cash flow hedge accounting requires an entity to defer gains or losses on the hedging instrument in other comprehensive income. The deferred amounts are reflected in the statement of changes in equity in the cash flow hedge reserve. IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. In conformity with its objectives for hedge accounting disclosures, the Board proposed that the reconciliation required by IAS 1 should have the same level of detail as the information that identifies the effects of hedge accounting on the statement of profit or loss and other comprehensive income. The Board also proposed that the reconciliation should be by type of risk. The Board considered that such a disclosure would allow users of financial statements to evaluate the effects of hedge accounting on equity and the statement of profit or loss and other comprehensive income.

BC35FF Many respondents to the exposure draft agreed with the Board's proposal to explain the effects of hedge accounting disclosures using a tabular disclosure format. However, some respondents raised concerns that the proposal seems too prescriptive. Some also commented that they did not think that the tabular disclosure, as proposed, provided a clear enough link between hedged items and hedging instruments for the purpose of explaining hedge ineffectiveness. A few respondents also commented that the disclosures did not allow them to differentiate between financial instruments that have been designated as hedging instruments and those that have not. These respondents believe that it is helpful to understand the purpose and effect of financial instruments if their designation is made clear through disclosures.

BC35GG The Board thinks that providing a tabular disclosure format separated by type of hedge (ie fair value hedges or cash flow hedge), risk category and by risk management strategy provides a sufficient link between the accounting information and the risk management information.

BC35HH The Board did not propose any more specific format other than requiring information to be disclosed in a tabular format. The Board thought that entities should have the freedom to present the disclosures that require a tabular format however they feel is best in order to provide users with the most useful information.

BC35II While the exposure draft on hedge accounting was open for public comment, the Board issued IFRS 13 *Fair Value Measurement*. As a consequence of issuing that standard, the Board moved the fair value disclosures in IFRS 7 to IFRS 13. To improve the usefulness of the hedge accounting disclosures, the Board decided to require entities to use the same level of aggregation or disaggregation it used for other IFRS 7 or IFRS 13 disclosures related to the same underlying information.

BC35JJ In its redeliberations of the exposure draft, the Board also considered a disclosure that would allow understanding how the hedge ineffectiveness that is recognised in the statement of comprehensive income relates to the changes in the values of the hedging instruments and the hedged items. The Board decided to require disclosure of the change in fair value of the hedging instruments and the change in the value of the hedged items on the basis that is used to calculate the hedge ineffectiveness that is recognised in the statement of comprehensive income. Those are the changes in value during the period (after taking into account the effect of the 'lower of' test for cash flow hedges and hedges of a net investment in a foreign operation). This means that the difference between the amount included in the table for hedged items and the amount included in the table for hedging instruments equals the hedge ineffectiveness recognised in the statement of comprehensive income.

BC35KK The Board also did not think that it was necessary to provide a specific disclosure that indicates which financial instruments have been designated as hedging instruments and which have not. The Board thought that such a disclosure would provide potentially misleading information to users of financial statements. This is because users of financial statements might think that all financial instruments not designated as hedging instruments might be held for speculative purposes. This is not necessarily the case. Entities might hold financial instruments for hedging purposes but may decide not to elect hedge accounting. In addition to this, the Board thought that, because entities need to provide the information that requires a tabular format based on the same level of aggregation or disaggregation as in IFRS 13, users of financial statements should be able to identify the financial instruments not designated as hedging instruments by simply comparing the disclosures with each other. In addition, users should be able to understand how an entity manages the risks it is exposed to as a result of financial instruments using the disclosure requirements in IFRS 7 that are not related to the hedge accounting disclosures.

Time value of options accumulated through other comprehensive income

BC35LL The Board proposed accounting requirements that involve other comprehensive income for the time value of an option when an entity elects to separate the time value of the option and designate (as the hedging instrument) only its intrinsic value. Consequently, the Board also considered disclosures regarding the amounts that would be recognised in other comprehensive income under these proposals.

