INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

Our special thanks are addressed to the international team of authors who contributed to this manual: Egle Mockaityte, Florence Michel, Heike Hartenberger, Mohamed Taghia and Nicolas Millot. Additional thanks go to Isabelle Grauer-Gaynor, Marie Fossat and Marion Platevoet for their precious help in finalising this publication.

Vincent Guillard
IFRS Lead Partner for Financial Instruments
10 KEY POINTS TO REMEMBER

1. Scope
The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – *Financial Instruments* provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – *Financial Instruments: Presentation* provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – *Financial Instruments: Disclosures* deals with most of the disclosure requirements, and IFRS 13 – *Fair Value Measurement* provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see chapter 1)

2. Initial recognition
All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see chapter 6)

3. Classification of financial assets
Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see chapter 7)

4. Impairment for expected credit losses
Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.
A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see chapter 9).

5. Classification of financial liabilities

Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntarily classification in the FV-PL category upon their initial recognition. (see chapter 8)

6. Debt vs. Equity

Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives

Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see chapter 13)

8. Hedge accounting

Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation-related conditions. (see chapter 14)

9. Derecognition

A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the “new” instrument are substantially different.

10. Disclosures on financial instruments

The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see chapter 16)
MAZARS INSIGHTS ON FINANCIAL INSTRUMENTS

- **CHAPTER 1**: Scope of standards applicable to financial instruments
- **CHAPTER 2**: Definitions, acronyms and abbreviations used
- **CHAPTER 4**: Amortised cost
- **CHAPTER 6**: Recognition and Initial measurement
- **CHAPTER 7**: Classification of financial assets
- **CHAPTER 8**: Classification of financial liabilities
- **CHAPTER 9**: Subsequent measurement of financial instruments (including impairment)
- **CHAPTER 13**: Derivatives and embedded derivatives
- **CHAPTER 14**: Hedge accounting under IFRS 9
- **CHAPTER 16**: Disclosures about financial instruments
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HEDGE ACCOUNTING UNDER IFRS 9
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14.1. Introduction

14.1.1. Need for hedging & economic vs accounting hedge

14.1.1.1. Need for hedge accounting

IFRS 9 relies on a dual measurement model. Financial instruments are measured either at fair value or at amortised cost depending on their contractual characteristics and the business model in which they are managed.

An entity is commonly exposed to different kinds of financial risks such as changes in interest rates, foreign currency rates, commodity prices, etc. Financial instruments, and more specifically derivatives, are the most common means used by entities in their hedging strategies of financial risks.

Under IFRS 9, all derivative instruments are measured, by default, at fair value through profit or loss (FV-PL) whereas a lot of other financial instruments are measured at amortised cost (most financial liabilities, basic loans held within a Held-to-Collect business model, etc.) or Fair Value through Other Comprehensive Income (basic loans held within a Held-to-Collect-and-Sell business model). Therefore, even if a derivative perfectly matches the exposure borne by another financial instrument, this may not be appropriately reflected in the profit or loss of the entity because the derivative hedging instrument will be measured at FV-PL whereas the exposure may be measured on a different basis. This difference in measurement methodology will result in a profit or loss volatility that does not reflect the actual economic situation of the entity.

The aim of the hedge accounting requirements is to provide an overriding accounting treatment to allow the economic hedging strategy to be better reflected in the profit or loss of the entity.

14.1.1.2. Economic vs. accounting hedge

As explained above, hedge accounting is an overriding and optional accounting treatment. Any entity can choose not to apply hedge accounting to risk management transactions even if they are fully efficient from an economic standpoint and managed internally as pure hedging strategies.

As any overriding treatment, hedge accounting is subject to several conditions which are organised as shown below:

![Figure 14.1](image)

These criteria and other features of hedge accounting will be further addressed in the rest of this chapter.
14.1.2. Alternatives to hedge accounting

The conditions required to apply hedge accounting (see section 14.5) are not always straightforward and may necessitate significant effort from entities (documentation, measurement of effectiveness, etc.). Thus, some entities may consider applying alternative accounting treatments that may lead to “similar” outcomes.

There are situations where the hedging instrument and the hedged exposure are measured in a similar way so that their economic offset is directly reflected in the profit or loss of the entity. These situations are often named “natural hedge” (see section 14.1.2.1).

IFRS 9 also offers options to account for some financial assets and liabilities (see section 14.1.2.2), contracts to sell or buy non-financial instruments (see section 14.1.2.4) and exposures to credit risk (see section 14.1.2.3) at fair value under some conditions.

14.1.2.1. Natural hedge

As explained previously the aim of hedge accounting is to minimise profit or loss volatility generated by offsetting positions that are measured on a different basis for accounting purposes (e.g. cost vs. fair value).

There are situations where a derivative may not need to be documented in a hedging relationship to offset the accounting impact of the economically hedged exposure. This is the case of a foreign exchange (FX) basis swap hedging a foreign currency financial liability. The derivative is by default measured at fair value through profit or loss, and the financial liability is remeasured at each reporting date at the closing spot rate through profit or loss as well in accordance with IAS 21 requirements for monetary items. Therefore, their change in value according to the change in the FX spot rate naturally offset in profit or loss without the need for hedge accounting.

Even in this situation, hedge accounting has some merits as it aligns the financial reporting with the actual management of the entity. Hedge accounting may also allow the entity to achieve a better outcome in terms of profit or loss volatility. But the existence of a “natural hedge” effect may lead some entities to consider that the constraints of applying hedge accounting in such a situation outweigh its benefits.

14.1.2.2. Optional designation as at fair value through profit or loss to reduce an accounting mismatch

As explained in section 14.1.1.1, the dual measurement method in IFRS 9 may lead to some profit or loss volatility between two instruments that fully offset economically. This situation is often referred to as an “accounting mismatch”.

IFRS 9 (IFRS 9.4.1.5 and IFRS 9.4.2.2(a)) permits entities to designate at fair value through profit or loss financial assets and liabilities that would not be measured that way, if such designation would eliminate or significantly reduce an accounting mismatch. This election (the “fair value option for accounting mismatch”) is available at initial recognition and is irrevocable. See section 7.4.5 for more details on the fair value option and some examples of situations where an accounting mismatch may arise.

IFRS does not permit the designation of only a part of a financial asset or a financial liability at fair value through profit or loss. The designation of only some of the financial assets and liabilities that generate the accounting mismatch is prohibited as well, if doing so would not eliminate or significantly reduce the accounting mismatch.
Example 14.1

Entity A issues a single €500 million fixed rate debt liability and uses the cash received to purchase a vanilla financial fixed rate debt asset for €450 million that is managed on a fair value basis. Applying the general requirements of IFRS 9 for classification and measurement, the entity would recognise the financial debt at amortised cost and the financial asset at fair value through profit or loss. To reduce the accounting mismatch, the entity may consider applying the fair value option to its financial liability. However, the entity cannot designate only €450 million out of the €500 million of the financial liability at fair value through profit or loss.

Applying this fair value option permits to reduce the volatility in profit or loss but does not replicate the hedge accounting outcome. Indeed, the election needs to be done upon initial recognition (unlike hedge accounting) and the ‘hedged item’ must be remeasured at fair value for all its attributes which could lead to some volatility in profit or loss (unlike hedge accounting where entities could hedge only some risk components for a given hedged item under some conditions - see section 14.3.2.1). In the above example where the entity elects to design a fixed rate debt at fair value to reduce the accounting mismatch with the fixed rate asset measured at fair value, the offsetting positions on interest rates will be better reflected in profit or loss. But the entity will have to remeasure its financial liability fully at fair value, triggering changes in value from other risk components such as own credit risk.

14.1.2.3. Credit risk exposures

14.1.2.3.1. A dedicated approach is needed for credit risk management based on credit derivatives

Many financial institutions 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 on a loan commitment to a third party. This might also reduce the regulatory capital requirements of the bank for these credit exposures.

However, the credit risk component of a financial item does not meet the eligibility criteria for hedged items (IFRS 9.BC6.470). One of the hedge accounting requirements is that the hedged risk must be separately identifiable to be able to isolate its impact on the change in fair value of the hedged instrument. The IASB considered that it is not the case for the credit risk component of a loan because, if it is obvious that it is a component of a spread between the risk-free rate and the market interest rate for a given debt instrument, it is not possible to isolate it within this spread from other risks such as liquidity risk, funding risk, etc.

We presented in the previous section the principles of the fair value option for accounting mismatch. This could have been a potential solution to solve this issue. However, it has many limits as:

- it applies only to financial instruments that are within the scope of IFRS 9, excluding for example loan commitments;
- it has to be designated upon initial recognition of the instrument and is irrevocable; and
- it has to be applied to the instrument as a whole (not a proportion of it).

1 Note that the own credit risk component of the change in fair value of a financial liability designated at FV-PL is recognised in Other Comprehensive Income. Please refer to chapter 8 Classification of financial liabilities for more information.
These limits do not enable entities to adequately reflect the credit risk management based on credit derivatives that financial institutions often implement. Therefore, the Board introduced with IFRS 9 a new mechanism to address these situations.

14.1.2.3.2. Principles and conditions of the approach

An entity that uses a credit derivative to manage the credit risk of all, or part of, a financial instrument, may designate that financial instrument as measured at FV-PL if (IFRS 9.6.7.1):

— the name of the credit exposure of the hedged financial instrument matches the reference entity of the credit derivative; and
— the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

This designation has to be done to the extent that the credit risk is so managed (e.g. only for a proportion of the financial instrument if the credit derivative only hedges a proportion of it).

This designation may apply to any financial instrument, even if it is not within the scope of IFRS 9 (including loan commitments for example).

This designation may be made upon initial recognition, subsequently, or even while the financial instrument is unrecognised (e.g. loan commitments).

This designation must be accompanied by a related documentation that explains the risk management link between the credit derivative and the financial instrument, and documents the date of initial designation at FV-PL of the financial instrument.

Upon initial designation at FV-PL, any difference between the carrying amount, if any, of the financial instrument and its fair value is recognised in profit or loss. Any change in value accumulated in other comprehensive income has to be immediately reclassified from equity to profit or loss as a reclassification adjustment (IFRS 9.6.7.2).

The designation at FV-PL must be discontinued if the situation does not meet the requirement described above anymore, for example:

— the credit derivative is sold, terminated or settled; or
— the credit risk of the financial instrument is no longer managed using a credit derivative.

When such designation is discontinued, the fair value of the instrument at the date of discontinuation becomes its new carrying amount. Subsequently, the instrument is subject to the same measurement methodology that was used before designating the financial instrument at FV-PL (IFRS 9.6.7.4). For example, if the instrument was measured at amortised cost, the entity will have to determine a new effective interest rate based on the new gross carrying amount of the instrument.

14.1.2.4. Own use contracts

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) are accounted for in accordance with IFRS 9 requirements as if these contracts were financial instruments unless they are entered into
and continue to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (IFRS 9.2.4). These contracts that are excluded from the scope of IFRS 9 are often referred to as ‘own use’ contracts. This concept is mostly applied to contracts to buy or sell commodities. They are accounted for as executory contracts, and as a result their accounting treatment falls within other applicable IFRS standards (Please refer to chapter 1 for more information on this scoping issue).

When a contract to buy or sell a non-financial item is within the scope of IFRS 9, it is accounted for as a derivative at fair value through profit or loss, unless it is documented as a hedging instrument.

Note that IFRS 9 allows entities to irrevocably designate their own use contracts (that would otherwise be out of scope of IFRS 9) as measured at fair value through profit or loss. This designation is available only at inception of the contract, and only if it eliminates or significantly reduces an accounting mismatch that would otherwise arise (IFRS 9.2.5).

14.1.3. IFRS 9 hedge accounting approach & changes vs. IAS 39

IAS 39 hedge accounting requirements were largely criticised as being rule-based and not reflecting the risk management activities of entities. The outcome in the financial statements was sometimes prejudicial and did not reflect the economic substance of these types of relationships leading to a limitation of the use of hedging instruments by many entities.

The IASB had these criticisms in mind when defining the IFRS 9 hedge accounting requirements and decided to move hedge accounting from rule-based requirements to more principle-based requirements reflecting the risk management activities of the entities. The Board notably did so by introducing two notions in the standard: risk management strategy and risk management objective which are fundamental in the new hedge accounting model (see section 14.2). The objective is to link hedge accounting entries and the related information disclosed in the financial statements to the way entities manage their risks.

Moving from a rule-based approach to a principle-based approach for hedge accounting, IFRS 9 softens some of the qualifying criteria and proposes more favourable accounting treatments for some of the hedging relationships. This will normally lead to more hedging relationships being eligible to hedge accounting even if the basics of hedge accounting were not modified.

