

Heads Up

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The new IFRS 9 hedge accounting model significantly differs from the IAS 39 hedge accounting model in a number of respects.

General Renovations

IFRS 9 Gets a New Hedge Accounting Model

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Introduction

On November 19, 2013, the IASB issued amendments to IFRS 9¹ that (1) introduce a new “general hedge accounting model” to IFRSs;² (2) remove the January 1, 2015, mandatory effective date from IFRS 9; and (3) allow entities to early adopt the provision in IFRS 9, as issued in 2010 (IFRS 9 (2010)), related to the presentation of changes in an entity’s own credit risk within other comprehensive income (OCI). This *Heads Up* focuses primarily on the amendments that introduce a new general hedge accounting model to IFRS 9. The other two amendments are addressed briefly at the end of this publication.

The new hedge accounting model, set forth in Chapter 6 of IFRS 9, significantly differs from the IAS 39³ hedge accounting model (as well as its U.S. GAAP counterpart, ASC 815⁴) in a number of respects, including the following:

- Eligibility of hedging instruments.
- Eligibility of hedged items.
- Accounting for the time value component of options and forward contracts.
- Qualifying criteria for applying hedge accounting.
- Modification and discontinuation of hedging relationships.
- Required disclosures.

Under the amendments, entities that adopt IFRS 9 (as amended in November 2013) can choose an accounting policy of either adopting the new IFRS 9 hedge accounting model now or continuing to apply the hedge accounting model in IAS 39 for the time being. The Board granted this option in response to constituents’ concerns regarding the possible ramifications of adopting the new general hedge model before the IASB finalizes its macro hedge accounting model. The IASB plans to revisit the accounting-policy choice upon completion of the macro hedging project.

Reasons for the Change to Hedge Accounting

The IAS 39 hedge accounting rules have long been criticized for (1) not faithfully representing entities’ risk management practices to financial statement users and (2) being too complex and difficult to apply and interpret. To address these criticisms, the IASB revised its hedge accounting model to more closely focus on how an entity manages its risks and to simplify the general hedge accounting model.

¹ IFRS 9, *Financial Instruments*.

² The new general hedge accounting model does not address the macro hedging issues that the IASB continues to deliberate. A discussion paper on the IASB’s macro hedge accounting model is expected to be issued in the first quarter of 2014.

³ IAS 39, *Financial Instruments: Recognition and Measurement*.

⁴ FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

The sections below provide a brief overview of the **major** changes from the IAS 39 model. In addition, the appendix of this *Heads Up* summarizes major differences between the IFRS 9 model and hedge accounting under existing U.S. GAAP. For more information about the new IFRS 9 hedge accounting model, see Deloitte's November 2013 *IFRS in Focus*.

Major Changes From IAS 39

Eligibility of Hedging Instruments

IAS 39 permits entities to designate derivative instruments (or portions thereof) as hedging instruments, except for certain written options. In addition, exclusively for hedges of foreign currency risk, IAS 39 permits entities to designate nonderivative financial instruments as hedging instruments. Under IFRS 9, however, a financial instrument's eligibility as a hedging instrument depends on whether the financial instrument is measured at fair value through profit or loss (FVTPL), not on whether it is a derivative instrument. Therefore, the IFRS 9 hedge accounting model permits entities to designate a derivative instrument (except for certain written options), as well as a nonderivative financial instrument that is measured at FVTPL, as a hedging instrument for all types of risks, not just foreign-currency risk.

Eligibility of Hedged Items

IAS 39 permits entities to designate recognized assets or liabilities, firm commitments, highly probable forecast transactions, and net investments in foreign operations as hedged items. In addition, for financial assets and financial liabilities, entities may designate certain risk components of the asset or liability (e.g., interest-rate risk, foreign-currency risk) as the hedged item, provided that the risk is separately identifiable and reliably measurable. However, for nonfinancial assets and nonfinancial liabilities, IAS 39 prohibits the designation of risk components (other than foreign-currency risk).

