November 2013

Project Summary

IFRS 9 *Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)

IFRS®

At a glance

This is a brief introduction to the amendments to IFRS 9 *Financial Instruments* added in November 2013. It provides an overview of the main additions and changes and explains why they were made.

IFRS 9 is replacing IAS 39 *Financial Instruments: Recognition and Measurement* in phases. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements.

What do these changes include?

These amendments make three important changes to IFRS 9.

Firstly, a new chapter on hedge accounting has been added to IFRS 9. This represents a major overhaul of hedge accounting and puts in place a new model that introduces significant improvements principally by aligning the accounting more closely with risk management. There are also improvements to the disclosures about hedge accounting and risk management.

The second amendment makes the improvements to the reporting of changes in the fair value of an entity's own debt contained in IFRS 9 more readily available.

The third change is the removal of the mandatory effective date of IFRS 9.

What remains to be completed?

This document finalises the hedge accounting phase of the IFRS 9 project. The IASB is continuing to consider limited amendments to the classification and measurement requirements already included in IFRS 9 and is working on finalising the new expected credit loss impairment model.

The IASB has a separate active project on accounting for macro hedging.

First amendment

An overview of hedge accounting

What is the objective of hedge accounting?

The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities when they use financial instruments to manage exposures arising from particular risks and those risks could affect profit or loss (P&L).

Until now the hedge accounting requirements were contained in IAS 39.

Why use hedge accounting?

An entity uses hedging to manage its exposure to risks, for example, foreign exchange risk, interest rate risk or the price of a commodity. Many choose to apply hedge accounting to show the effect of managing those risks in the financial statements.

Why change the hedge accounting requirements?

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

Hedging risks and components of items has become common business practice. Investors have said that they want to be able to understand the risks that an entity faces, what management is doing to manage those risks and how effective those risk management strategies are.

Many investors believe that the IAS 39 hedge accounting requirements fall short in providing this information. As a result, investors often use non-audited (pro-forma) information to understand risk management. Investors, and others, also believe that the requirements in IAS 39 are arbitrary and too rule-based, and they argue for a closer alignment with risk management.

Reflecting risk management appropriately

Many believe that IAS 39 does not allow entities to adequately reflect their risk management practices. For example, there are instances in which hedge accounting cannot be applied to groups of items, whereas for risk management purposes items are often hedged on a group basis. In addition, IAS 39 does not allow hedge accounting to be applied to components of non-financial items, but when entities hedge such items they usually only hedge components (parts) of them.

This meant that the greatest challenges were faced by those hedging non-financial risks, therefore entities hedging these risks (such as non-financial institutions) are expected to benefit most from the new hedge accounting model.