Some of the main changes brought by IFRS 9 are summarised below (this list is not exhaustive):

— Eligibility of hedged items:
  > IFRS 9 permits, under some conditions, the designation of components of a non-financial instrument as a hedged item (see section 14.3.2).
  > IFRS 9 expands the eligibility to some net positions (see section 14.3.4.2).
  > Unlike IAS 39, IFRS 9 permits the designation of an aggregated exposure that is a combination of eligible non-derivative items and derivatives as hedged items (see section 14.3.4.3).

— Effectiveness: IFRS 9 replaces the 80-125 per cent effectiveness threshold with a more qualitative requirement reflecting the risk management purposes (see section 14.5.3). Ineffectiveness will continue to be monitored and recognised directly in profit or loss when it occurs (except for hedging equity instruments for which the entity elected to recognise fair value changes in OCI).
— Accounting for time value of options and forward points: IFRS 9 introduce a new accounting treatment which is more consistent with the economic substance of these elements often considered as “cost of hedging” (see section 14.8).

— Discontinuation: entities no longer have the possibility to voluntarily de-designate a hedging relationship if its risk management is unchanged (see section 14.10.1). Hedge accounting continues to be optional (i.e. entities can choose not to apply hedge accounting even if they enter into hedging relationships (regardless of their effectiveness)).

Most of the changes introduced by IFRS 9 on hedge accounting are driven by the objective of a better alignment with the hedging strategy of the management. Those changes come with new disclosure requirements to enable users of financial statements to have a clear view of the entity’s hedging strategy and its implications for future cash flows (see chapter 16).

14.1.4. IFRS 9, Macro-hedging, and related transition options

The new hedge accounting model introduced by IFRS 9 does not address the dynamic risk management implemented mostly by financial institutions to manage the risk related to their asset and liability management. These strategies are often named “macro hedging” activities.

The Board has launched a project to provide users of financial statements with better information about a company’s dynamic risk management activities.

Meanwhile, the Board decided to grant any preparer with the option to differ the application of the new IFRS 9 hedge accounting requirements until the project on accounting for macro hedging is completed. In this case, the entity continues to apply IAS 39 hedging requirements.

The standard does not indicate whether it is possible to apply IFRS 9 for example in 2018, electing the option to differ the application of the new hedging requirements of IFRS 9, and to apply these new hedging requirements in 2021 even if the IASB project on macro hedging is not yet finalised. Doing this would, in our opinion, be possible, as nothing in the standard seems to prevent it. However, once an entity elects to apply IFRS 9 hedge accounting requirements, it cannot revert back to IAS 39 afterwards.

14.2. Risk management: strategy vs. objective

As mentioned above, IFRS 9 aims at reflecting risk management activities in the financial statements.

Risk management activities are the implementation of the risk management strategies of the entity. IFRS 9.B6.5.24 makes a distinction between risk management strategy and risk management objective.

A risk management strategy is established at the highest level at which an entity determines how it manages its risks. A risk management strategy is generally maintained over a relatively long period of time. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them (for example, which risks are being hedged and if relevant, to which extent, using which instruments, over which period(s)...). Generally, they are flexible to react to changes in circumstances.
In contrast, the risk management objective is related to a given hedging relationship and reflects how the entity implements the risk management strategy at this level (i.e. how the particular hedging instrument that has been designated is used to hedge the particular risk that has been designated as the hedged item to satisfy the risk management strategy).

**Example 14.2**

For example, an entity may have as a risk management strategy for the management of the interest rate exposure to keep its net indebtedness at floating rate at or below 60 per cent of its total indebtedness. The entity decides from time to time at which proportion to keep the floating rate indebtedness depending on the market interest rates (on 1 January 202X, given the market interest rates and the entity’s expectation for their evolution, the entity sets this level at 50 per cent).

On 1 January 202X, the entity issues a debt (assume there is no cash, and this is the only debt in the balance sheet of the entity) for €100 million at floating rate. To comply with its management risk strategy the entity decides to contract at the same time an interest rate swap (pay fixed / receive variable) for €50 million. After this transaction, the entity’s net indebtedness at floating rate amounts to €50 million and fixed rate indebtedness amounts to €50 million.

- The hedge objective is to hedge against the variability in interest rate for 50% of the future interest rates of the issued debt.
- Floating rate net indebtedness amounts to 50 per cent of the total net indebtedness of the entity which is compliant with the risk management strategy of the entity.

Three months later (on 31 March 202X), the entity takes advantage of the low level of interest in the market and issues a new debt for €50 million at fixed rate. The new net indebtedness (considered hedging transactions) profile is thus composed of:

- €100 million (€50 million corresponding to the fixed rate leg of the interest swap entered into on 1 January 202X and €50 million corresponding to the new fixed rate debt issued on 31 March 202X) at fixed rate; and
- €50 million (€100 million corresponding to the floating rate debt issued as 1 January 202X reduced for €50 million by the received floating rate of the interest rate swap entered into by the entity at the same date) at floating rate.

Floating rate net indebtedness amounts to 33.3 per cent of the total net indebtedness of the entity which is compliant with its risk management strategy.

The entity decided given the market interest rates to put the level of floating rate at 60 per cent of the total indebtedness and thus decided to change the hedge objective of the hedging relationship described above to comply with this new level. To do so, the entity now designates as the hedge objective to hedge against variability of 10 per cent of the future interest payments of the debt issued in January 202X. The entity then uses only a proportion of the interest rate swap entered into in January 202X corresponding to €10 million as the hedging instrument, the other €40 million are now excluded from the hedging relationship and could either be used in another hedging relationship or considered as a trading position.

In this example, the risk management strategy (to keep the floating rate indebtedness at a level below 60 per cent) did not change. However, the risk management objective did change as the entity no longer hedges against the variability of 50 per cent of the future interest payments of the floating rate debt issued in January 202X but rather hedges against variability of 10 per cent of the future interest payments of the same debt.

These two concepts are very important under IFRS 9 for hedge accounting. They will interact with the hedging documentation of the entity (see section 14.5.2), the ability to discontinue a hedging relationship (see section 14.10.1), and the disclosure requirements (see chapter 16).
14.3. Hedged items

14.3.1. Introduction to eligible hedged items

14.3.1.1. Why is it important to appropriately design the hedged item?

The correct designation of the hedged item is of crucial importance as it will:

— allow the application of hedge accounting or not depending on its eligibility;
— have to be described in the hedging documentation;
— impact the possibility to maintain or not an existing hedging relationship; and
— drive potentially significant impacts in profit or loss.

For example, it is on the basis of the documented hedged item that the entity will perform:

— the hedge ineffectiveness measurement that will impact the profit or loss of the period; and
— the assessment of whether the hedged item disappeared or is no more likely to occur, to determine whether the discontinuation of an existing hedging relationship is required.

14.3.1.2. General principles governing eligible hedged items

Under IFRS 9.6.3.1, a hedged item could be:

— a recognised asset or liability;
— an unrecognised firm commitment;
— a highly probable forecast transaction; or
— a net investment in a foreign operation.

A hedged item can be a single item or a group of items.

A hedged item can also be a component of such item or group of items (specific cash flows, proportion or layer of a nominal amount, a net position, an aggregated exposure...).

A hedged item can also relate to a risk component, that can be explicit or implicit, and that can be hedged fully or partially.

By combining the two above concepts (hedging an item in its entirety or a component of it, fully or partially hedging a risk component...) there are numbers of ways to determine what the hedged item will exactly be. But in any case, such designation is only possible provided the hedged risk is separately identifiable and reliably measurable (IFRS 9.6.3.2, i.e. it must be possible to clearly identify and quantify the change in value attributable to the risk(s) being hedged). This applies to financial and non-financial instruments.

As a general principle, a hedged item has an impact on the profit or loss of the entity entering into the hedging relationship (IFRS 9.6.5.2, see section 14.3.5).

All these concepts will be explained in more details below.
14.3.2. A hedged item can be a component

Under IFRS 9 (IFRS 9.6.3.7) an entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship.

IFRS 9.6.3.7 specifies that an entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

- only changes in the cash flows or fair value of an item attributable to a specific risk or risks provided this risk is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (commonly known as “one-sided risk”), of a hedge of an exposure for only a partial term for which it is outstanding (see section 14.3.2.1);
- one or more selected contractual cash flows (see section 14.3.2.2);
- components of a nominal amount: there are two types of nominal amounts that can be designated as the hedged item in a hedging relationship:
  - a component that is a proportion of an entire item (e.g. when an entity hedges only 50 per cent of the interest cash flows of a floating rate debt) (see section 14.3.2.3.1), or
  - a layer component (see section 14.3.2.3.2).

Finally, an entity can designate as the hedged item all the cash flows of an eligible item, or only a given risk component provided that this does not result in hedging more than the total cash flows of the hedged item (see section 14.3.3).

14.3.2.1. Hedging a risk component of a hedged item

Under IFRS 9.6.3.7, entities can designate any risk component as a hedged item for financial and non-financial items provided this risk is separately identifiable and reliably measurable.

14.3.2.1.1. Explicit and implicit risk components

The two conditions mentioned above (separately identifiable and reliably measurable) have to be analysed for the specific risk in the context of the particular market structure. These conditions can be satisfied for risks that are contractually specified and those that are not (the risk component is implicit) (IFRS 9.6.3.7).

Example 14.3

(IFRS 9.B6.3.10(a)) An example of a contractually specified risk is when an entity A enters into a long term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (for example, gas oil, fuel oil and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Because of the pricing formula, the entity concludes that the gas oil price exposure is separately identifiable. At the same time, there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable. Consequently, entity A concludes that the gas oil price exposure in the supply contract is a risk component that is eligible for designation as a hedged item.
Example 14.4

(IFRS 9.B6.3.10(c)) An example of an implicit risk component is when Entity C hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the volume that it hedges over time. Entity C hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity C uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity C uses gas oil derivatives because they are sufficiently liquid. For time horizons up to six months Entity C uses jet fuel contracts. Entity C’s analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances is as follows:

> Entity C operates in a geographical area in which Brent is the crude oil benchmark. Crude oil is a raw material benchmark that affects the price of various refined oil products as their most basic input. Gas oil is a benchmark for refined oil products, which is used as a pricing reference for oil distillates more generally. This is also reflected in the types of derivative financial instruments for the crude oil and refined oil products markets of the environment in which Entity C operates, such as:

  - the benchmark crude oil futures contract, which is crude oil for Brent; the benchmark gas oil futures contract, which is used as the pricing reference for distillates—for example, jet fuel spread derivatives cover the price differential between jet fuel and that benchmark gas oil; and
  - the benchmark gas oil crack spread derivative (i.e. the derivative for the price differential between crude oil and gas oil—a refining margin), which is indexed to Brent crude oil.

> the pricing of refined oil products does not depend on which particular crude oil is processed by a particular refinery because those refined oil products (such as gas oil or jet fuel) are standardised products.

Hence, Entity C concludes that the price risk of its jet fuel purchases includes a crude oil price risk component based on Brent crude oil and a gas oil price risk component, even though crude oil and gas oil are not specified in any contractual arrangement. Entity C concludes that these two risk components are separately identifiable and reliably measurable even though they are not contractually specified. Consequently, Entity C may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil). This analysis also means that if, for example, Entity C used crude oil derivatives based on West Texas Intermediate (WTI) crude oil, changes in the price differential between Brent crude oil and WTI crude oil would cause hedge ineffectiveness.

Permitting the designation of risk components as hedged items for hedge accounting purposes leads to an accounting treatment that reflects more accurately the risk management activities of the entities. It also facilitates the demonstration of the existence of the economic relationship between the hedging instrument and the hedged item.

If entities could not designate risk components as hedged items for hedge accounting purposes, they would have to demonstrate the existence of an economic relationship between the hedging instrument and all (or a proportion of) the hedged item. This would lead to some ineffectiveness that may limit the cases when entities use hedge accounting or alter the performance of the hedging relationship communicated to users.

14.3.2.1.2. Inflation as an implicit risk component

IFRS 9 (IFRS 9.B6.3.13) considers there is a presumption that unless inflation risk is contractually specified, it is not a separately identifiable and reliably measurable risk component and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.
Example 14.5

IFRS 9.B6.3.14 takes the example of an entity which issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (i.e. in a manner similar to how a risk-free (nominal) interest rate component can be determined).

However, in an environment where the inflation-linked bonds market is not sufficiently liquid to determine a term structure of zero-coupon real interest rates, the analysis of the market structure would not support the entity concluding that inflation is a relevant factor that is separately considered by debt markets. Therefore, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable.

14.3.2.1.3. Hedging a one-sided risk

Once an entity has identified which risk component it wishes to hedge, it has to decide whether it will hedge the risk in full or only a portion of it.

For example, an entity may consider hedging the change in interest rate cash flows of a floating rate liability against the risk of an increase of the benchmark rate above 4% with a cap. In this case the entity is only hedging a “one-sided risk” and not the full exposure of its future cash flows to the interest rate volatility (IFRS 9.6.3.7).