In contrast, the IFRS 9 hedge accounting model permits entities to also designate risk components of nonfinancial assets and liabilities as hedged items as long as certain criteria are met (e.g., the risk component is separately identifiable and can be reliably measured). IFRS 9 also expands the list of eligible hedged items by allowing entities to designate as a hedged item an aggregated exposure (i.e., the combination of an eligible hedged item and a derivative instrument) as well as certain group and net exposures (e.g., a net interest rate exposure), which were generally not eligible as hedged items under IAS 39.

Accounting for Options, Forwards, and Foreign-Currency Derivatives

Under IAS 39, an entity can exclude the time value of an option contract and the forward element of a forward contract when designating such contracts as hedging instruments. IAS 39 requires that changes in the excluded components (i.e., the time value component of the option and the forward element of the forward) always be recognized in profit or loss, thus resulting in increased volatility in earnings. The IFRS 9 hedge accounting model, however, takes a different approach.

Option Contracts

Under the IFRS 9 hedge accounting model, the appropriate accounting for the time value component of an option that has been excluded from the designated hedging relationship depends on whether the hedged item is transaction-based (e.g., a hedge of a forecast transaction) or time-period-based (e.g., a hedge of changes in the fair value of a recognized asset, such as inventory, over a period). For hedges of transaction-based items, the time value of the option contract, to the extent that it is related to the hedged item, would initially be deferred in OCI. Subsequently, the amount deferred in accumulated other comprehensive income (AOCI) would be (1) included in the initial cost or carrying amount of a recognized nonfinancial asset or nonfinancial liability arising from the hedged transaction or (2) reclassified into earnings as the hedged item affects earnings if the hedged transaction does not result in recognition of a nonfinancial asset or liability.⁵

⁵ Any portion of the deferred amount not expected to be recovered in future periods would be immediately reclassified into profit or loss.

The IFRS 9 hedge accounting model permits entities to designate risk components of nonfinancial assets and liabilities as hedged items.

The new IFRS 9 hedge accounting model employs a more principles-based approach for determining whether a hedging relationship qualifies for hedge accounting.

For hedges of time-period-based items, the time value of the option contract is also initially deferred in OCI to the extent that it is related to the hedged item. However, instead of recognizing the option cost at the time the hedged item is recognized in the statement of comprehensive income, an entity releases the time value component from AOCI into earnings by using a systematic and rational basis (possibly a straight-line approach) over the period during which the hedging relationship could affect earnings. This approach is consistent with certain constituents' views that the time value of an option is a cost of hedging (i.e., a cost incurred to protect against unfavorable changes).

Forward Contracts and Foreign-Currency Derivatives

Under the IFRS 9 hedge accounting model, an entity may elect to account for the forward element of a forward contract that is excluded from the designated hedging relationship similarly to how the time value component of an option contract that is excluded from a hedging relationship is accounted for (see above). Alternatively, an entity can elect to account for changes in the excluded forward element in profit or loss in a manner consistent with the approach under IAS 39.

After considering feedback received on its staff draft related to the IFRS 9 hedge accounting model, the IASB also decided to allow an entity to account for changes in the fair value of a foreign-currency basis spread in a foreign-currency derivative similarly to how it accounts for the forward element in a forward contract. Many constituents argued that the basis spread, like the forward element in a forward contract, is an unavoidable cost of hedging.

Qualifying Criteria for Applying Hedge Accounting

The qualifying criteria in the IFRS 9 hedge accounting model significantly differ from those in IAS 39. To qualify for hedge accounting under IAS 39, the hedging instrument must be highly effective at achieving offsetting changes in fair value or cash flows attributable to the hedged risk both prospectively and retrospectively. To be highly effective, the level of offset must be between 80 percent and 125 percent. Entities must perform quantitative effectiveness tests on an ongoing basis to demonstrate that the hedging relationship qualifies for hedge accounting.

The IFRS 9 hedge accounting model employs a more principles-based approach. The following conditions must be met for a hedging relationship to be considered effective and to qualify for hedge accounting under IFRS 9:

- “[T]here is an economic relationship between the hedged item and the hedging instrument.”
- “[T]he effect of credit risk [from either the hedged item or hedging instrument] does not dominate the value changes that result from that economic relationship.”
- “[T]he *hedge ratio* of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item [(unless the weightings of the hedged item and hedging instrument would create hedge ineffectiveness that would be inconsistent with the purpose of hedge accounting)].”