BC35MM The Board noted that IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. Consequently, as a result of IAS 1, an entity would disclose the amounts in relation to the time value of options that would be accumulated in other comprehensive income and the movements in that balance.

BC35NN However, in its exposure draft, the Board proposed that an entity should differentiate between transaction related hedged items and time-period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.

BC35OO Most respondents agreed with the Board's proposal and consequently, the Board decided to retain the proposal from its exposure draft. However, as a consequence of the Board's decision to also allow an alternative accounting treatment for forward elements, the Board also required that amounts recognised in accumulated other comprehensive income that

relate to forward elements should be separated for the purpose of the IAS 1 reconciliation.

Hedging credit risk using credit derivatives

BC35PP For situations in which entities hedge credit risk using credit derivatives the Board decided to mitigate accounting mismatches in relation to credit derivatives accounted for at fair value through profit or loss by also using fair value through profit or loss accounting for the hedged credit exposure. Consequently, the Board also considered disclosures to provide transparency when entities apply that accounting.

BC35QQ The Board considered that the following information would be useful for understanding the accounting in such situations:

- (a) a reconciliation of amounts at the beginning and end of the period for the nominal amount and for the fair value of the credit derivatives;
- (b) the gain or loss recognised in profit or loss as a result of changing the accounting for a credit exposure to fair value through profit or loss; and
- (c) when an entity discontinues fair value through profit or loss accounting for credit exposures, the fair value that becomes the new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

BCA27 Paragraphs BC39 and BC39B–BC39E are amended to read as follows [amendment previously made by IFRS 9 2010]:

BC39 Paragraph 28 requires disclosure about the difference that arises if the transaction price differs from the fair value of a financial instrument that is determined in accordance with paragraph B5.4.8 of IFRS 9. Those disclosures relate to matters addressed in the December 2004 amendment to IAS 39 *Transition and Initial Recognition of Financial Assets and Financial Liabilities*. That amendment does not specify how entities should account for those initial differences in subsequent periods. The disclosures required by paragraph 28 inform users about the amount of gain or loss that will be recognised in profit or loss in future periods. The Board noted that the information required to provide these disclosures would be readily available to the entities affected.

BC39B Because its own fair value measurement project was not yet completed, the Board decided not to propose a fair value hierarchy for measurement but only for disclosures. The fair value hierarchy for disclosures is the same as that in SFAS 157 but uses IFRS language pending completion of the fair value measurement project. Although the implicit fair value hierarchy for measurement in IFRS 9 is different from the fair value hierarchy in SFAS 157, the Board recognised the importance of

using a three-level hierarchy for disclosures that is the same as that in SFAS 157.

BC39C The Board noted the following three-level measurement hierarchy implicit in IFRS 9:

- (a) ...
- (b) ...
- (c) ...

BC39D For example, the Board acknowledged that some financial instruments that, for measurement purposes, are considered to have an active market in accordance with paragraphs B5.4.3–B5.4.5 of IFRS 9 might be in Level 2 for disclosure purposes. Also, the application of paragraph B5.4.9 of IFRS 9 might result in no gain or loss being recognised on the initial recognition of a financial instrument that is in Level 2 for disclosure purposes.

BC39E The introduction of the fair value disclosure hierarchy does not affect any measurement or recognition requirements of other standards. In particular, the Board noted that the recognition of gains or losses at inception of a financial instrument (as required by paragraph B5.4.8 of IFRS 9) would not change as a result of the fair value disclosure hierarchy.

BCA28 Paragraph BC73(b) is amended to read as follows [amendment previously made by IFRS 9 2010]:

BC73 The main changes to the proposals in ED 7 are:

- (a) ...
- (b) a requirement has been added for disclosures about the difference between the transaction price at initial recognition (used as fair value in accordance with paragraph B5.4.8 of IFRS 9) and the results of a valuation technique that will be used for subsequent measurement.
- (c) ...

BCA29 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17 and the reference to 'IAS 39' in paragraph BC23A are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.

IAS 1 *Presentation of Financial Statements*

BCA30 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC38A, to the reference to 'IAS 39' in paragraph BC38B are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial*

Instruments. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued.