14.3.2.1.4. Partial term hedging

It is possible to document a hedging relationship on a hedged risk for only a partial term for which it is outstanding. This was explained in the Implementation Guidance of IAS 39 and remains relevant under IFRS 9.

This kind of documentation applies both to financial and non-financial instruments and requires that the hedged risk components meets the usual eligibility conditions and in particular that the hedged risk is separately identifiable and reliably measurable.

Example 14.6

Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as measured at FV-OCI. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap.

The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap (IAS 39.IG.F.2.17).

14.3.2.2. Hedging specific contractual cash flows

An entity has the possibility to document only one or several specific contractual cash flows as a hedged item.
Example 14.7

An entity may choose to implement a hedge against the impact of the change in interest benchmark rates on the interest cash payments only for the first 3 years of a 5-year floating rate debt.

Example 14.8

An entity issued a 5-year foreign currency bond. Interests are paid each year but the principal repayment is in fine. The entity may document a foreign currency hedge only on the final redemption cash payment in year 5 without hedging the foreign currency exposure related to the interest payments.

14.3.2.3. Hedging a proportion or a layer of a nominal amount

14.3.2.3.1. Hedging a proportion of a nominal amount

An entity has the possibility to hedge a strict proportion of an instrument’s contractual cash flows. For example, it can hedge 50% of all the cash flows of a debt instrument (IFRS 9.86.3.17).

14.3.2.3.2. Hedging a layer component

A layer component can be specified from a defined, but open, population or from a defined nominal amount.

Example 14.9

Below are examples of layer components that may be documented as a hedged item:

> a part of a monetary transaction volume: such as the first $10 million cash inflows from sales to customers in March 202X (for an entity the functional currency of which is euro);
> a part of a physical volume: such as 100 tons bottom layer of rubber inventory in a specified location;
> a part of a physical or other transaction volume: such as the first 200 oil barrel purchases in March 202X or the first 200 MWh of electricity sales in June 202X;
> a layer from the nominal amount of the hedged item: such as the last €80 million of a €100 million firm commitment or the bottom layer of €20 million of a €100 million fixed-rate bond.

It is important to note that a layer has to be identifiable so that it is possible to identify the hedged exposure or cash flow when it occurs.

Example 14.10

Consider an entity frequently selling goods in a foreign currency. The entity would like to document a foreign currency hedge on the last 100 units of goods sold on a given period. In practice, the entity will only be able to identify those “last sales” at the end of the period as additional transactions may occur by the end of the period. In such situation the entity will not be allowed to document the 100 units sold as a hedged item because it is unable to identify the transaction when it occurs. The identification can only be performed afterwards.

Similarly, when a layer component is designated in a fair value hedge, an entity must specify it from a defined nominal amount. To comply with the requirements of fair value hedge accounting, an entity hedging a layer component must re-measure it for fair value changes attributable to the hedged risk and...
the resulting adjustment must be recognised in profit or loss no later than when the item is derecognised. Therefore, it is necessary to track the nominal amount from which the layer is defined to track the designed layer and, when relevant (e.g. the hedged layer is derecognised), amortise the accumulated adjustment.

IFRS 9.B6.3.20 states that a layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option’s fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

14.3.3. Relationship between components and the total cash flows of a hedged item

IFRS 9.B3.21 states that if a component of the cash flows of a financial or a 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.

This type of situation, often referred to as the “Sub-LIBOR” issue, may seem to be counterintuitive at first sight but actually occurs in various circumstances.

Example 14.11

Some financial institutions and sovereigns are able to raise funding at an interest rate that is below the benchmark interest rate (e.g. LIBOR – 20 bp). In such a situation the standard would not allow the entity to document as a hedged item the LIBOR component as, given the negative spread of -20, this component may be more than the total cash flows of the entire item.

In the example of a floating rate debt paying LIBOR – 20bp, one solution to consider would be to document the whole instrument (and not just the LIBOR component) as being hedged against the change in value of the LIBOR index.

Such situation may also occur in the commodity environment as mentioned by IFRS 9.B6.3.25. For example, for quality, storage or transportation reasons, negative spreads applied to index prices are common.

Example 14.12

Consider a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price.

14.3.4. Group of items

For a group of items to be eligible as a hedged item for hedge accounting purposes, IFRS 9.6.6.1 requires that:

— the individual items constituting the group are eligible as hedged items under IFRS 9 (see sections above); and

— for risk management purposes, the items in the group are managed together on a group basis.
The items composing the group being managed together on a group basis for risk management purposes is a matter of facts and not documentation (it depends on the entity’s behaviour).

The standard provides additional requirements for situations where:

— the hedged item is a component of a group (see section 14.3.4.1);
— the items composing a group have offsetting impact so that they constitute net positions, including nil net positions (see section 14.3.4.2); and
— the items hedged consist in an aggregated exposure (see section 14.3.4.3).

14.3.4.1. Component of a group of items

IFRS 9 permits not only a component of a single item to be designated as a hedged item for hedge accounting purposes under some conditions (see section 14.3.2) but also components of a group of items that is eligible as a hedged item.

Under IFRS 9, entities can hedge a proportion or a layer component of a group of items eligible as hedged items (see conditions in section 14.3.4) if the hedge is consistent with the entity’s risk management objective and, as for any eligible hedged item, if it is separately identifiable and reliably measurable.

Authorising layer components for a group of items to be eligible as hedged items is supported by all the reasons that support the eligibility of layer components of a single item but also because (IFRS 9.BC6.439):

— uncertainties relating to the transactions (e.g. breach of contracts or prepayment options) can be better modelled when considering a group of items;
— in practice, hedging layers of groups of items is a common risk management strategy; and
— arbitrarily identifying and designating specific items from a group of items that are exposed to the same hedged risk can:
  > 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
  > can provide opportunities for earnings management (for example, by choosing to transfer and derecognise particular items from a homogeneous group of items when only some were specifically designated into a fair value hedge and therefore have fair value hedge adjustments attached to them).

Hedging a layer component of an eligible group of items is subject to additional specific requirements (IFRS 9.6.6.3):

— the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not significantly affected by which particular items from the overall group form part of the hedged layer);
— for a hedge of existing items (for example an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships); and
— any items in the group that contain prepayment options meet the requirements for a layer component of a nominal amount (see section 14.3.2.3.2).
Example 14.13

Consider a hedge of a proportion of a group of items. Entity A issues a group of 1,000 loans in March 202X at fixed rates and with similar characteristics. The loans cannot be early repaid. Entity A’s risk management strategy consists in hedging 50% of the group of loans against changes in fair value due to changes in interest rates. Thus, the entity enters in a hedging derivative to hedge 50% of the changes in fair value related to the 1,000 loans issued in March 202X. This proportion is eligible as a hedged item under IFRS 9.

14.3.4.2. Net positions

14.3.4.2.1. General requirements for hedges of net positions

Under IFRS 9, net positions can be a hedged item only if the entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact. Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy.

14.3.4.2.2. Specific requirements for cash flow hedges of net positions

Net positions are common situations in many segments of activities, but the most common is probably the situation where foreign currency exposures of an entity with offsetting impacts are managed and hedged on a net basis. This is generally achieved with a cash flow hedge relationship.

IFRS 9.6.6.1 and IFRS 9.B6.6.7 permit that net positions be designated as hedged items for hedge accounting purposes under a cash flow hedge relationship if:

— it is a hedge of a foreign currency risk; and
— the designation of the net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

The requirement for specifying the reporting periods on which the expected transactions impact profit or loss was set by the IASB to avoid the selection effect (which would lead to earnings management).

14.3.4.2.3. Presentation requirements for hedging relationships on net positions

For a hedge of a group of items with offsetting risk positions (i.e. a hedge of a net position) where hedged risk affects different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses in that statement is to be presented in a separate line from those affected by the hedged items (IFRS 9.6.6.4 and BC6.4.5.8).

Hence, in the income statement, the amount in the line item that relates to the hedged item itself remains unaffected by hedging gains and losses.

For asset and liabilities that are hedged together as a group in a fair value hedge, the individual items composing the group will be adjusted for the changes of the hedged risk in the financial position (for example when the group of items includes assets and liabilities with offsetting positions, the individual assets and liabilities will be adjusted for the change in the hedged risk) as for hedging single items (see section 14.7.2.1). If these items do not impact the same line of the income statement, the hedging gains and losses will be presented on a separate line as for cash flow hedge relationships.
Example 14.14

An entity, the functional currency of which is EUR, is hedging the foreign currency risk of a net position of foreign currency sales of USD 100 and a foreign currency expense of USD 80 using a forward exchange contract for USD 20. Both the sales and the expenses will be recognised in profit or loss as if they were not hedged, and the performance of the forward exchange contract will be presented in a separate line item. The benefit from the hedging strategy will be effective on the bottom line of the profit or loss statement (or on an intermediate level such as EBIT), but the sales and the expenses will be presented without the benefit of hedge accounting.

The Board decided to require such presentation principles because it considers that recognising the benefit of the hedge on each line item of the profit or loss affected by the hedged item would be tantamount to recognising gross gains and losses that do not exist. In the example above, it would have been “as if” two derivatives where implemented for a respective gross amount of USD 100 and USD 80 whereas the entity actually entered a USD 20 forward only. The IASB thus considered that hedging gains and losses for cash flow hedges of a net position are to be recognised in a separate line within profit or loss or other comprehensive income to avoid recognising “fictitious” gains and losses.

Additionally, IFRS 9.B6.6.9 requires that, if the hedged items of a group hedged on a net basis will not impact the profit or loss during the same period, the entity has to recognise the changes in value of the items in the net position that have a similar effect as the hedging instrument only once the transactions that they relate to are recognised.

Example 14.15

Consider the same fact pattern as for Example 14.14 above except that the expenses of USD 80 are expected to occur in year N+1, and the sales of USD 100 are expected in year N+2. The entity enters a USD 20 forward having the same maturity as the expected sales in year N in order to hedge its net position in a cash flow hedge relationship.

At the end of year N, the entity recognises the change in value of the forward in other comprehensive income. No additional entries are recognised related to the future expected transactions as they have not yet occurred.

At the end of year N+1, the entity will recognise the expenses of USD 80 at the spot rate applicable upon the expense recognition date, and recognise on a separate line item of the profit or loss statement the change in value of these expenses attributable to the change in the foreign exchange rate between the designation of the hedging relationship and the recognition of expenses. The offsetting entry of this cumulative change in value will be recognised in other comprehensive income as a cash flow hedge reserve together with the performance of the hedging derivative.

In year N+2, the entity will recognise the sales at the spot rate applicable upon the revenue recognition date and transfer in a separate line of the profit or loss statement the amount accumulated in the cash flow hedge reserve within other comprehensive income.

14.3.4.2.4. Nil net positions

IFRS 9.6.6.6 states that when the hedged item is a group that is a nil net position (i.e. the hedged items among themselves fully offset the risk that is managed on a group basis), an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument, provided that:

— the hedge is part of a rolling net risk hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (for example, when transactions move into the time horizon for which the entity hedges);
— the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments to hedge the net risk (i.e. when the net position is not nil);
— hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and
— not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

### 14.3.4.3. Aggregated exposures

Entities can designate as hedged item an aggregated exposure that is a combination of an exposure eligible as a hedged item under IFRS 9 and a derivative (IFRS 9.6.3.4). To be eligible as a hedged item, the aggregated exposure must be managed as one exposure for a particular risk by the entity.

**Example 14.16**

An example of an aggregated exposure is combination of a floating rate debt denominated in USD (the entity functional currency is euro) and an interest rate swap (pay fixed / receive variable) denominated in USD. Economically, the aggregated exposure in this case corresponds to a fixed rate debt denominated in USD that the entity can hedge under IFRS 9 against changes in the exchange rates between USD and the functional currency of the entity.

An aggregated exposure can be a forecast transaction (i.e. uncommitted but anticipated future transaction that would give rise to an exposure and a derivative) provided that it is highly probable and, once it has occurred, is eligible as a hedged item.

**Example 14.17**

At 1 January 202X, entity A, the functional currency of which is EUR, expects (transaction is highly probable) to issue a fixed rate debt denominated in USD in 12 months. The entity’s strategy is to have all its indebtedness in its functional currency, so it is highly probable that when the debt will be issued, entity A will transact a cross-currency interest rate swap converting the fixed rate debt denominated in USD to a fixed rate debt denominated in EUR.

To hedge against the evolution of interest rates between 1 January 202X and the debt issuance date, entity A decides to contract a forward starting interest rate swap (pay fixed / receive variable).

Under IFRS 9, entity A can designate this forward starting interest rate swap as hedging the forecast aggregated exposure against changes in EUR interest rates over the next 12 months. This hedging relationship will qualify as a cash flow hedge.