The IFRS 9 hedge accounting model requires entities to perform a hedge effectiveness assessment only prospectively, thereby removing the burden of performing retrospective hedge effectiveness assessments as currently required by IAS 39. However, entities must still measure and recognize hedge ineffectiveness at the end of each reporting period.

Accounting for Qualifying Hedges

Like IAS 39, the IFRS 9 hedge accounting model recognizes three types of hedging relationships:

- Cash flow hedges.
- Fair value hedges.
- Net investment hedges.

The accounting for each type of hedge generally has not changed from the requirements in IAS 39. The following table, however, identifies certain areas in which changes have been made and the type of hedging relationship that would be affected:

Nature of Change	Type of Hedging Relationship Affected
<i>Basis adjustments</i> — Under IAS 39, if an entity’s hedge of a forecast transaction results in the recognition of a nonfinancial asset or liability, the entity could choose to (1) reclassify the effective portion of the cash flow hedge recorded in AOCI to profit or loss when the hedged item affects earnings or (2) include the amount recorded in AOCI in the initial cost or carrying amount of the nonfinancial item. Under IFRS 9, an entity must remove the amount from AOCI and include it in the initial cost or carrying amount of the nonfinancial item (i.e., the entity must apply the second option above).	Cash flow hedge.
<i>Discontinuing a hedging relationship</i> — Under IAS 39, a hedging relationship is discontinued when (1) the hedging instrument expires or is sold or terminated, (2) the hedging relationship no longer meets the qualifying criteria, (3) the entity revokes the hedge designation, or (4) the forecast transaction in a cash flow hedge is no longer expected to occur. Under IFRS 9, the same facts and circumstances generally will still trigger discontinuation of a hedging relationship; however, an entity cannot voluntarily revoke or otherwise dedesignate a hedging relationship (i.e., the third item above would not apply).	Cash flow hedge, fair value hedge, net investment hedge.
<i>Modifying a hedging relationship</i> — Under IAS 39, when an entity changes a hedging relationship, it would generally have to discontinue hedge accounting for the existing hedging relationship and redesignate a new hedging relationship that reflects the desired change. Under IFRS 9, when an entity’s hedging relationship no longer satisfies the hedge ratio criterion but its risk management objective remains the same for that hedging relationship, the entity must adjust the hedge ratio so that it meets the hedging criteria prospectively. Such a “rebalancing” would not trigger discontinuation of the entire hedging relationship.	Cash flow hedge, fair value hedge, net investment hedge.

Under the new model, an entity cannot voluntarily revoke or otherwise dedesignate a hedging relationship.

Extension of the Fair Value Option

The amendments that introduce the new IFRS 9 hedge accounting model also extend the use of the fair value option to two common risk management activities. First, when an entity uses a credit derivative measured at FVTPL to manage the credit risk of all or a portion of a credit exposure (e.g., a financial instrument such as a debt security), it may designate the managed portion of the credit exposure at fair value through profit or loss if certain conditions are met (e.g., the name and seniority of the financial instrument referenced by the credit derivative match those of the hedged credit exposure). Second, the amendments allow an entity to elect to account for certain contracts to buy or sell a nonfinancial item for “own use” at FVTPL if doing so “eliminates or significantly reduces a recognition inconsistency.” In both cases, the use of the fair value option allows entities to achieve an effect similar to hedge accounting without having to apply the hedge accounting model.

It is unclear to what extent the provisions of the IASB's new hedge accounting model will affect the FASB's future discussions.

Disclosures and Transition

The flexibility afforded by the IFRS 9 hedge accounting model is tempered by the IASB's amendments to the related hedge accounting disclosure requirements in IFRS 7.⁶ The purpose of the new disclosure requirements is to obtain information about:

- “[A]n entity’s risk management strategy and how it is applied to manage risk.”
- “[H]ow the entity’s hedging activities may affect the amount, timing and uncertainty of its future cash flows.”
- “[T]he effect that hedge accounting has had on the entity’s statement of financial position, statement of comprehensive income and statement of changes in equity.”