- BCA31 The references to 'available-for-sale' in paragraphs BC49 and BC69 are deleted.
- BCA32 The term 'available-for-sale financial assets' in paragraphs BC49 and BC69 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.
- BCA33 The term 'held-to-maturity investments' in paragraph BC77 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-to-maturity financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

IAS 17 Leases

- BCA34 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC21 is replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 17 was issued.

IAS 19 Employee Benefits

- BCA35 The rubric below the title is amended to read as follows:
- The original text has been marked up to reflect the revision of IAS 39 Financial Instruments: Recognition and Measurement in 2003 and the issue of IFRS 2 Share-based Payment in 2004, Improvements to IFRSs in May 2008 and IFRS 9 Financial Instruments in October 2010; new text is underlined and deleted text is struck through. The terminology ...*
- BCA36 Paragraph BC68D(b) is amended and footnoted to read as follows [the reference to the footnote is not shown here]:
- BC68D Supporters of ...
- (b) if offsetting is allowed when condition (c) is not met, this would seem to be equivalent to permitting a net presentation for 'in-substance defeasance' and other analogous cases where IAS 32 indicates explicitly that offsetting is inappropriate. The Board has rejected 'in-substance defeasance' for financial instruments (see ~~IAS 39 Application Guidance paragraph AG59~~ IFRS 9 paragraph AG3.3.3)* and there is no obvious reason to permit it in accounting for defined benefit plans. In these cases the entity retains an obligation that should be recognised as a liability and

the entity's right to reimbursement from the plan is a source of economic benefits that should be recognised as an asset. Offsetting would be permitted if the conditions in paragraph 3342 of IAS 32 are satisfied;

...

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA37 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC75A and to the references to 'IAS 39' in paragraphs BC68H is replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

BCA38 The footnotes to the reference to 'IAS 39' in paragraph BC68I is deleted.

BCA39 The footnote to the reference to 'available-for-sale financial assets' in paragraph BC48W is replaced with:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 19 was issued.

BCA40 The footnote to the references to 'IAS 25 *Accounting for Investments*' in paragraphs BC69 and BC73 is replaced with:

* superseded by IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

BCA41 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the first reference to 'IAS 39' in paragraph BC3 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 20 was amended in 2008.

IAS 27 Consolidated and Separate Financial Statements

BCA42 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and to the references to 'IAS 39' in paragraphs BC65–BC66C are deleted.

- BCA43 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the first references to 'IAS 39' in paragraphs BC65–BC66C are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA44 The first references to the term 'available-for-sale' in paragraphs BC54, BC56 and BC65 are footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009, and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA45 In the dissenting opinions on the amendments to IFRS 1 and IAS 27 issued in May 2008 the footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph DO3 is replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 28 *Investments in Associates*

- BCA46 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC9 is deleted.
- BCA47 The footnotes to the reference to 'IAS 39' in the heading above paragraph BC7 and to the first references to 'IAS 39' in paragraphs BC22 and BC26 are replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA48 The first reference to 'IAS 39' in paragraph BC9 is footnoted as follows:
- † In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. IFRS 9 eliminated the category of available-for-sale financial assets and permits entities to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading.
- BCA49 The term 'available-for-sale equity instrument' in paragraph BC26 is footnoted as follows:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IAS 31 Investments in Joint Ventures

- BCA50 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC7 and to the references to 'IAS 39' in paragraphs BC9 and BC17 are deleted.
- BCA51 The heading above paragraph BC7 and the first references to 'IAS 39' in paragraphs BC9 and BC17 are footnoted as follows:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 32 Financial Instruments: Presentation

- BCA52 In the introduction, paragraph IN5A is added as follows:
- IN5A In [Date] 2012 the scope of IAS 32 was conformed to the scope of IAS 39 as amended in [Date] 2012 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).
- BCA53 After paragraph BC3A a heading and paragraph BC3B are added as follows:

Scope

- BC3B In [Date] 2012 the Board amended the scope of IAS 32 so that it conformed to the scope of IAS 39 as amended in [Date] 2012 regarding the accounting for some executory contracts (which was changed as a result of replacing the hedge accounting requirements in IAS 39).
- BCA54 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and to the first references to 'IAS 39' in paragraph BC26 replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.
- BCA55 The footnote to the first reference to 'IAS 39' in paragraph BC25 is replaced with:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. The requirements of paragraph 43 of IAS 39 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9.
- BCA56 In the dissenting opinion on the issue of IAS 32 in December 2003, the reference to 'IAS 39' in paragraph DO2 is footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 36 Impairment of Assets

BCA57 The footnote to the reference to 'IAS 39' in paragraph BCZ15(d) is replaced with:

* The IASB's project to revise IAS 32 and IAS 39 in 2003 resulted in the relocation of the requirements on fair value measurement from IAS 32 to IAS 39. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 39 Financial Instruments: Recognition and Measurement

BCA58 The following paragraphs are added to the rubric:

In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of financial assets within the scope of IAS 39 and relocated them to IFRS 9 Financial Instruments. Accordingly, the following were deleted: paragraphs BC13 and BC14, the heading above paragraph BC25 and paragraphs BC25–BC29, paragraph BC70, the heading above paragraph BC104A and paragraphs BC104A–BC104E, the headings above paragraphs BC125, BC127 and BC129 and paragraphs BC125–BC130, the heading above paragraph BC221 and that paragraph and the heading above paragraph BC222 and that paragraph.

In October 2010 the Board relocated to IFRS 9 the requirements of IAS 39 relating to classification and measurement of financial liabilities and derecognition of financial assets and financial liabilities. The Board did not reconsider most of those requirements. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC37–BC79A and BC85–BC104.

BCA59 In the introduction, paragraph IN7A is added as follows:

IN7A In the third phase of its project to replace IAS 39, the Board considered replacing the hedge accounting requirements in IAS 39. As part of those deliberations, the Board considered the accounting for executory contracts that gives rise to accounting mismatches in some situations. In [October] 2012 the scope of this IFRS was amended by extending the fair value option (for situations in which it eliminates or significantly reduces an accounting mismatch) to contracts that meet the 'own use' scope exception.

BCA60 Paragraphs BC11C, BC11E, BC11F, BC13 and BC14, BC25–BC29, BC37–BC104E, BC105–BC107, BC125–BC130, BC221 and BC222 and the headings above BC25, BC37, BC104A, BC105 ('Impairment of investments in equity instruments (paragraph 61)' only), BC221 and BC222 are deleted.

BCA61 Paragraph BC20A is amended to read as follows:

BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on

loan commitments from the scope section to the section on subsequent measurement. The purpose of this change was to rationalise the presentation of this material without making substantive changes.

- BCA62 The headings above paragraphs BC15, BC21 and BC24 are amended to read as follows:

Loan commitments

Financial guarantee contracts

Contracts to buy or sell a non-financial item

- BCA63 Paragraphs BC24A–BC24E are renumbered as paragraphs BC24R–BC24V. After paragraph BC24 a heading and paragraphs BC24A–BC24Q are added as follows:

Accounting for a contract to buy or sell a non-financial item as a derivative

BC24A In the third phase of its project to replace IAS 39, the Board considered replacing the hedge accounting requirements in IAS 39. As part of those deliberations, the Board considered the accounting for executory contracts that gives rise to accounting mismatches in some situations. The Board's decision is discussed in more detail below.

BC24B Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell a non-financial item that can be settled net in cash (including net settlement in another financial instrument or by exchanging financial instruments), as if the contracts were financial instruments. In addition, IAS 39 specifies that there are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. For example, a contract is considered to be settleable net in cash even if it is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash.

BC24C However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39. The 'own use' scope exception in IAS 39 mostly applies to contracts for commodity purchases or sales.