Hedging an aggregated exposure does not mean that the combination of the exposure and the derivative composing this aggregated exposure are no longer accounted for following the relevant requirements of IFRS 9. Both the exposure and the derivative constituting the aggregated exposure will continue to be accounted for following the relevant IFRS 9 requirements.

When designating an aggregated exposure as a hedged item, an entity considers the combined effect of the items that constitute the aggregated exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness.
14.3.5. A hedged item must be exposed to a risk that could affect profit or loss

The definition of fair value hedge and cash flow hedge (IFRS 9.6.5.2) explicitly states that they aim at hedging a risk that could affect the profit or loss of the entity. This is also the case for a net investment hedge as IAS 21 stipulates that the foreign currency risk hedged in such a hedging relationship will impact the profit or loss upon disposal of the net investment.

Example 14.18

A EUR functional entity is considering issuing a new USD debt in 3 months. The transaction is highly probable. The entity would like to enter a foreign currency derivative to hedge the change in the EUR/USD spot rate between the derivative transaction date and the USD debt origination date. This derivative cannot benefit from a hedge accounting treatment in such a situation because the profit or loss of the entity will never be impacted by the change in the spot rate occurring between the trade date of the derivative and the date of the USD debt origination.

In practice this condition is often related to the counterparty of the hedged transaction. IFRS 9.6.3.5 states that only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items.

Intragroup transactions fully eliminated through the consolidation process have no impact on the consolidated profit or loss and cannot therefore be documented as a hedged item in the group consolidated account. Royalty payments, interest payments and management charges between members of the same group will not generally affect the consolidated profit or loss and consequently cannot qualify as hedged items in a cash flow hedge unless there is a related external transaction (IFRS 9.B6.3.5).

Hedge accounting can however be applied to transactions between entities in the same group in the individual or separate financial statements of those entities.

There are however several exceptions to this principle on intragroup transactions:

- In the consolidated financial statements of an investment entity as defined in IFRS 10, transactions between the investment entity and its subsidiaries measured at fair value through profit or loss will not be eliminated and are therefore eligible as hedged items.

- IFRS 9 provides a specific exception for equity investments classified at FV-OCI-NR. Even if the gain or loss realised upon the sale of the equity instrument will never impact the profit or loss, IFRS 9 explicitly allows entities to document them as a hedged item provided that the hedged exposure could affect other comprehensive income (IFRS 9.6.5.3).

- The foreign currency risk of an intragroup monetary item may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21. This will occur when an intragroup monetary item exists between two entities having different functional currencies (e.g. a USD payable / receivable between a USD functional currency entity and a EUR functional currency entity).

- The foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering that transaction and the foreign currency risk will impact profit or loss.
Example 14.19

Entities A and B belong to the same group. Entity A’s functional currency is EUR, Entity B’s functional currency is USD. Entity A manufactures equipment and sells it to the other entities of the group to be used in their industrial process.

Entity B expects to buy equipment from entity A in 9 months for €5 million.

Entity B wants to hedge its exposure against changes in the EUR/USD spot rate on the highly probable forecast intragroup transaction with entity A. Entity B enters a forward contract to buy EUR / sell USD.

The highly probable intragroup transaction is eligible as a hedged item as the changes in the EUR/USD spot rate will impact the consolidated financial statements of the group in the future through the depreciation of the purchased equipment (the basis for calculation of the depreciation expense will depend on the exchange rate at the date entity B recognises the equipment in its balance sheet).

Example 14.20

Entities A and B belong to the same group. Entity A is a manufacturing entity based in Europe and its functional currency is EUR. Most of the costs of Entity A are denominated in EUR. Entity A sells its goods only to intragroup commercial entities. The sales are denominated in the functional currency of the intragroup commercial entity. Entity B is a commercial entity, based in the United States, in charge of selling the goods produced by Entity A to local external parties. Entity B has a USD functional currency and buys goods from Entity A in USD.

Entity A has an exposure to changes in the EUR/USD spot rate as most of its expenses are in EUR whereas its sources of income are in USD. To hedge the forecast highly probable sale of goods to Entity B, Entity A enters a forward to sell USD / purchase EUR. The forecast intragroup transaction can be a hedged item in this situation as it is highly probable, denominated in a currency other than the functional currency of Entity A, and there is a related external transaction (the sale of the goods in USD by Entity B to external clients).

14.4. Hedging instruments

14.4.1. Hedging with derivatives

14.4.1.1. General principle

IFRS 9 does not restrict the use of derivative instruments that are measured at fair value through profit or loss as hedging instruments for hedge accounting purposes (provided the hedge accounting criteria are met) except for some written options (see section 14.4.1.2) and some intragroup transactions.

14.4.1.2. Written options

Written options are not eligible as hedging instruments under IFRS 9 except in the following two situations:

— when the hedging written option is documented as a hedge of a purchased option, including one that is embedded in another instrument (IFRS 9.8.2.4);

— when the written option is combined with one or several purchased options so that the net position of the combined hedging instruments, at the date of designation, does not result in a net written position (IFRS 9.6.2.6).
Example 14.21

To minimise the cost of hedging instruments, entities in practice often use tailored solutions to meet their hedging requirements. As a result, such solutions may include written options. IFRS 9 permits entities to combine several hedging instruments, and such combinations may include written options provided that the combination is not in effect a net written option (IFRS 9.6.2.5). An interest rate collar is an example of a combination of hedging instruments including a written option. This type of combination provides a tailored solution to the entity’s hedging needs. It also reduces costs for the entity: by combining a purchased call option with a written put option in this way, an entity can hedge against rising interest rates without having to pay an option premium (a zero-cost collar).

14.4.2. Hedging with non-derivative financial instruments

14.4.2.1. Financial instruments accounted for at fair value through profit or loss

IFRS 9 permits non-derivative financial instruments to be designated as hedging instruments provided they are accounted for at fair value through profit or loss (IFRS 9.6.2.2).

Financial liability designated as at fair value through profit or loss for which the amount of change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income (see chapter 8), is not considered to meet the above-mentioned requirement and is therefore not eligible as a hedging instrument.

14.4.2.2. Hedge of a foreign currency risk with non-derivative financial instruments

For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument can be designated as a hedging instrument. In this case, its foreign currency risk component is determined in accordance with IAS 21 (IFRS 9.B6.2.3).

However, an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income without recycling (see chapter 7) cannot be documented as a hedging instrument as its changes in value related to the foreign currency risk component will never impact profit or loss.

14.4.2.3. Own equity instruments

An entity’s own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments (IFRS 9.B6.2.2).

14.4.3. Hedging with a combination of financial instruments

An entity may view in combination, and jointly designate as the hedging instrument, any combination of the following (including those circumstances where the risk arising from one hedging instrument offsets the risk arising from others):

— derivatives or a proportion of derivatives; and
— non-derivative or a proportion of them.
This possibility is subject to the fact that the combination of instruments does not result in a net written option position (IFRS 9.6.2.56).

The use of proportions of instruments is further detailed in the next section.

**14.4.4. Portions and proportions of hedging instruments**

**14.4.4.1. General principle**

As a general principle, a qualifying instrument must be designated in its entirety as a hedging instrument. (IFRS 9.6.2.4). For example, it is prohibited to document as a hedging instrument only a portion of the remaining time period during which the instrument remains outstanding at the designation date.

**Example 14.22**

An entity has entered a 10-year swap. At the end of year 2, the entity has the possibility to designate this swap as a hedging instrument for the remaining 8 years. However, at the end of year 2, the entity is not allowed to designate only a portion of these 8 remaining years as a hedging instrument.

Derivatives embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments (IFRS 9.B6.2.1).

However, this general principle comes with several exceptions:

— documenting a proportion of an instrument (see section 14.4.4.2);
— separating the hedging instrument into several risk components and document each of them in a hedging relationship (see section 14.4.4.3);
— separating the forward element from the spot element of a forward contract (see section 14.4.4.4);
— separating the currency basis spread (see section 14.4.4.5);
— separating the time value component from the intrinsic value component of an option (see section 14.4.4.6);
— separating the foreign currency component of a non-derivative financial instrument (see section 14.4.4.7).

**14.4.4.2. Proportions of hedging instruments**

A proportion of an eligible hedging instrument, such as 50% of its notional amount, may be designated as the hedging instrument in a hedging relationship (IFRS 9.6.2.4(c)).

The proportion not designated as a hedging instrument in this hedging relationship can either be:

— designated in one or several other hedging relationships, or
— classified in accordance with the general classification requirements of IFRS 9.
14.4.4.3. Separating the hedging instrument into several risk components

A single hedging instrument can be split into several risk components provided each of them is documented in a hedging relationship.

The risk components can be documented in hedging relationships of different nature (cash flow hedge, fair value hedge...) (IFRS 9.B6.2.6).

Example 14.23

A EUR functional currency entity bears a EUR floating rate loan asset, and a USD fixed rate financial liability. The entity enters a cross-currency interest rate swap paying EUR floating interest rate and receiving USD fixed interest rate. The entity may separate this derivative into two risk components:

> a EUR interest rate component hedging the floating interest rate asset in a cash flow hedge relationship; and
> a foreign currency component hedging the USD financial liability in another cash flow hedge relationship.

14.4.4.4. Separating the spot element and the forward element of a forward contract

IFRS 9.6.2.4(b) permits the separation of the spot element and of the forward element of a forward contract and the designation of only the change in the spot element as a hedging instrument (instead of the change in value of the whole forward contract).

This possibility applies to hedges of foreign currency exposure as well as to hedges of commodity risk.

See section 14.8.2 for additional guidance on the accounting treatment of forward elements excluded from the hedging relationship.

14.4.4.5. Separating the currency basis spread

The currency basis spread of a foreign currency hedging instrument may be separated and excluded from the designation of a financial instrument as the hedging instrument.

See section 14.8.3 for additional guidance on the accounting treatment of currency basis spreads excluded from the hedging relationship.

14.4.4.6. Separating the time value element and the intrinsic value element of an option

IFRS 9.6.2.4(a) permits the separation of the intrinsic value element and of the time value element of an option contract and the designation as the hedging instrument of only the change in the intrinsic value of an option and not of the change in its time value.

See section 14.8.1 for additional guidance on the accounting treatment of the time value of options excluded from the hedging relationship.
14.4.4.7. Separating the foreign currency component of a non-derivative financial instrument

IFRS 9.6.2.2 permits the documentation of only the foreign currency component of a non-derivative financial instrument as a hedging instrument.

See section 14.4.2.2 for more guidance.

14.5. Qualifying criteria

14.5.1. General requirements

Hedge accounting is an optional accounting treatment (i.e. an entity has the possibility to choose transaction by transaction to apply hedge accounting requirements or not), but in order to apply hedge accounting, the following cumulative criteria must be met (IFRS 9.6.4.1):

— the hedging relationship consists only of eligible hedging instruments (see section 14.4) and eligible hedged items (see section 14.3);

— at the inception of the hedging relationship there is a formal designation and documentation of the hedging relationship and of the entity’s risk management objective and strategy for undertaking the hedge (see section 14.5.2);

— the hedging relationship meets all hedge effectiveness requirements (see section 14.5.3); and

— the hedging relationship meets the definition of at least one of the following three kinds of hedging relationships: fair value hedge, cash flow hedge or net investment hedge (see section 14.7.1).

A hedging relationship is discontinued if the qualifying criteria cease to be met (IFRS 9.6.5.6) (see section 14.10.1). In practice this will require to monitor the qualifying criteria of each hedging relationship at each reporting date.

14.5.2. Documenting a hedging relationship

IFRS 9 requires a formal designation and documentation of the hedging relationship at its inception. This documentation must contain each of the following (IFRS 9.6.4.1(b)):

— documentation of the entity’s risk management objective and strategy for undertaking the hedge (see section 14.2);

— identification of the hedging instrument (see section 14.4);

— identification of the hedged item(s) (see section 14.3);

— the nature of the risk(s) being hedged; and

— how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).
Hedge accounting may only be applied when all qualifying criteria are met, including this documentation set up. In the absence of formal documentation, hedge accounting cannot be applied. Accordingly, hedge accounting can only start from the date the required documentation is completed. Furthermore, hedge accounting is applicable only prospectively, hedge accounting cannot be designated retrospectively. Therefore, the date of designation must be explicitly mentioned in the documentation.

The designation of the hedged item is of crucial importance as changes in the hedged item (included timing, and disappearance) may have very significant impacts on the hedging relationship. Therefore, the hedged item must be designated in a way that leaves no doubt on the ability of the entity to identify it when it occurs.

**14.5.3. Hedge effectiveness criteria**

**14.5.3.1. Effectiveness assessment vs. ineffectiveness measurement**

Hedge effectiveness of a hedging relationship under IFRS 9 (IFRS 9.B6.4.1) corresponds to the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item.