Insufficient disclosures

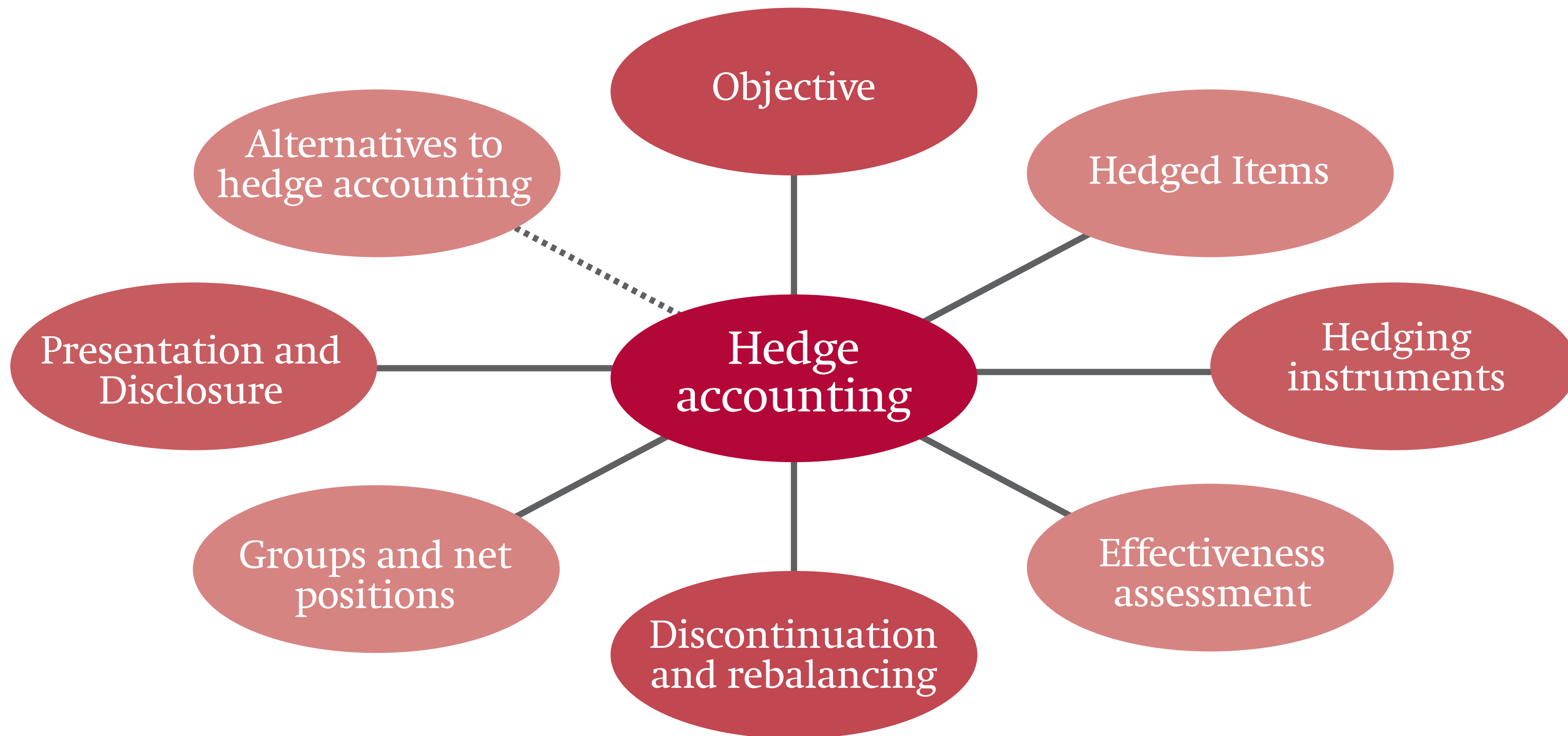
Others believed that the disclosure requirements in IFRS did not provide sufficient information in the financial statements about an entity's risk management activities.

What preceded this document?

Before publishing these new requirements the IASB published a number of documents on which comments were received. Most recently those included the Exposure Draft *Hedge Accounting*, published in December 2010, and a draft of the final hedge accounting requirements that was posted on the IASB's website for a 90-day period in 2012. Comments received on these documents have been considered in finalising the new hedge accounting model.

The proposals were generally well received and most of the changes from the Exposure Draft reflect the clarification of concepts and words.

Fundamental review of hedge accounting
Aspects reconsidered



What does the new hedge accounting model achieve?

The new hedge accounting model enables companies to better reflect their risk management activities in the financial statements. This will help investors to understand the effect of hedging activities on the financial statements and on future cash flows.

Closer alignment with risk management

The new model more closely aligns hedge accounting with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures. It will enable more entities, particularly non-financial institutions, to apply hedge accounting to reflect their actual risk management activities. This will assist users of financial statements to understand entities' risk management activities.

An example of this is the treatment of risk components. Largely as a reflection of less advanced risk management practices when the IAS 39 hedge accounting model was developed, IAS 39 allowed components of financial items to be hedged, but not components of non-financial items.[1]