BC24D It is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative. Many commodity contracts meet the criteria for net settlement in cash because in many instances commodities are readily convertible to cash. When such a contract is accounted for as a derivative, it is measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the change in the fair value of the commodity contract,

that derivative is also measured at fair value with changes in fair value recognised in profit or loss. Because the changes in the fair value of the commodity contract and the derivative are recognised in profit or loss, an entity does not need hedge accounting.

BC24E However, in situations in which a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sale or purchase contract ('executory contract'). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value arising from a commodity supply contract that is not within the scope of IAS 39, an accounting mismatch is created. This is because the change in the fair value of the derivative is recognised in profit or loss while the change in the fair value of the commodity supply contract is not recognised (unless the contract is onerous).

BC24F To eliminate this accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as a hedged item in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the fair value changes would offset the changes in the fair value of the derivative instruments (to the extent that those are effective hedges). However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts and some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. That net position as a whole is then managed using derivatives to achieve a net position (after hedging) of nil (or close to nil). The net position is typically monitored, managed and adjusted daily. Because of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil by using derivatives, an entity would have to adjust the fair value hedge relationships frequently if the entity were to apply hedge accounting.

BC24G The Board noted that in such situations hedge accounting would not be an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Consequently, the Board considered amending the scope of IAS 39 so that it would allow a commodity contract to be accounted for as a derivative in such situations. The Board considered two alternatives for amending the scope of IAS 39:

- (a) allowing an entity to elect to account for commodity contracts as derivatives (ie a free choice); or

- (b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair-value based risk management strategy.

BC24H The Board noted that giving an entity the choice to account for commodity contracts as derivatives would be tantamount to an elective 'own use' scope exception, which would have outcomes that would be similar to the accounting treatment in US generally accepted accounting principles (GAAP). This approach would, in effect, allow an entity to elect the 'own use' scope exception instead of derivative accounting at inception or a later date. Once the entity had elected to apply the scope exception it would not be able change its election and switch to derivative accounting.

BC24I However, the Board noted that such an approach would not be consistent with the approach in IAS 39 because:

- (a) the accounting treatment in accordance with IAS 39 is dependent on, and reflects, the purpose (ie whether it is for 'own use') for which the contracts to buy or sell non-financial items are entered into and continue to be held for. This is different from a free choice, which would allow, but not require, the accounting treatment to reflect the purpose of the contract.
- (b) in accordance with IAS 39, if similar contracts have been settled net, a contract to buy or sell non-financial items that can be settled net in cash must be accounted for as a derivative. Hence, a free choice would allow an entity to account for a commodity contract as a derivative regardless of whether similar contracts have been settled net in cash.

Consequently, in its exposure draft, the Board decided not to propose that entities can elect to account for commodity contracts as derivatives.

BC24J Alternatively, the Board considered applying derivative accounting to commodity contracts if that is in accordance with the entity's underlying business model and how the contracts are managed. Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would consider not only the purpose (based solely on the actual type of settlement) but also how the contracts are managed. As a result, if an entity's underlying business model changes and the entity no longer manages its commodity contracts on a fair value basis, the contracts would revert to the 'own use' scope exception. This would be consistent with the criteria for using the fair value option for financial instruments (ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis).

BC24K Consequently, the Board proposed that derivative accounting would apply to contracts that would otherwise meet the 'own use' scope exception if that is in accordance with the entity's fair-value based risk management strategy. The Board believed that

this approach would faithfully represent the financial position and the performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.