Hedge effectiveness assessment is different from hedge ineffectiveness measurement. Hedge effectiveness assessment is a qualifying criterion for a hedging relationship to be accounted for following hedge accounting requirements (if a hedging relationship is not effective, hedge accounting cannot be applied).

Hedge ineffectiveness measurement aims at measuring the ineffectiveness of a qualifying hedging relationship to be recognised in profit or loss (a hedging relationship being effective does not mean it is 100% effective but just that it meets the qualifying criteria).

**14.5.3.2. Criteria for hedge effectiveness assessment**

To qualify for hedge accounting, a hedging relationship has to comply with the following hedge effectiveness requirements:

- there is an economic relationship between the hedged item and the hedging instrument (see section 14.5.3.2.1);
- the effect of credit risk does not dominate the value changes that result from that economic relationship (see section 14.5.3.2.1), and
- the hedge ratio (see section 14.5.3.2.3) of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, such ratio may not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would in turn create hedge ineffectiveness (irrespective of whether recognised or not).
14.5.3.2.1. Economic relationship

For a hedging relationship to qualify for hedge accounting, there is an expectation that the changes in values of the hedging instrument and of the hedged item will generally move in the opposite directions because of the same risk, which is the hedged risk, during the term of the hedging relationship. This is known as the “economic relationship” under IFRS 9.

Example 14.24

For example, when an entity hedges a fixed rate bond against changes in fair value using an interest rate swap (pay variable / receive fixed), the hedged risk or the underlying is “interest rate”. In this case and provided the hedged item and the hedging instrument have similar main characteristics, their values will usually be expected to move in the opposite directions and offset each other and the existence of the economic relationship is easily demonstrated.

IFRS 9 does not provide any “bright line” and the use of quantitative techniques to demonstrate the existence of an economic relationship is not mandatory for all hedging relationships. For example, for non-sophisticated hedging relationships where the main characteristics of the hedged item and the hedging instrument are the same (see the example above), a qualitative demonstration is sufficient. In some circumstances, the existence of a statistical correlation is a good starting point to demonstrate the existence of an economic relationship.

However, an economic relationship does not exist (IFRS 9.B6.4.6) only as a consequence of the existence of a statistical correlation between the changes in values of the hedging instrument and the hedged item. An economic relationship is usually based either on a kind of receipt (e.g. the use of crude oil to produce jet fuel), or an economic rationale (e.g. existence of a peg between two currencies, link between the share price of a mining entity and the spot price of the underlying commodity...).

An economic relationship may exist even if it is expected that in some situations the hedging instrument’s and the hedged item’s respective values move in the same direction. This is for example the case when the underlying items are not the same but are economically related and the price differential between the two related underlying items moves while the underlying items themselves do not move significantly (IFRS 9.B6.4.5).

14.5.3.2.2. The effect of credit risk

IFRS 9 requires that entities take into account the credit risk associated with the hedging instrument and with the hedged item in assessing the hedge effectiveness of a hedging relationship.

Credit risk has always been identified as a source of ineffectiveness as it alters the change in fair value of the hedging instrument without a corresponding change in the hedged item. However, its importance in the effectiveness assessment is emphasised in IFRS 9, probably because this standard was written by the IASB shortly after a significant financial crisis.

Taking into account the credit risk movements (gains or losses) in the hedge effectiveness assessment could give rise to some ineffectiveness even when the main characteristics of the hedging instrument and the hedged item match as the credit risk movements will not be the same for the hedging instrument and the hedged item. Entities can exclude the credit risk associated to the hedged instrument from the hedging relationship to avoid some unintended movements in value of the hedged item. But they cannot
do the same for the hedging instrument the change in fair value of which will always come with a credit risk component (as required by IFRS 13, including adjustments for credit risk such as CVA, DVA...).

When credit risk movements dominate the changes in values of the hedging instrument or of the hedged item related to the economic relationship, hedge effectiveness requirements are not met and thus hedge accounting cannot be used. IFRS 9 does not specify thresholds to assess whether such domination exists for a hedging relationship, but entities must monitor the evolution of the credit risk on both the hedging instrument and the hedged item to ensure that there is no significant deterioration that could cause the hedge relationship to not be effective.

The domination mentioned above does not exist (see IFRS 9.B6.4.7) when accidently the changes associated with the credit risk dominate the changes in values of the hedging instrument or of the hedged item associated with the hedged risk. This could occur for example if there is little change in value in the hedged underlying item. Conversely such a domination exists when the credit risk gains / losses dominate significant changes in values of the hedging instrument or the hedged item associated with the hedged underlying.

In our opinion, the assessment of the effect of credit risk on the effectiveness of a hedging relationship should mainly be a qualitative one. In most cases entities apply general counterparty risk limits, general counterparty selection guidelines (such as a minimum rating, etc.), and other credit risk mitigation tools such as collateral agreements. Therefore, in most cases, taking into account such credit risk management mechanisms largely facilitates the assessment of the impact of credit risk on hedge effectiveness.

14.5.3.2.3. Hedge ratio

IFRS 9 in its Appendix A defines the hedge ratio as the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

In most situations, the hedge ratio is 1:1. However, a hedge ratio is frequently used when the hedging relationship is based on a proxy hedge (i.e. when the underlying item of the hedging instrument is not identical to the underlying item of the hedged item).

Requiring the hedge ratio to be derived from the quantity of the hedged item and of the hedging instruments an entity actually uses aims at aligning the hedge ratio used in the documentation of the hedging relationship with the actual risk management strategy / objective.

The requirement to avoid any imbalance in the weightings of the hedging instrument and of the hedged item is not aimed at authorising only perfect hedging relationships to be accounted for using hedge accounting but to ensure that entities do not use hedge ratios that are not consistent with their risk management strategies / objectives to merely achieve an accounting outcome (by introducing or avoiding accounting ineffectiveness).

Example 14.25

As explained in section 14.7.3, in a cash flow hedge relationship, under-effectiveness will not impact profit or loss whereas over-effectiveness will impact profit or loss. Consider an entity that chooses to document a given
The hedge ratio is determined upon the original hedging relationship designation. It must be monitored by the entity and, when relevant, be adjusted to reflect changes in the relationship between the hedging instrument and the hedged item. This mechanism known as “rebalancing” under IFRS 9 is further explained in section 14.9.

### 14.6. Methods for hedge effectiveness assessment and ineffectiveness measurement

#### 14.6.1. Hedge effectiveness assessment vs. hedge ineffectiveness measurement

As mentioned in section 14.5.3.1, hedge effectiveness assessment is different from hedge ineffectiveness measurement as:

- the former is required by IFRS 9 as a qualifying criterion for hedge accounting. It consists in documenting an existing economic relationship between the hedging instrument and the hedged item, taking into account the effect of credit risk and the use of the hedge ratio (see section 14.5.3.2.3); whereas
- hedge ineffectiveness corresponds to the extent to which the changes in the fair value of the hedging instrument actually match those on the hedged item. With limited exceptions, hedge ineffectiveness will always impact the profit or loss of the period (see sections 14.7.2.1 and 14.7.3).

#### 14.6.2. Assessment of hedge effectiveness

IFRS 9 does not prescribe a single method for the assessment of hedge effectiveness. Any method used by entities to assess the hedge effectiveness must take into account the main characteristics of the hedging instrument and of the hedged item and any expected sources of ineffectiveness.

The sophistication of the method to be used to assess the hedge effectiveness of a hedging relationship depends on the extent to which the main characteristics of the hedging instrument and of the hedged item match one each other:

- when the critical characteristics of the hedging instrument match (or are closely aligned to) the characteristics of the hedged item, a qualitative analysis of those critical terms may be sufficient to assess whether the hedge is effective (IFRS 9.B6.4.15).
- when the critical characteristics of the hedging instrument do not match (or are not closely aligned to) the critical characteristics of the hedged item, there will be a higher uncertainty on the ability of the hedging instrument to offset the change in value of the hedged item. In such situation, the entity may have to perform a quantitative analysis to conclude on its effectiveness assessment (IFRS 9.B6.4.16).
14.6.3. Measurement of hedge ineffectiveness

Hedge ineffectiveness measurement aims at determining the amount of ineffectiveness that must be recognised. With limited exceptions this ineffectiveness will be recorded in the profit or loss of the period.

When measuring hedge ineffectiveness, IFRS 9 requires entities to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

The most common sources of ineffectiveness are:
- a mismatch in the critical terms of the hedging instrument compared to the hedged item (timing, fixing, index...);
- the credit risk borne by the hedging instrument;
- a change in the hedged item’s risk profile occurring after the initial designation of the hedging relationship (e.g. a cash flow occurring later than initially expected);
- a financing component embedded in the hedging instrument that is not replicated in the hedged item (e.g. interest rate swap with a fair value different from zero at the date of initial designation of the hedging relationship).

14.6.4. Methods for hedge effectiveness assessment / ineffectiveness measurement

IFRS 9 does not prescribe a specific method for hedge effectiveness assessment whereas the ineffectiveness measurement must be performed in accordance with the Dollar offset method.

The next sections will present this Dollar offset method that must be used for ineffectiveness measurement and may be used for effectiveness assessment, as well as the main principle of linear regression that can be used for effectiveness assessment.

As a reminder, the methods applied by the entity for effectiveness assessment and measurement are to be mentioned and explained in the documentation of the hedging relationship.

14.6.4.1. Dollar offset method

The Dollar offset method involves comparing the change in fair values of the hedged item and of the hedging instrument.

One of the well-known approaches of the Dollar offset method is the hypothetical derivative method which compares the change in the fair value or cash flows of the actual hedging instrument with the changes in the fair value or cash flows of a “hypothetical” derivative that replicates the critical characteristics of the hedged item. IFRS 9.B6.5.5 considers that the hypothetical derivative is not a method in its own right but rather a mathematical expedient that can only be used to calculate the change in value of the hedged item. Consequently, it cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (conversely, a hypothetical derivative has to include all the critical characteristics of the hedged item).
Example 14.26

An entity issued a floating rate debt to Bank A. At the same time the entity enters a non-collateralised interest rate swap with a different counterparty to hedge its cash flow exposure related to the change in the floating rate. The entity documents this swap in a cash flow hedge relationship and will use the hypothetical derivative method to measure the hedge ineffectiveness of this hedging relationship. The entity bears a credit risk on the derivative counterparty. This risk may have an impact on the change in fair value of the hedging derivative. Even if all the derivative’s other critical terms match those of the hedged item, the hypothetical derivative cannot include this counterparty risk as it is specific to the hedging derivative and not embedded in the hedged item.

The hypothetical derivative method can also be used to analyse the sources of ineffectiveness.

The Dollar offset method (and its hypothetical derivative practical expedient) is commonly used for retrospective hedge effectiveness tests. It can also be used for prospective hedge effectiveness assessment if the entity is able to simulate the changes in the fair value of the hypothetical derivative and compare them with expected changes in fair value of the hedging instrument.

14.6.4.2. Regression analysis method

Regression analysis is a statistical process aiming at estimating the relationship / correlation between variables.

In the context of hedge accounting, entities may use the regression analysis to:

- demonstrate that an economic relationship between the hedging instrument and the hedged item (i.e. the hedging instrument and the hedged item move in the opposition directions and offset each other) exists; and
- choose the best hedge ratio before entering a hedging relationship.

Regression analysis is commonly based on historical data but can also be performed on forecast scenarios.

14.7. Accounting for qualifying hedging relationships

14.7.1. Three kinds of hedging relationships

Under IFRS 9, there are three types of hedging relationships, the accounting treatment of which is detailed in the next sections:

- **Fair value hedge**: this type of hedging relationship corresponds to a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss (see section 14.7.2 for the accounting treatment of such hedging relationships).

Example 14.27

An entity has issued a fixed rate bond. The entity enters a pay floating / receive fixed interest rate swap. The floating rate index paid on the swap is consistent with the yield curve used to calculate the fair value of the fixed rate bond. The other characteristics of the swap are aligned with those of the bond (nominal, maturity, coupon payment date, etc.). The entity’s hedging strategy is to hedge its exposure to the changes in fair value
of the bond caused by changes in interest rates. This hedging relationship is consistent with the definition of a fair value hedge.

— **Cash flow hedge**: this type of hedging relationship corresponds to a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component, of a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or of a highly probable forecast transaction, and could affect profit or loss (see section 14.7.3 for the accounting treatment of such hedging relationships).

**Example 14.28**

An entity plans to purchase a piece of equipment in 12 months for an amount denominated in a foreign currency. This transaction is considered as highly probable. The entity is exposed to the change in the foreign currency rate that could increase or decrease the price to be paid in its functional currency. The entity enters a foreign currency forward contract. The resulting net economic position is that the price to be paid is now a fixed amount of its functional currency. This kind of hedging strategy meets the definition of a cash flow hedge.