The IFRS 9 hedge accounting model, if adopted, generally applies prospectively. Certain exceptions to prospective application include:

- The requirement to retrospectively apply the guidance on accounting for the time value of option contracts to all hedging relationships that existed at the beginning of the earliest comparative period (or were entered into later) for which only the intrinsic value of the option contract was designated as the hedging instrument.
- The option to retrospectively apply the guidance on accounting for the forward element or foreign-currency basis spread to all hedging relationships that existed at the beginning of the earliest comparative period (or were entered into later) for which (1) only the spot element of the forward contract was designated as the hedging instrument or (2) the foreign-currency basis spread is excluded from the hedging instrument.

Next Steps for the FASB?

To date, the FASB has not spent significant time on the hedging phase of its financial instruments project and it is unclear to what extent the provisions of the IASB's new model will affect the FASB's future discussions. If the FASB's May 2010 proposed ASU⁷ serves as any indication, the FASB's approach might result in fewer changes to existing hedge accounting requirements than the IASB's approach.

Other Amendments

In addition to introducing a new general hedge accounting model to IFRS 9, the amendments released by the IASB on November 19, 2013, (1) remove the mandatory effective date from IFRS 9 and (2) allow a reporting entity to present changes in its own credit risk (associated with liabilities designated at fair value through profit or loss) in OCI.

Removal of Mandatory Effective Date

In light of the slow progression on the impairment phase of its financial instruments project, the IASB has decided to remove the January 1, 2015, mandatory effective date from IFRS 9. As explained in the press release accompanying the issuance of the amendments to IFRS 9, the IASB “decided that a mandatory date of 1 January 2015 would not allow sufficient time for entities to prepare to apply the new Standard. Accordingly, the IASB decided that a new date should be decided upon when the entire IFRS 9 project is closer to completion.” The amendments do not, however, remove the early-adoption provisions from IFRS 9.

⁶ IFRS 7, *Financial Instruments: Disclosures*.

⁷ FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

Entities are now permitted to early adopt the requirements for presenting changes in an entity's own credit risk through OCI without having to early adopt the other provisions of IFRS 9.

Presentation of Changes in an Entity's Own Credit Risk in OCI

IFRS 9 (2010) requires an entity to recognize in earnings a gain or loss on a financial liability that is measured at fair value through profit or loss, unless (1) the liability is designated at fair value through profit or loss and (2) the reporting entity is required to present changes in the entity's own credit risk in OCI. Through the IASB's outreach activities and in comment letters on its November 2012 [exposure draft](#) on classification and measurement,⁸ many of the IASB's constituents urged the IASB to allow an entity to early adopt only this provision related to presentation of changes in an entity's own credit risk through OCI (without also having to adopt the other provisions of IFRS 9). On the basis of the feedback received, the IASB decided to amend IFRS 9 to permit an entity to early adopt the requirements for presenting changes in an entity's own credit risk through OCI without having to early adopt the other provisions of IFRS 9.

⁸ IASB Exposure Draft ED/2012/4, *Classification and Measurement: Limited Amendments to IFRS 9*.

Appendix — Hedge Accounting Comparison

The table below summarizes certain similarities and differences between the IASB's hedging model (IFRS 9) and current U.S. GAAP (ASC 815).

