# Snapshot – IFRS 9 – Financial Instruments - Hedge accounting

**EFFECTIVE DATE**

An entity shall apply this Standard for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

PKF

## OBJECTIVE

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

## SCOPE

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items.

b) at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk 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).

c) the hedging relationship meets all of the following hedge effectiveness requirements:

i) there is an economic relationship between the hedged item and the hedging instrument;

ii) the effect of credit risk does not dominate the value changes that result from that economic relationship; and

iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

## QUALIFYING INSTRUMENTS & HEDGE ITEMS

A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options.

A non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.

For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.

For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e. external the group or individual entity that is being reported on) can be designated as hedging instruments.

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a forecast transaction or a net investment in a foreign operation. The hedged item can be:
(a) a single item; or
(b) a group of items.

A hedged item can also be a component of such an item or group of items. The hedged item must be reliably measurable.

### Disclosure requirements

The disclosure requirements for IFRS 9 are contained within IFRS 7 Financial Instruments: Disclosure.

## DEFINITIONS

*Derivative* is a financial instrument or other contract with all three of the following features:

- Its value changes in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
- It requires little or no initial net investment relative to the other types of contracts that have a similar response to changes in market conditions.
- It is settled at a future date.

*Hedging* involves designating one or more hedging instruments such that the change in fair value or cash flows of the hedging instrument is an offset, in whole or part, to the change in fair value or cash flows of the hedged item. The objective is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period that the hedged item affects profit or loss.

*Hedging instrument for hedge accounting purposes*, is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

## ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

There are three types of hedging relationships:

a) **fair value hedge**: 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.

b) **cash flow hedge**: 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 a highly probable forecast transaction, and could affect profit or loss.

c) **hedge of a net investment** in a foreign operation as defined in IAS 21 The effects of changes in Foreign Exchange Rates.

### Fair value hedges

As long as a fair value hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:

a) the gain or loss on the hedging instrument shall be recognised in profit or loss (or elects other comprehensive income, if the hedging instrument hedges an equity instrument).

b) the hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss but

   i. If the hedged item is a financial asset (or a component thereof), measured at FVTOCI, the hedging gain or loss on the hedged item shall be recognised in profit or loss,

   ii. if the hedged item is an equity instrument elected to present changes in FVTOCI, those amounts shall remain in OCI,

   iii. when a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

### Cash flow hedges

As long as a cash flow hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:

a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):

   i. the cumulative gain or loss on the hedging instrument from inception of the hedge; and

   ii. the cumulative change in fair value (present value) of the hedged item (i.e. the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

### Hedges of a net investment in a foreign operation

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment shall be accounted for similarly to cash flow hedges:

a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income; and

b) the ineffective portion shall be recognised in profit or loss.