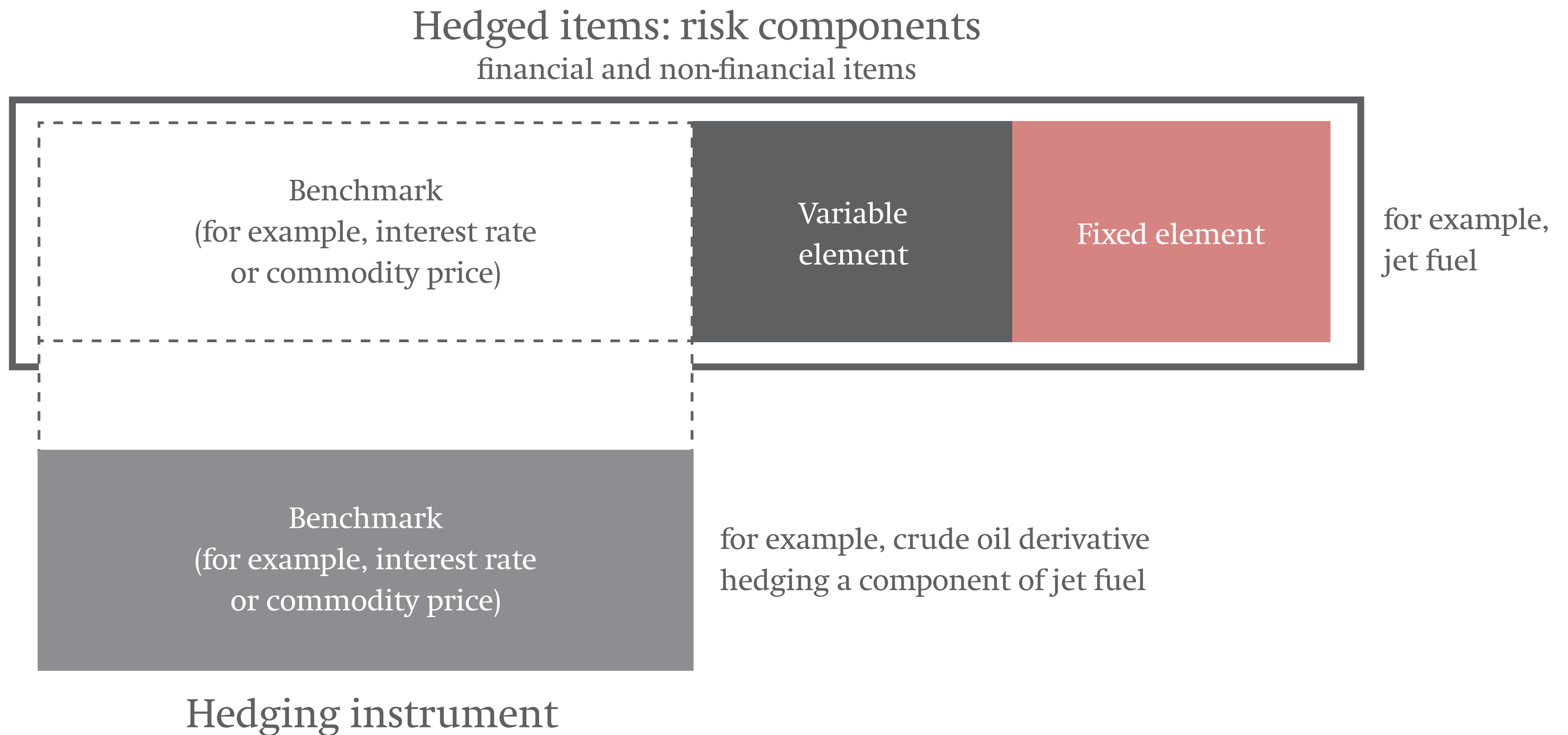
An example of a risk component in a financial item is the LIBOR risk component of a bond. However, risk managers often hedge a risk component for non-financial items as well; for instance, the oil price component of jet fuel price exposure. This is an important issue for many companies.

IFRS 9 eliminates this distinction. As a principle-based approach, IFRS 9 looks at whether a risk component can be identified and measured and does not distinguish between types of items. This will enable more entities to apply hedge accounting that reflects their risk management activities.

The new model also enables an entity to use information produced internally for risk management purposes as a basis for hedge accounting. Today it is necessary to exhibit eligibility and compliance with the requirements in IAS 39 using metrics that are designed solely for accounting purposes. The new model also includes eligibility criteria but these are based on an economic assessment of the strength of the hedging relationship. This can be determined using risk management data. This should reduce the costs of implementation compared with those for IAS 39 hedge accounting because it reduces the amount of analysis that is required to be undertaken only for accounting purposes.

1 Except foreign currency risk.

How components of items are hedged



Improved information about risk management activities

When an entity enters into derivatives for hedging purposes but hedge accounting cannot be applied, the derivatives are accounted for as if they were trading instruments. This gives rise to volatility in P&L that is inconsistent with the economic situation. This means that the hedging relationship is not apparent to users of financial statements and an entity that has reduced its risk by entering into derivatives for hedging purposes may paradoxically appear more risky. Enabling hedge accounting to better reflect risk management improves the information provided to users of financial statements.

In addition, improved disclosures are provided with the new hedge accounting model. These disclosures explain both the effect that hedge accounting has had on the financial statements and an entity's risk management strategy, as well as providing details about derivatives that have been entered into and their effect on the entity's future cash flows.