— **Net investment hedge**: this type of hedging relationship aims to hedge the net investment in a foreign operation as defined in IAS 21 (see section 14.7.4 for the accounting treatment of such hedging relationships).

It is interesting to note that hedging a risk of change in fair value may expose the entity to a cash flow risk and reciprocally. In the above Example 14.28, the entity is hedging the change in value of the fixed rate bond by swapping it into a floating rate instrument. But, doing so, it creates an exposure to change in cash flows indexed to this floating rate.

There are some situations where the hedging strategy may meet both the fair value hedge and the cash flow hedge definitions. In such situations the entity is free to choose which kind of hedging relationship it wishes to apply.

**Example 14.29**

An entity issued a foreign currency zero-coupon bond. To hedge the related foreign currency risk the entity enters a foreign currency forward receiving the foreign currency amount to pay the final redemption cash payment of the bond and paying a fixed amount of functional currency. This strategy can be documented either as a fair value hedge of the bond, or as a cash flow hedge of the final redemption cash payment.

**14.7.2. Accounting for Fair Value Hedge**

**14.7.2.1. General principle**

Subject to a fair value hedge relationship meeting the qualifying criteria, the hedging relationship is accounted for as follows (IFRS 9.6.5.8):

— the gains or losses on the hedging instrument are recognised in profit or loss (A);

— the carrying amount of the hedged item is adjusted to reflect gains or losses related to the changes in fair value according to the hedged risk (B);

— any ineffectiveness (i.e. difference between (A) and (B) above) is recognised in the profit or loss of the period.
In practice a fair value hedge relationship has generally little impact on the accounting treatment of the hedging instrument but modifies the accounting treatment of the hedged item so that their change in value offset one another in the profit or loss of the period. However, this principle comes with some exceptions.

Any adjustment to the carrying amount of a financial instrument measured at amortised cost is amortised to profit or loss. This amortisation may begin as soon as an adjustment exists and may not begin later than when the hedged item ceases to be adjusted (IFRS 9.6.5.10). This amortisation is performed by adjusting the effective interest rate of the hedged item when the amortisation begins.

### 14.7.2.2. Fair value hedge of an equity instrument classified as fair value through other comprehensive income

As explained in chapter 7, an entity may classify any equity instrument, at its initial recognition date, as fair value through other comprehensive income. In such case, any change in value accumulated in other comprehensive income will never impact the profit or loss of the entity.

As an exception to the definition of a fair value hedge that requires that a hedged risk must have an impact in profit or loss, an entity has the possibility to document a hedging relationship on such equity instruments.

In such case, the fair value hedge relationship must be accounted for as follows (IFRS 9.6.5.8):

- gains or losses on the hedging instrument are recognised in other comprehensive income;
- gains or losses on the equity instrument classified as fair value through other comprehensive income remain in comprehensive income;
- any ineffectiveness is thus recognised in other comprehensive income.

#### Example 14.30

At 1 January 202X, Entity A, the functional currency of which is euro, buys a share of Company X for €100. The entity elects to recognise the changes in the fair value of this share through other comprehensive income.

To hedge against changes in the fair value of the share, Entity A contracts a forward to sell the share at €100. To simplify this illustrative example, assume that the spot price of the share is always equal to its forward price. The forward maturity is 1 April 202X. The entity documents this forward as a hedge of the share in a fair value hedge relationship.

At 31 March 202X, the fair value of the share is €130. Entity A recognises the change in the fair value of the share through other comprehensive income for €30. At the same date, the fair value of the forward contract amounts to €-30 which Entity A recognises in other comprehensive income (the net impact on other comprehensive income is thus nil).

### 14.7.2.3. Fair value hedge of an SPPI financial asset classified as fair value through other comprehensive income

When the hedged item is an “SPPI” instrument for which the changes in fair value are recognised in other comprehensive income (i.e. it is an “SPPI” instrument managed in a “held to collect cash flows and sell” business model), the fair value hedge relationship is accounted for as follows:
the gains or losses on the hedging instrument are recognised in profit or loss;
— the gains or losses of the hedged instrument according to the hedged risk are recognised in profit or loss, any remaining change in fair value of the hedged instrument remains in other comprehensive income;
— any ineffectiveness of the hedging relationship is thus recognised in the profit or loss of the period.

**Example 14.31**

At 1 January 202X, Entity A, the functional currency of which is euro, purchases a non-amortising, non-callable debt instrument for €100. The instrument carries fixed interest of 5%, will mature in 3 years and meets the conditions to be accounted for at fair value through other comprehensive income.

At the same date, Entity A contracts an interest rate swap (pay variable / receive fixed) with the same main characteristics as the debt instrument to hedge against fluctuations in fair value of the debt instrument related to changes in interest rates. The swap is therefore documented in a fair value hedge relationship.

At 31 March the fair value of the debt instrument increased to €130, €25 due to changes in interest rates and €5 due to changes in the credit risk of the instrument. Applying IFRS 9 requirements for fair value hedges, Entity A recognises the change in the fair value of the debt instrument related to interest rates (the hedged risk component) of €25 in profit or loss. The remaining change in value of the debt remains recorded in other comprehensive income for €5. At the same date, the change in fair value of the hedging instrument (interest rate swap) amounts to €-24 and is recorded in the profit or loss of the period. The net impact in profit or loss is €1 for the first quarter of 202X and reflects that the hedging relationship bears some ineffectiveness.

Even if the carrying amount of the hedged item is not adjusted by the hedging relationship (as the hedged instrument is already measured at fair value), its impact in profit or loss is the same as for any instrument measured at amortised cost. Therefore, the adjustment mechanism of the effective interest rate that exists for instruments classified at amortised cost being hedged in a fair value hedge relationship to amortise the fair value hedge adjustment to their carrying amount is applied. The offsetting entry of the effect of the adjusted effective interest rate in profit or loss will be other comprehensive income (instead of the amortisation of the adjustment to the carrying amount of amortised cost instruments).

**14.7.2.4. Fair value hedge of an unrecognised firm commitment**

When the hedged item is an unrecognised firm commitment (or a component thereof), a fair value hedge relationship is accounted for as follows:

— the gains or losses on the hedging instrument are recognised in profit or loss;
— the cumulative change in value of the hedged item since the initial designation of the hedging relationship is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss;
— any ineffectiveness is thus recognised in the profit or loss of the period.

When the firm commitment leads to the recognition of an asset or a liability, the amount accumulated in the financial position for changes in the values of the hedged item adjusts the initial carrying amount of the asset or liability generated by the settlement of the firm commitment (IFRS 9.6.5.8).
Example 14.32

At 1 January 202X, Entity A, the functional currency of which is euro, enters a firm commitment to purchase equipment for £10 million the delivery of which is planned in 9 months. At the same date, Entity A enters a forward contract to buy £10 million against €12 million in 9 months (payment of the equipment is expected to occur at the delivery date).

Entity A uses only the spot element of the forward contract as the hedging instrument and recognises the changes in forward points directly in profit or loss (see section 14.8.2).

The table below summarises the evolution of the exchange rates and the total fair value of the forward contract:

<table>
<thead>
<tr>
<th>Date</th>
<th>01/01/202X</th>
<th>31/03/202X</th>
<th>30/06/202X</th>
<th>30/09/202X</th>
</tr>
</thead>
<tbody>
<tr>
<td>£/€</td>
<td>1,10</td>
<td>1,15</td>
<td>1,00</td>
<td>1,30</td>
</tr>
<tr>
<td>Forward contract fair value (in € million)</td>
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<td>1,0</td>
<td>-1,0</td>
<td>1,0</td>
</tr>
<tr>
<td>o/w spot element</td>
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</tr>
<tr>
<td>o/w forward element</td>
<td>-</td>
<td>0,5</td>
<td>0,0</td>
<td>-1,0</td>
</tr>
</tbody>
</table>

At 1 January 202X, Entity A does not recognise any journal entry as the forward contract was entered into at market conditions (i.e. with a nil fair value).

At 30 March 202X, Entity A recognises a liability for the changes of the value of the hedged item for €0.5 million ((1.15€/£ – 1.10€/£) * £10 million) with a corresponding impact in profit or loss and an asset for €1 million corresponding to the fair value of the forward contract. The profit or loss impacts of the hedged item and of the spot element are presented within the same line and lead to a nil impact. The total profit or loss impact corresponds to the forward element value change (€0.5 million).

At 30 June 202X, Entity A reverses the liability recognised in the first quarter (for €0.5 million) and recognises an asset for €1 million corresponding to the value of the hedged item. This leads to a profit or loss impact of €1.5 million. At the same date, the forward contract corresponds to a liability of €1 million thus entity A reverses the asset recognised in the first quarter for €1 million and recognises a liability for the same amount leading to a profit or loss impact of €2 million of which €1.5 million recognised in the same line as the hedged item (leading to a nil impact in this line) and €0.5 million corresponding to the change in the value of the forward element.

At 30 September 202X, Entity A reverses the asset corresponding to the value of the hedged item recognised at the end of the second quarter and recognises a liability for €2 million corresponding to the value of the hedged item at the end of the third quarter. This leads to a profit or loss impact of €-3 million. At the same time, Entity A reverses the liability recognised in the second quarter related to the fair value of the forward contract and recognises an asset for €1 million which leads to a profit or loss impact of €2 million of which €3 million corresponding to the change in the value of the spot element and €-1 million corresponding to the change in the value of the forward element.

At the same date, Entity A receives the equipment and recognises it in the financial position at the exchange rate at this date for €13 million (£10 million * 1.3€/£). The entity then applies the requirements of IFRS 9.6.5.8 and reverses the liability (€2 million) corresponding to the value of the hedged item and incorporates its amount in the carrying amount of the equipment. Consequently, the equipment is recognised in the financial position for a value of €11 million consistent with the hedged level of the spot rate at the hedging relationship inception date.
14.7.3. Cash Flow Hedge

Subject to a cash flow hedge relationship meeting the qualifying criteria, the hedging relationship is accounted for as follows (IFRS 9.6.5.11):

— the accounting treatment of the hedged item over the life of the hedging relationship remains unaffected;

— a cash flow hedge reserve is created in other comprehensive income and dynamically adjusted to the lesser of the following:
  > the cumulative gain or loss on the hedging instrument from inception of the hedging relationship;
  and
  > the cumulative change in fair value of the hedged item from inception of the hedge.
  > This is frequently referred to as the “lower of” accounting of cash flow hedges. The amount recorded in other comprehensive income is considered to be the effective part of the hedging relationship;

— any remaining gain or loss on the hedging instrument is considered as ineffectiveness and is recognised in profit or loss.

It can be noted that the “lower of” approach is not symmetrical so that in practice, only over-effectiveness (i.e. when the change in value of the hedging instrument in absolute terms exceeds the change in value of the hedged item) will impact profit or loss whereas under-effectiveness will not.

The accounting treatment of the amount accumulated in the cash flow hedge reserve within other comprehensive income depends on the nature of the hedged item:

— If the hedged item subsequently leads to the recognition of a non-financial asset or non-financial liability, the entity removes it from the cash flow hedge reserve and incorporates it directly in the cost or other initial carrying amount of the non-financial asset or liability. This mechanism is often called “basis adjustment”.

— If the hedged forecast transaction subsequently becomes a firm commitment for which fair value hedge accounting is applied, the amount accumulated in the cash flow hedge reserve is removed and incorporated in the asset / liability resulting from the firm commitment.

— In any other situation the amount accumulated in the cash flow hedge reserve is reclassified to the profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (e.g. when the hedged foreign currency cash inflow impacts profit or loss as revenue in accordance with IFRS 15).

This latter accounting treatment illustrates the importance of the clear and precise designation of the hedged item in order for the entity to be able to perform the reclassification from other comprehensive income to profit or loss with the right timing to match the hedged exposure.

However, if the amount accumulated in the cash flow hedge reserve is a loss which the entity will not recover in full or in part in one or more future periods, the entity immediately reclassifies this loss to profit or loss as a reclassification adjustment.
14.7.4. Net Investment Hedge

14.7.4.1. What is a net investment hedge?

IAS 21.8 defines net investment in a foreign operation as the amount of the reporting entity’s interest in the net assets of that operation. This includes monetary items for which settlement is neither planned nor likely to occur in the foreseeable future (e.g. some long-term receivables or intragroup loans). IFRIC 16.1 specifies that the foreign operation could be a subsidiary, an associate, a joint venture or a branch.

A net investment is generally a long-term investment in an entity the functional currency of which is different from that of the holding company, which creates an exposure to the changes in foreign currency rates. This risk ultimately impacts the profit or loss of the group upon the disposal of the foreign operation. IAS 21 requires the reporting entity’s net investment in a foreign operation to be translated into the parent’s functional currency at the closing exchange rate and all exchange differences to be recognised in other comprehensive income until the reporting entity disposes of the foreign operation (IAS 21.48-49). Upon disposal of the foreign operation, the amount accumulated in other comprehensive income is reclassified to profit or loss.