- BC24L Most respondents to the exposure draft supported the Board's approach of using fair value accounting for resolving the accounting mismatch that arises when a commodity contract that is outside the scope of IAS 39 is hedged with a derivative. Those who supported the proposal thought that it would facilitate a better presentation of the overall economic effects of entering into such hedging transactions.
- BC24M However, some respondents were concerned that the proposal would have unintended consequences by creating an accounting mismatch for some entities. They argued that in scenarios in which there are other items that are managed within a fair-value based risk management strategy and those other items are not measured at fair value under IFRSs, applying derivative accounting to 'own use' contracts would introduce (instead of eliminate) an accounting mismatch. For example, in the electricity industry the risk management for some power plants and the related electricity sales is on a fair value basis. If these entities had to apply derivative accounting for customer sales contracts it would create an accounting mismatch. This accounting mismatch would result in artificial profit or loss volatility if the power plant is measured at cost under IAS 16 *Property, Plant and Equipment*. Another example raised by respondents was that of entities risk-managing the 'own-use' contracts, inventory and derivatives on a fair value basis. An accounting mismatch would arise if the inventory is measured in accordance with IAS 2 *Inventories* at the lower of cost and net realisable value while the 'own use' contracts are measured at fair value.
- BC24N Some respondents also requested that the Board remove the precondition that an entity achieves a nil or close to nil net risk position in order to qualify for accounting for executory contracts as derivatives. They argued that if the condition was not removed it would limit the benefits of the proposal. This is because some entities, while generally seeking to maintain a net risk position close to nil, may sometimes take an open position depending on market conditions. These respondents noted that, from an entity's perspective, whether it takes a position or manages its exposure close to nil, it is still employing a fair-value based risk management strategy and that the financial statements should reflect the nature of its risk management activities.
- BC24O Some also requested that the Board clarify whether the proposal required that a fair-value based risk management strategy is adopted at an entity level or whether the business model can be assessed at a level lower than the entity level. These respondents commented that within an entity, a part of the

business may be risk-managed on a fair value basis while other businesses within the entity may be managed differently.

BC24P In the light of the arguments raised by respondents to the exposure draft, the Board discussed whether an alternative would be extending the fair value option in IFRS 9 (for situations in which it eliminates or significantly reduces an accounting mismatch) to contracts that meet the 'own use' scope exception. The Board noted that because the fair value option would be an election by the entity, it would address the concerns raised about creating unintended accounting mismatches (see paragraph BC24M) while still providing an efficient solution to the problem that the Board wanted to address through its exposure draft.

BC24Q The Board considered that the disadvantage of providing an election (ie different accounting outcomes as the result of the entity's choice) by extending the fair value option in IFRS 9 was outweighed by the benefits of this alternative because:

- (a) it is consistent with the Board's objective to represent more faithfully the financial position and performance of entities that risk-manage an entire business on a fair value basis;
- (b) it provides operational relief for entities that risk-manage an entire business on a dynamic fair value basis (ie it is less onerous than applying hedge accounting); and
- (c) it does not have the unintended consequences of creating an accounting mismatch in some situations.

BCA64 The footnotes to the references to 'IAS 39' in paragraphs BC185(d), BC186 and BC189(a) are deleted. The following footnotes are amended to read as follows and added:

To the reference to 'IAS 39' in paragraph BC12 In November 2009 the Board amended the requirements of IAS 39 relating to the classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

To the heading above paragraph BC15 In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

At the end of paragraph IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of

BC16	loans and receivables.
To the heading above paragraphs BC21, BC24, BC40B, BC41 and BC70A	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the reference to 'held-to-maturity' in paragraph BC80A	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
To the reference to 'loans and receivables' in paragraph BC111	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.
At the end of paragraph BC185(d) and to the references to 'required to be paid' in paragraphs BC186 and BC189(a)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the reference to 'held-to-maturity' in paragraph BC201(f)	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
At the end of paragraph BC203(b)	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
BCA65	The dissenting opinions from the issue of IAS 39 in December 2003, <i>The Fair Value Option</i> in June 2005 and <i>Reclassification of Financial Assets</i> in October 2008 are deleted.

IAS 40 Investment Property

BCA66	The footnotes to the reference to 'IAS 39 <i>Financial Instruments: Recognition and Measurement</i> ' in paragraph BC8 is replaced with: * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 <i>Financial</i>
-------	---

Instruments. IFRS 9 applies to all items within the scope of IAS 39. Paragraph BC8 refers to matters relevant when IAS 40 was issued.