Today, information about hedge accounting is provided by the type of hedge, and those types are established by accounting standards (such as cash flow and fair value hedges). Users of financial statements have told us this is confusing as these distinctions use terms only used for accounting purposes. To make this information more accessible, information about all hedges is now required to be provided in a single location in the notes to the financial statements.

Accounting for macro hedging

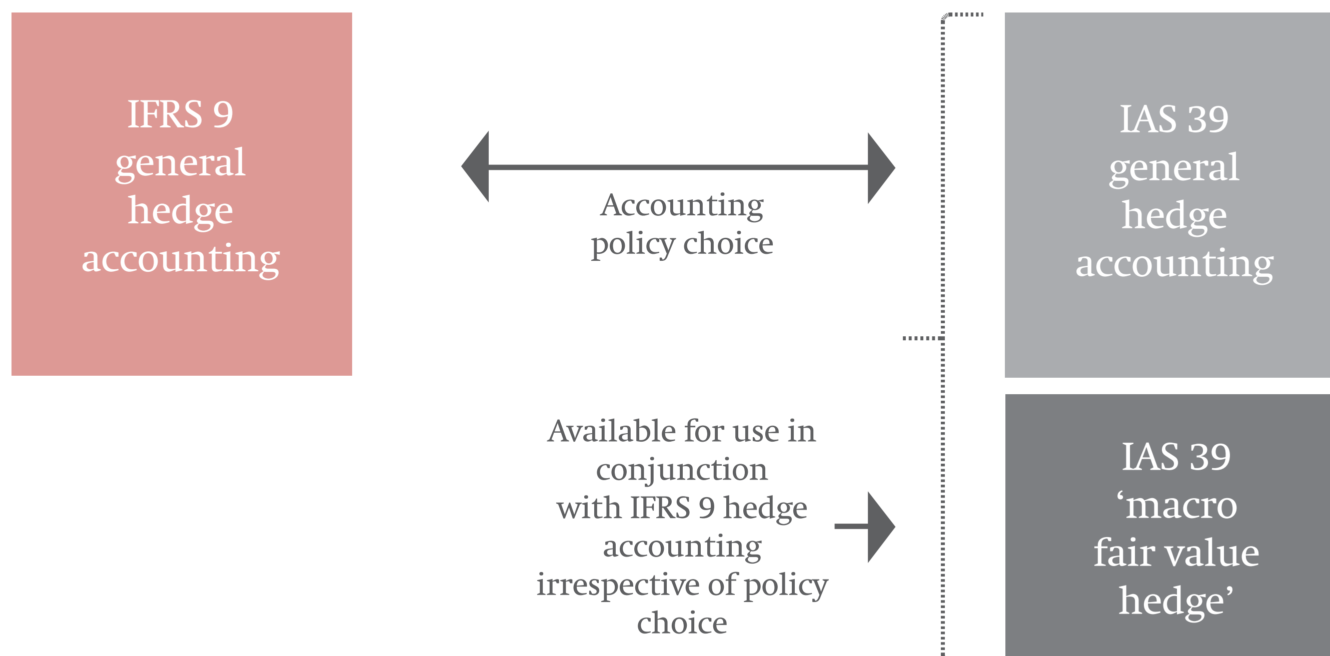
The IASB currently has a separate, active project on accounting for macro hedging activities (the 'macro project'). In this project, the IASB is exploring a new way to account for dynamic risk management of open portfolios ('macro hedging activities'). This project is still at an early stage of development with a Discussion Paper currently planned for early 2014.

Currently, entities undertaking such risk management and using hedge accounting use a combination of IAS 39's general hedge accounting requirements and the specific model in IAS 39 for accounting for macro hedging. That model only applies to fair value hedges of interest rate risk. IFRS 9 was designed so that entities would not be adversely affected while the new macro project is ongoing. Therefore, an entity undertaking macro hedging activities can apply the new accounting model in IFRS 9 while continuing to apply the specific IAS 39 accounting for macro hedges if they wish to do so.

In response to the draft final hedge accounting requirements posted on the IASB's website, some requested that they be allowed to continue to apply IAS 39 for all of their hedge accounting.

Although the IASB noted that entities would not be disadvantaged by the change to IFRS 9 and that the change was not expected to be unduly burdensome, it acknowledged that some may prefer to move directly from using IAS 39 to the potential new model for accounting for macro hedging.