Entities may have as risk strategy to hedge their net investment against foreign currency risk using derivative and non-derivative financial instruments.

14.7.4.2. Hedged item in a net investment hedge

IFRIC 16.10 stipulates that hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity’s functional currency. Hedging exchange differences arising between the functional currency of the foreign operation and the reporting entity’s presentation currency is not permitted.

This position can be explained by the fact that, unlike the functional currency for which IAS 21 details how it is determined, there is no restriction on the presentation currency that an entity can use for the presentation of its financial statements. Thus, economically, there is not always a real exposure to this currency as it is the case for the functional currency. In practice, when the group presentation currency is identical to the functional currency of the group’s parent company, this prohibition of hedging net investment against the presentation currency will not be a constraint for the group.

Entities may qualify as a hedged item the net investment in the reporting entity’s financial statements for an amount equivalent to its carrying amount or less.

A foreign operation may be held by intermediate parent(s). The hedged exchange differences do not need to relate to the ultimate parent’s functional currency but may relate to any intermediate parent’s functional currency.

Example 14.33

The following example (extracted from IFRIC 16.AG2) shows how to apply IFRS 9 requirements for a net investment hedge in a group situation:
A parent entity wholly owns (directly and indirectly) 3 subsidiaries for which the net investment is reported in the following figure:

**Figure 14.3**

A parent entity wholly owns (directly and indirectly) 3 subsidiaries for which the net investment is reported in the following figure:

![Diagram showing the financial relationships between the parent and the subsidiaries.](image)

In this case, the group presented above can hedge any of the following:

- the parent can hedge its net investment in each of the subsidiaries A, B and C for the foreign exchange risk between their respective functional currency and its functional currency (EUR);
- the parent can hedge the USD / GBP foreign exchange risk between the functional currencies of subsidiaries B and C.

Besides, subsidiary B can document a hedging relationship for the foreign exchange risk arising between the functional currency of subsidiary C (USD) and its functional currency (£) in its own consolidated financial statements.

### 14.7.4.3. Hedging instruments in a net investment hedge

There is no restriction on the use of eligible hedging instruments (see section 14.4 for eligible hedging instruments) for net investment hedges: entities may use derivative and financial non-derivative instruments to hedge the exchange differences arising from foreign operations. Hedging instruments may be held by any entity within the group as long as the documentation of the hedging relationship permits the tracking of these hedging instruments and the accounting for the hedging gains and losses correctly.

### 14.7.4.4. Accounting treatment

The accounting treatment of net investment hedging relationships is similar to the accounting treatment applicable for cash flow hedging relationships except that the amounts accumulated in other comprehensive income are reclassified to profit or loss only when the investment is disposed of or liquidated.
14.8. Time value of options and forward elements of forward contracts

IFRS 9 introduced new accounting requirements that are specific to hedging relationships based on options and forward contracts.

14.8.1. Time value of options

14.8.1.1. Time value vs. intrinsic value

The fair value of an option consists of two components:

— the **intrinsic value** which represents the value of the option if it were to be exercised at the date of valuation. Consider the following example:

**Example 14.34**

At 1 January 2018, Entity A buys a call option to buy 1 share of Entity B for €30 any time until 31 December 2018. The price at which an option can be exercised is called the “strike” (here it is €30). The market price of the share at 1 January 2018 is €29.

At this date the intrinsic value of the put option is nil as the market price is lower than the strike price. At 30 June 2018, the market price of the share increases to €32 thus the intrinsic value of the option at this date amounts to €2 (if Entity A chooses to exercise its put option it would buy the share at a price which is €2 lower than market price).

An option is said “in the money” when the intrinsic value is positive for the buyer of the option so that he has a financial interest to exercise the option. An option is said “at the money” when the spot price of the underlying equals the strike price. An option is said “out of the money” in any other situation.

— the **time value** which is generally measured by difference between the fair value of the option and its intrinsic value. The time value has a probabilistic nature and economically represents the probability that an “out of the money” option becomes “in the money” or that an “in the money” option becomes “out of the money”. As options are generally purchased out of the money, a simplified way to explain the time value of an option is to consider that it represents the probability that the buyer of the option will have a financial interest to exercise the option.

> Time value is mainly influenced by the time left to maturity (the longer the period, the higher the time value), the difference between the spot price and the strike (the closest the spot price is to the strike, the higher the probability for the option to become in the money, the higher the time value), the volatility of the underlying item...

> Thus, economically, the time value corresponds to an “insurance” premium paid by the investor to hedge against unfavourable evolutions of the price of an underlying item.

Generally, an option is purchased when it is “out of the money” so that its intrinsic value is nil and the whole fair value of the option contract consists in its time value. The buyer of the option pays a premium (equivalent to the time value of the option) to be protected against the unfavourable evolutions of the spot price of the underlying. This mechanism is, from an economic point of view, pretty similar to the premium payment of an insurance contract.
The time value component of an option at maturity is always zero. Therefore, when an entity purchases an out of the money option, the entity knows that the premium paid (which represents the initial time value of the contract) represents the cost of the hedge.

### 14.8.1.2. Documentation of options as hedging instruments

Options can be designated as a hedging instrument under IFRS 9 (see section 14.4.1.2 for limitations regarding written options). An entity can elect to document an option as a hedging instrument either:

- **only for the intrinsic value** of the designated option. This is generally the best way to maximise the effectiveness of the hedging relationship. In this case IFRS 9 provides a specific accounting treatment for the time value component, excluded from the hedging relationship, that is explained further in the next section; or,

- **in its entirety**. In this case, all changes in fair value of the option will be considered in the effectiveness assessment and measurement of the hedging relationship.

When an entity designates all the fair value of an option as the hedging instrument in a hedge relationship, the changes in the time value component of the option’s fair value result in ineffectiveness as this component is not offset by similar changes in the fair value of the hedged item (unless the hedged item contains optionality). Entities using all the fair value of an option as the hedging instrument have to monitor the level of ineffectiveness during the life of the hedge relationship and recognise its impacts in profit or loss. Under some circumstances (for example, if the ineffectiveness is so important that it is not possible to demonstrate the existence of an economic relationship between the hedged item and the hedging instrument), the entity may be obliged to discontinue the hedge relationship.

### 14.8.1.3. Accounting treatment of time value of option when it is excluded from the hedging relationship

#### 14.8.1.3.1. General principles

When an entity separates the intrinsic value and the time value component of an option to document only the intrinsic value as a hedging instrument, it accounts for the time value component as follows (IFRS 9.6.5.15):

**Step 1:** determine whether the time value is fully aligned with the hedged item. The non-aligned portion will have its change in fair value recognised in profit or loss, and the aligned portion will be treated in accordance with step 2 (see section 14.8.1.3.3 for further guidance on aligned time value).

**Step 2:** determine whether the option hedges a time period-related hedged item (go to step 3) or a transaction-related hedged item (go to step 4) (see section 14.8.1.3.2 for further guidance on the distinction between time period and transaction-related hedged item).

**Step 3:** the aligned time value component of an option hedging a time period-related hedged item is accounted for as follows:

- any change in fair value of the aligned time value component is recognised in other comprehensive income and accumulated in a separate component of equity;
— the initial aligned time value is amortised on a systematic and rational basis over the time period during which the effective part of the hedge (i.e. the intrinsic value) could affect profit or loss (or other comprehensive income in the specific situation of hedge of an equity instrument classified at fair value through other comprehensive income). This amortisation is performed by a reclassification from the separate component of equity to profit or loss as a reclassification adjustment.

Step 4: the aligned time value component of an option hedging a transaction-related hedged item is accounted for as follows:

— any change in fair value of the aligned time value component is recognised in other comprehensive income and accumulated in a separate component of equity;

— the initial aligned time value is treated differently depending on the nature of the hedged item:

  > If the hedged item subsequently results in the recognition of a non-financial asset or a non-financial liability, or a firm commitment for a non-financial asset or a non-financial liability for which hedge accounting is applied, the entity removes the amount from the separate component of equity and includes it directly in the initial carrying amount of the asset or the liability. This is not a reclassification adjustment and hence does not affect other comprehensive income.

  > In all other situations, the amount is reclassified from the separate component of equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss.

The following figure presents a simplified overview of the accounting treatment of the time value of options when only the intrinsic value is documented as a hedging instrument.

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**Figure 14.4**

An option is designated as a hedging instrument on the basis of its intrinsic value

- Are the critical terms of the option aligned with those of the hedged item?
  - Yes
  - No: mandatory split

  The time value at inception (premium) must be treated as a cost of hedging: subsequent changes in the fair value of the time value of the option are recognised in OCI

Is the hedged item related to a transaction or to a time period?

- Transaction related
  - The hedged transaction results in the recognition of a non-financial instrument

- Time period related
  - The hedged transaction results in the recognition of a financial instrument

  The time value of the option at inception is transferred from OCI and incorporated into the initial carrying amount of the non-financial item

  The time value of the option at inception is recycled from OCI to P&L in order to amortise the time value of the option at inception (premium) over the life of the hedging relationship

  Changes in the fair value of the non-aligned portion of the time value recognised in P&L, as for ineffectiveness

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14.8.1.3.2. Distinction between transaction-related hedged item and time period-related hedged item

IFRS 9 provides some guidance on the distinction between a transaction-related hedged item and a time period-related hedged item (IFRS 9.B6.5.29). This distinction is important as it directly impacts the way the initial time value of the option is accounted for as explained in section 14.8.1.3.1.

For transaction-related hedged items, the time value of the option is considered as part of the cost of the transaction. This is for example the case when an entity hedges an expected purchase of inventory or a future sale in a foreign currency.

For time-period related hedged items, the time value of the option is considered as the cost of protection against risk during a given period. This is for example the case when an entity hedges a commodity inventory against changes in fair value over one year.

In practice this distinction is sometimes difficult to apply and qualifying a hedged item may need the use of judgement.

14.8.1.3.3. Situation where the time value is not aligned with the hedged item

The accounting treatments described in step 3 and 4 above apply to the entire time value component only when the critical terms of the option designated as the hedging instrument and the hedged item are aligned. When this is not the case, and thus, the actual time value of the option differs from that of an aligned option, entities must determine the amount to accumulate in a separate component of equity as follows (IFRS 9.B6.5.33):

— If, at inception of the hedging relationship, the actual time value is higher than the aligned time value, entities have to:

  > determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and

  > account for the differences in the fair value changes between the two time values in profit or loss.

— If, at inception of the hedging relationship, the actual time value is lower than the aligned time value, entities must determine the amount to be accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:

  > the actual time value; and

  > the aligned time value.

14.8.1.4. Illustrative examples

The figures below present examples of how to account for the time value of an option applying hedge accounting.
**Figure 14.5**

Accounting treatment of the time value of an option with a hedged item related to a time period

- Hedged risk: value of nickel inventory recorded in the company’s balance sheet
- Hedging instrument: purchase of a put at T0
- Time value at inception (premium): €10
- Duration of the hedge: 10 reporting periods

<table>
<thead>
<tr>
<th>Time value (balance sheet)</th>
<th>10</th>
<th>12</th>
<th>8</th>
<th>9</th>
<th>7</th>
<th>8</th>
<th>6</th>
<th>4</th>
<th>5</th>
<th>2</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time value at inception yet to be amortised</td>
<td>10</td>
<td>9</td>
<td>8</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>2</td>
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</tr>
<tr>
<td>Balance recognised in OCI (balance sheet)</td>
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<td>2</td>
<td>1</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>1</td>
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<tr>
<td>Amortisation of time value at inception recognised in P&amp;L</td>
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<td>-1</td>
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<td>-1</td>
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<td>-1</td>
</tr>
</tbody>
</table>

**Figure 14.6**

Accounting treatment of the time value of an option with a hedged item related to a transaction

- Hedged risk: sales in USD in N+9
- Hedging instrument: purchase of a EUR call / USD put at T0
- Time value at inception: €10
- Duration of the hedge: 10 reporting periods

<table>
<thead>
<tr>
<th>Time value (balance sheet)</th>
<th>10</th>
<th>12</th>
<th>6</th>
<th>9</th>
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<th>8</th>
<th>1</th>
<th>4</th>
<th>5</th>
<th>2</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Time value at inception yet to be amortised</td>
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<tr>
<td>Balance recognised in OCI (balance sheet)</td>
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<td>-9</td>
<td>-6</td>
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<tr>
<td>Recognition of time value in P&amp;L</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>-10</td>
</tr>
</tbody>
</table>
14.8.2. Forward element of a forward contract

The fair value of forward contracts is not only impacted by changes in the spot rates of the underlying item but also by changes in the forward elements.

The difference between the spot rate and the forward rate is explained by various factors that are specific to each underlying item. For example, the forward element of a foreign currency forward will be mainly driven by the change in the interest rate curve of each currency whereas the forward element of a commodity forward contract may be driven by interest rate, transportation and storage cost.