- BCA67 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B2 and the references to 'IAS 39' in paragraphs B46(b), B54 and B63(d) are footnoted as follows:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.
- BCA68 The reference to 'IAS 39' in paragraph B35 is replaced with:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the held-to-maturity category. This paragraph discusses matters relevant when IAS 40 was issued.
- BCA69 The footnote to the reference to 'IAS 39' in paragraph B63(a) is replaced with:
- * IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.
- BCA70 In paragraph B67(a)(i) the footnote to 'IAS 39' is amended to read as follows:
- * Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. In 2009 paragraph 46 of IAS 39 was deleted by IFRS 9 *Financial Instruments*.

IAS 41 Agriculture

- BCA71 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B48 and to the reference to 'IAS 39' in paragraph B54 are replaced with:
- * In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

- BCA72 In paragraph BC18 the reference to 'IAS 39' is footnoted as follows:
- * In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. Paragraph 49 of IAS 39 was relocated to paragraph 5.4.3 of IFRS 9. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

IFRIC 4 Determining whether an Arrangement contains a Lease

- BCA73 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC14 is replaced with:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

BCA74 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC6 and to the references to 'IAS 39' in paragraphs BC20 and BC24 are replaced with:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA75 The footnotes to the references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraphs BC11(a) and BC12 are deleted.

BCA76 The first reference to 'IAS 39' in paragraphs BC8(c) BC27 and the heading above paragraph BC11 are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The term 'available-for-sale financial asset' in paragraph BC11 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the categories of available-for-sale and held-to-maturity financial assets.

IFRIC 10 Interim Financial Reporting and Impairment

BCA77 The footnotes to the references to 'IAS 39' in paragraphs BC2 and BC9 are replaced with:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 12 Service Concession Arrangements

BCA78 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC43(a) is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA79 The footnotes to the reference to 'IAS 39' in paragraph BC59 and to the heading above paragraph BC60 are replaced with:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 16 Hedges of a Net Investment in a foreign Operation

BCA80 The reference to IAS 39 in paragraph BC11 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in [insert date 2012], replaced the hedge accounting requirements in IAS 39. However, the requirements regarding hedges of a net investment in a foreign operation were retained from IAS 39 and relocated to IFRS 9.

IFRIC 17 Distributions of Noncash Assets to Owners

BCA81 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22, to the last sentence of paragraph BC28(a), to the reference to 'AG81' in paragraph BC29, to the reference to 'IAS 39' in paragraph BC32 and to the reference to 'available-for-sale' in paragraph BC47(e) are deleted.

BCA82 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the references to 'IAS 39' in paragraphs BC37 and BC50 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA83 The reference to 'IAS 39' in paragraph BC28(a) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, requires all investments in equity instruments to be measured at fair value.

BCA84 The reference to 'AG81' in paragraph BC29 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, amended paragraphs AG80 and AG81 of IAS 39 so that they apply only to derivatives on unquoted equity instruments. IFRS 9, issued in October 2010, deleted paragraphs AG80 and AG81 of IAS 39.

BCA85 The reference to 'IAS 39' in paragraph BC32 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the requirement in IAS 39 for some assets to be measured using a historical cost basis.

BCA86 The term 'available-for-sale investment' in paragraph BC47(e) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA87 The reference to 'IAS 39' in paragraph BC47(f) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in [insert date 2012] replaced the hedge accounting requirements in IAS 39.

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

BCA88 The references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the references to 'IAS 39' in paragraphs BC10, BC20, BC24, BC31 and BC34(c) are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

SIC Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

BCA89 The rubric '*[The original text ... struck through]*' is deleted and replaced with the following rubric:

[In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments. To avoid confusion with earlier amendments marked up on the original text to reflect the revision of IAS 39 in 2003 and the subsequent issue of IFRS 4, paragraphs 14 and 15 have been amended for consistency with IFRS 9 as issued in 2010.]

BCA90 Paragraph 14 is amended to read as follows:

- 14 When an Entity ... A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs 3.2.1–3.2.23, 3.3.1–3.3.4, B3.2.1–B3.2.17 and B3.3.1–B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an 'underlying') are subject to IAS 39.*

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.