For this reason the IASB decided that until the macro project is completed entities will be allowed to choose to continue to apply IAS 39 for all their hedge accounting.



Second amendment

Own credit

IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of an entity's own debt when the entity has chosen to measure that debt at fair value under the fair value option. The fair value of an entity's own debt is affected by changes in the entity's own credit risk. This means, somewhat counterintuitively, that when an entity's credit quality declines the value of its liabilities fall, and if those liabilities are measured at fair value a gain is booked in P&L. To address this issue, IFRS 9 requires changes in the fair value of an entity's own debt caused by changes in its own credit quality to be recognised in other comprehensive income rather than in P&L.

This change was included in IFRS 9 in 2010. However, in order to apply this change entities were required to apply all of the requirements in IFRS 9 that relate to the classification and measurement of financial instruments. This included changing how financial assets are classified.

In the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* the IASB proposed making this change more readily available by allowing an entity to change the treatment of the effects of changes in its own credit in isolation ie before applying any of the other classification and measurement requirements in IFRS 9. Respondents expressed strong support for allowing the changes to address own credit to be available separately. The amendments made to IFRS 9 in November 2013 allow this.

So in effect, IFRS now allows an entity to continue to measure its financial instruments in accordance with IAS 39 but to benefit from the improved accounting for own credit in IFRS 9.

The IASB decided to include this change in these amendments prior to completion of the classification and measurement phase of IFRS 9 so that it was available as soon as possible.

More information about the own credit requirements can be found in the Feedback Statement *Financial Liabilities* which is available on www.ifrs.org.

Third amendment

Mandatory effective date of IFRS 9

The date when entities would be required to apply IFRS 9 was 1 January 2015, with earlier application permitted. On the mandatory effective date, an entity would be required to apply the new requirements in IFRS 9 for classification and measurement, impairment and hedge accounting.[1] This means that entities would need to make systems changes to apply an expected credit loss impairment model in time for the mandatory effective date, which, at least for some, would be an extensive undertaking.

In response to the recent Exposure Draft *Expected Credit Losses* many requested that the IASB defer the mandatory effective date of IFRS 9.

Because the impairment phase of the IFRS 9 project is not yet completed, the IASB decided that a mandatory effective date of 1 January 2015 would not allow sufficient time for entities to prepare to apply IFRS 9. Accordingly, the IASB decided that it would be necessary to have a later mandatory effective date and that the new date should be determined when IFRS 9 is closer to completion.

The amendments made to IFRS 9 in November 2013 remove the mandatory effective date from IFRS 9. Entities may however still choose to apply IFRS 9.

1 Subject to the accounting policy choice for hedge accounting described in this document.

Where are we at with IFRS 9?

Following these amendments, IFRS 9 continues to be available if entities choose to apply it and entities currently have a choice about which parts of IFRS 9 they apply. Entities can choose to apply: only the own credit requirements; only the classification and measurement requirements for financial assets; the classification and measurement requirements for financial assets and financial liabilities; or the classification and measurement requirements for financial assets and financial liabilities and the hedge accounting requirements.[2]

What happens next to IFRS 9?

The IASB is currently discussing some limited amendments to the classification and measurement requirements in IFRS 9 and is also discussing the expected credit loss impairment model to be included in IFRS 9.

Once those deliberations are complete the IASB expects to publish a final version of IFRS 9 that will include all of the phases: Classification and Measurement; Impairment and Hedge Accounting. That version of IFRS 9 will include a new mandatory effective date.

2 The IASB has proposed that following the publication of the final version of IFRS 9, those entities that newly apply IFRS 9 must apply all parts of the Standard thus removing this choice. Entities could however still choose to apply IAS 39 hedge accounting rather than IFRS 9 hedge accounting as described in this document. This proposal is still subject to deliberation.

Important information

This Project Summary has been compiled by the staff of the IFRS Foundation for the convenience of interested parties. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the IASB and should not be considered authoritative in any way. The content of this Project Summary does not constitute any advice.

Official pronouncements of the IASB are available in electronic format to eIFRS subscribers. Publications are available for ordering from our website at www.ifrs.org.

Further information

The Basis for Conclusions included with the amendments made to IFRS 9 in November 2013 includes a detailed analysis of the feedback received on the proposals that preceded the amendments and how the IASB responded to that feedback. The Basis for Conclusions also includes an analysis of the likely effects of the amendments including the effects of the new hedge accounting model.

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