Under IFRS 9 (IFRS 9.6.5.16), entities hedging with forward contracts can choose between three different ways to document the forward instrument as hedging instrument:

— documenting the forward contract in its entirety as a hedging instrument (including the forward elements);
— documenting only the change in the spot rate element as a hedging instrument and recognising any change in the forward element directly in the profit or loss; or
— documenting only the change in the spot rate element as a hedging instrument and applying to the change in value of the forward element the same accounting treatment as that described above for the changes in the time value of options (see section 14.8.1.3).

This choice is made freely by the entity, hedging relationship by hedging relationship. The entity’s decision is mentioned in the hedging documentation.

Example 14.35

At 1 January 202X, Entity A, the functional currency of which is euro, expects to buy some equipment in 12 months for £10 million (the transaction is highly probable). Entity A’s foreign currency risk management strategy is to hedge all transactions in foreign currency that amount to the equivalent of €2 million or above. Hence, at the same date (1 January 202X), Entity A enters a forward contract to buy £10 million in exchange for €14 million in 12 months to hedge against unfavourable exchange rates changes. Entity A designates only the spot element as the hedging instrument and considers the forward element as a hedge cost. In this case, the hedge concerns a transaction (equipment purchase) and not a period, thus both the changes in the value of the spot element and the forward element are accumulated in a separate component of equity until the recognition of the equipment in the financial position. At 1 January 2020(X+1), Entity A receives the equipment and recognises in the financial position at the exchange rate prevailing at this date. The spot exchange rate is £1 = €1.3. The equipment is recognised in the financial position for €13 million. The amount accumulated in the separate component of equity for changes in the value of the forward contract is €-1 million. This corresponds to the gain or loss on the differential between the forward rate of the forward contract and the spot exchange rate at the date of the transaction. This amount is removed from the separate component of equity to adjust the initial carrying amount of the equipment. Ultimately, the equipment is recognised in Entity A’s financial position at the forward rate of the forward contract.

14.8.3. Foreign currency basis spread of financial instruments

Foreign currency basis spread is a component of a financial instrument that reflects the market’s appetite difference for a currency relatively to another. This element is generally relatively small when two “strong” currencies are compared. But it can be quite significant when a strong currency such as EUR or USD is compared to the currency of an emerging country.
For example, if an entity is considering exchanging USD against the currency of an emerging country, the entity that will sell USD and receive the emerging currency will be “receiving” the foreign currency basis spread from the counterparty. This foreign currency basis spread between two currencies may change overtime and thus influence the market price of a financial instrument.

IFRS 9 explicitly addresses the accounting treatment of this foreign currency basis spread of financial instruments when it is embedded in a hedging instrument. IFRS 9.6.5.16 states that the requirements described in section 14.8.2 for the forward component of a forward contract are also applicable to the foreign currency basis spread of financial instruments documented as hedging instruments.

### 14.9. Rebalancing

#### 14.9.1. Definition

The concept of rebalancing is directly connected to the concept of hedge ratio explained in section 14.5.3.2.3.

A rebalancing refers to the adjustment made to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirement presented in section 14.5.3.2.3 (IFRS 9.B6.5.7).

A rebalancing of the hedging relationship must occur each time that:

- it is related to a change in the relationship between the hedging instrument and the hedged item;
- without any change to the risk management; and
- the change aims to maintain a hedge ratio that complies with the hedge effectiveness requirements.

In most situations, rebalancing will be a matter of fact based on actual risk management decisions. Rebalancing is not optional and should occur each time the above conditions are met.

Entities may change the quantities designated as hedging instruments or hedged items for other reasons than those mentioned above (for example because part of a forecast transaction is no longer expected to occur or the credit risk of the counterparty to the hedging instrument is significantly deteriorated...). In these cases, “rebalancing” is not applicable and entities would apply other requirements of IFRS 9. For example, if an entity decreases the quantity of designated hedging instruments because a part of a future transaction is no longer expected to occur, the hedge relationship is to be partially discontinued (see section 14.10).

#### 14.9.2. Accounting for rebalancing

When rebalancing is required, entities measure and account immediately for any ineffectiveness that arose before the adjustment of the hedge ratio (IFRS 9.B6.5.8).

Subsequent consequences of rebalancing depend on the way the hedge ratio is adjusted. The impacts are limited to the consequences described below (all other accounting treatments of the hedging relationship remains unaffected) (IFRS 9.B6.5.17-20):
— The hedge ratio is adjusted by increasing the volume of the hedged item: from the date of the rebalancing, the changes in the value of the hedged item also include the changes in value of the additional volume of the hedged item.

— The hedge ratio is adjusted by decreasing the volume of the hedged item: from the date of the rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship.

— The hedge ratio is adjusted by decreasing the volume of the hedging instrument: from the date of the rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship.

— The hedge ratio is adjusted by increasing the volume of the hedging instrument: from the date of the rebalancing, the changes in the fair value of the hedging instrument also include the changes in the value of the additional volume of the hedging instrument.

Finally, a rebalancing will also trigger the need to update the analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term. The hedging documentation is updated accordingly (new hedge ratio, new effectiveness assessment...) (IFRS 9.B6.5.21).

14.9.3. Illustrative example

Example 14.36

The example below explains how to apply IFRS 9’s rebalancing requirements.

An entity, the functional currency of which is EUR, is considering a highly probable future revenue arising from the sale of equipment in 12 months. The revenue will be denominated and paid in Currency X (CX100 million). There is no traded derivative to hedge against fluctuations in the exchange rates EUR/CX. The entity decides to hedge the expected revenue using a currency derivative denominated in a currency CY that is well correlated with the currency CX and for which derivatives are traded in the market.

The entity performed statistical analysis and established that the current relationship between CY and CX remained stable around 1 CX = 1.1 CY. The entity uses a derivative with a nominal of CY91 million (100 /1.1) to hedge the revenue denominated in CY. A cash flow hedge relationship is documented between this CY derivative and the CX highly probable cash inflow.

Six months after the initial designation, the entity updates its statistical analysis and realises that the hedge ratio changed to 1 CX = 1.05 CY. The entity decides to adjust the quantity of CY hedging instrument used to hedge its CX exposure. The quantity of hedging instrument documented in the hedging relationship is increased so that from now on, a derivative of CY 95 million is documented as a hedge of a future cash inflow of CX 100 million.

This adjustment reflects a change in the relationship between CX and CY and it is consistent with the actual risk management of the entity (i.e. the risk strategy remained unchanged). By increasing the quantity of hedging instrument in the relationship, the entity will avoid remaining in an imbalanced situation under which the hedging relationship could remain constantly in an under-effectiveness situation where economic ineffectiveness would not have been recognised due to the “lower of” test of the cash flow hedge accounting (see section 14.7.3). Therefore, the entity treats it as a rebalancing. The accounting of the hedged item, and the previously designated part of the hedging instrument remain unaffected. From the rebalancing date onwards, an additional quantity of CY4 million will be documented as hedging instrument.

The entity will update its hedging documentation accordingly, mentioning that the new hedge ratio is now 1 CX = 1.05 CY.
14.10. Hedge discontinuation

14.10.1. When to discontinue a hedging relationship

A hedging relationship has to be discontinued prospectively when and only when the qualifying criteria are no longer met (after taking into account the effect of rebalancing when applicable) (IFRS 9.6.5.6).

This is, for example the case when:

— the hedging instrument expires or is sold, terminated or exercised. For the purpose of hedge relationship discontinuation, the replacement or rollover of a hedging instrument is not an expiration or a termination if such a replacement or rollover is part of, and consistent with, the risk management objective.

— the hedged item is sold, extinguished or no longer expected to occur;

— the hedge effectiveness requirements are no longer met (see section 14.5.3.2);

— the entity changed its risk management objective (see section 14.2).

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (IFRS 9.6.5.6).

Voluntary discontinuation of hedge accounting relationships that still meet the qualifying criteria, and for which the risk management objective is unchanged, is not permitted under IFRS 9 (IFRS 9.B6.5.23).

For the purpose of hedge discontinuation, a hedging instrument is not expired or terminated if:

— as a consequence of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. When the parties to the hedging instrument replace their original counterparties with different counterparties the requirement above is met only if each of those parties effects clearing with the same central counterparty; and

— other changes, if any, to the hedging instrument are limited to those that are necessary to perform such a replacement of the counterparty (IFRS 9.6.5.6).

14.10.2. Accounting for hedging relationship discontinuation

14.10.2.1. General principle

A hedging relationship must be discontinued from the date where the conditions mentioned in the precedent sections are met. The effect of the hedge accounting relationship has to be applied until that date, including any ineffectiveness measurement and recognition.

The effects of hedge accounting discontinuation are always prospective only.
14.10.2.2. Discontinuing a fair value hedge

When discontinuing a fair value hedge relationship (IFRS 9.6.5.8):

— the hedging instrument continues to be measured at fair value with changes in fair value recognised in profit or loss, unless it is derecognised or used in another hedging relationship; and

— the hedged item ceases prospectively to be adjusted for changes in its fair value attributable to the hedged risk.

The hedged item accounting treatment reverts to the measurement method that applies to its classification. Any adjustment created by the fair value hedge relationship on the hedged item’s carrying amount of instruments measured at amortised cost has to be amortised to profit or loss in accordance with the treatment described in section 14.7.2.

Example 14.37

At 1 January 202X, Entity A issues a fixed rate debt for €100 million repayable in five years. At the same date, Entity A enters an interest rate swap (pay variable / receive fixed) with the same maturity and designates it as a fair value hedge of the debt.

At the end of 202(X+2), Entity A changes its risk management objective and decides to stop hedging its debt. The entity cancels the swap at market conditions. The fair value hedge relationship is discontinued.

The cumulative adjustment to the debt at the end of 202(X+2) amounts to €4 million. The entity will amortise this amount to profit or loss over the remaining life of the debt by using an adjusted effective interest rate.

14.10.2.3. Discontinuing a cash flow hedge

When discontinuing a cash flow hedge relationship (IFRS 9.5.12):

— the cash flow hedge reserve created in other comprehensive income ceases to be adjusted by the change in value of the hedging instrument;

— if the hedged future cash flows are still expected to occur, that amount remains in the cash flow hedge reserve until the future cash flows occur, and then the accounting treatment described in section 14.7.3 is applied consistently with the nature of the hedged transaction;

— if the hedged future cash flows are no longer expected to occur, that amount is immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment.

Example 14.38

At 1 January 202X, Entity A, the functional currency of which is euro, expects (the transaction is highly probable) that it will disburse $500 million to acquire a new business in 6 months.

Entity A enters at the same date into a forward contract to receive $500 million and pay €490 million in 6 months to hedge against unfavourable changes in the exchange rates. Entity A designates as a hedging instrument only the spot element of the forward contract (the spot exchange rate amounts at 1 January 202X to €1 = $1).

At 31 March 202X (the spot rate at this date amounts to €1 = $1.05), the transaction is still highly probable but the acquisition price is modified and reduced to $450 million. Entity A decides to stop hedging the acquisition
price and cancels the forward at market conditions. Assuming that the hedging relationship had been fully effective, the accumulated cash flow hedge reserve amounted to €24 million (500 * (1 - 1/1.05)).

The initially hedged cash flows are separated in two parts:

> $50 million that are no longer expected to occur. The accumulated cash flow hedge reserve related to this part is immediately recorded in profit or loss for €2.4 million (24 * 50 / 500).

> $450 million that are still expected to occur. The accumulated cash flow hedged reserve related to this part remains in other comprehensive income until the acquisition occurs.

It is interesting to note that, although an expected cash flow that is no longer highly probable triggers the discontinuation of the hedging relationship as the qualifying criteria for cash flow hedge are no longer met, it may still be expected to occur.

There are situations where the hedged risk ceases to exist, but the hedged cash flow is still expected to occur.

**Example 14.39**

An entity is considering issuing a new fixed rate debt in 12 months. The bond issue is considered as highly probable but its interest rate will only be fixed 1 month before the issue. To hedge the risk of increase in interest rate over the first 11 months, the entity enters a forward starting interest rate swap and documents the swap in a cash flow hedge relationship of the bond. The risk being hedged is the change in the future interest rate expense of the entity on the future bond, according to changes in benchmark interest rate.

At the end of the 11th month, the entity will discontinue its hedging relationship because the hedged risk will cease to exist as the rate of the bond will be fixed and determined. The hedging relationship will have to be discontinued at that date. However, the performance accumulated in the cash flow hedge reserve will remain in other comprehensive income as the hedged cash flows (the interest payment of the bond) will still be highly probable. The amount accumulated in the cash flow hedge reserve will impact the profit or loss in the same periods during which the hedged interest expenses will impact profit or loss, i.e. over the life of the bond.