Subject	IASB's Hedging Model (IFRS 9)	Current U.S. GAAP (ASC 815)
Whether an entity can hedge risk components of financial and nonfinancial items	<p>A risk component of any item (financial or nonfinancial) can be designated as the hedged item if the risk component is (1) separately identifiable and (2) reliably measurable.</p> <p>Permits designation of two types of components of nominal amounts as a hedged item: (1) a proportion of the entire item and (2) a layer component (e.g., bottom layer).</p>	<p>An entity is allowed to designate certain risks of financial items (e.g., benchmark interest rate risk, foreign-currency risk, credit risk) as the hedge exposure. Component hedging of nonfinancial items is not permitted (except for foreign-currency risk in a cash flow hedge).</p>
Whether an entity can hedge group positions, including net group positions	<p>An entity is permitted to hedge groups of individually eligible hedged items collectively as a group (including a net position), provided that the group of items is managed together for risk management purposes.</p> <p>Such groups may be net positions (certain restrictions apply to cash flow hedges).</p> <p>For hedges of a group of items, IFRS 9 permits an entity to designate as a hedged item two types of components of a nominal amount: (1) a proportion of an eligible group and (2) a layer component (e.g., bottom layer) of an overall group if certain conditions are met.</p>	<p>Group positions are eligible if the group members meet certain criteria (e.g., similar risk characteristics). Hedges of net positions (e.g., offsetting assets and liabilities) are not permitted.</p>
How an entity accounts for the time value of an option when the designated hedging instrument is changes in the intrinsic value of the option	<p>An entity must defer changes in the time value of the option in AOCI (to the extent that it relates to the hedged item). The method of releasing such amounts from AOCI depends on whether the hedged item is related to a transaction or a time period.</p>	<p>If the change in the intrinsic value of the option is designated as the hedging instrument, the time value is recognized in earnings. If the time value of the option is included in the hedging instrument, an entity can defer the time value in OCI when certain conditions are met.</p>
Whether an entity can use a nonderivative financial instrument to hedge	<p>Permits nonderivative financial instruments accounted for at FVTPL to be designated as hedging instruments.</p>	<p>Not permitted, except for certain foreign-currency or net investment hedges.</p>
Determination of the required effectiveness threshold	<p>Threefold test:</p> <ol style="list-style-type: none"> 1. Economic relationship. 2. Credit risk does not dominate. 3. Hedge ratio match. 	<p>Highly effective.</p>
How an entity assesses hedge effectiveness (quantitative vs. qualitative)	<p>No specific requirement for a quantitative assessment; qualitative assessment may be sufficient in some cases.</p>	<p>Typically, a quantitative assessment is required; however, a qualitative assessment may be sufficient in certain cases.</p>
How often an entity must assess hedge effectiveness and the nature of the assessment (prospective vs. retrospective)	<p>An entity would need to determine that a hedging relationship meets the hedge effectiveness requirements at inception and on an ongoing basis (at a minimum, as of each reporting date or upon a significant change in circumstances). Retrospective assessment is not required.</p>	<p>At inception and, at a minimum, at the end of each reporting period. An entity must perform both a prospective and a retrospective assessment.</p>
Whether there are certain hedging relationships for which an entity can assume no ineffectiveness exists	<p>No.</p>	<p>Yes.</p>
How an entity determines the amount to be recorded in AOCI for cash flow hedges	<p>Retains the "lower of" test from IAS 39 — amount recorded in AOCI is the lesser of (1) the cumulative change in expected future cash flows for the hedged transaction since hedge inception and (2) the cumulative gain or loss on the hedging derivative instrument.</p>	<p>Same as IFRS 9.</p>

Subject	IASB's Hedging Model (IFRS 9)	Current U.S. GAAP (ASC 815)
For a cash flow hedge, how amounts are reclassified out of AOCI for hedged nonfinancial items	Eliminates the option in IAS 39 that permits an entity to either (1) adjust the basis of the hedged nonfinancial item (when it is initially recognized) or (2) reclassify amounts from AOCI to profit or loss when the hedged item affects profit or loss. IFRS 9 requires an entity to include amounts accumulated in AOCI in the initial cost or other carrying amount of the nonfinancial item.	Amount is reclassified from AOCI to earnings when the hedged transaction affects earnings. Basis adjustments are prohibited.
For a fair value hedge, how changes in the fair value of the hedged item attributable to the hedged risk affect the statement of financial position	No change from IAS 39. The carrying value of the hedged item is adjusted in the statement of financial position for gains and losses attributable to the hedged risk.	Same as IFRS 9.
For a fair value hedge, how changes in the fair value of the hedged item and hedging instrument affect the income statement	No change from IAS 39. Changes in the fair value of the hedging instrument and the hedged item (attributable to the hedged risk) are both recorded in earnings (unless the hedged item is an equity instrument carried at FV-OCI).	Changes in the fair value of the hedged item and the hedging instrument are both recorded in earnings.
Whether an entity can voluntarily dedesignate a hedging relationship	An entity cannot voluntarily remove hedge designation after it has been established; however, a change in an entity's risk management objective may trigger discontinuation of the hedging relationship.	Permitted. An entity can voluntarily dedesignate a hedging relationship after inception of the hedge.

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