An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

August 2017
# An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

## Introduction

This communication contains a general overview of the topic and is current as of August 31, 2017. The application of the principles addressed will depend upon the particular facts and circumstances of each individual case. Accordingly, this publication is not a substitute for professional advice and we recommend that any decisions you take about the application or not of any of the information presented be made in consultation with a qualified professional who can address any variance that may be required to reflect your circumstances. Please contact your local MNP representative for customized assistance with the application of this material. MNP LLP accepts no responsibility or liability for any loss related to any person’s use of or reliance upon this material. © MNP LLP 2017. All rights reserved.

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Introduction

In July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 *Financial Instruments*, including the new hedge accounting requirements first published in November 2013. The final hedge accounting requirements are unchanged from their previous version except to reflect the addition of the fair value through other comprehensive income (FVOCI) measurement category. IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement*, and is effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted.

When IAS 39 was drafted, hedging activities were relatively new and not as widely understood; hence, many financial statements users believe that IAS 39 does not adequately reflect an entity’s risk management practices in their financial reporting. As a result, the IASB undertook a fundamental overhaul of hedge accounting in formulating IFRS 9.

The new hedge accounting model aims to provide greater cohesion between an entity’s risk management strategy, their objectives for entering into hedging transactions and relationships, and the final impact of hedging on their financial statements. Improved disclosures are provided with the new model regarding the effect of hedge accounting on an entity’s financial statements and risk management strategy as well as details about derivatives entered into and their impact on an entity’s future cash flows.

This guide highlights the key differences between the IAS 39 and IFRS 9 hedge accounting models. It also provides an overview of the requirements and illustrative examples to assist in the application of the new IFRS 9 hedging model.

**Dynamic Risk Management**

Macro hedge accounting (i.e., accounting for risk management activities that assess risk exposures on a continuous basis and at a portfolio level, sometimes referred to as dynamic portfolio hedging) was originally part of the IASB’s comprehensive project on financial instruments. However, it is now being treated as a separate project by the IASB.

As part of its “Dynamic Risk Management” project, the IASB is currently exploring whether it can develop an accounting model that will allow financial statement users to understand an entity’s dynamic risk management and evaluate the effectiveness of the risk strategies applied. The IASB plans to publish a Discussion Paper in 2018. Until then, the guidance in IAS 39 for macro fair value hedges will continue to apply.
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Key Differences Between Hedge Accounting under IAS 39 and IFRS 9

<table>
<thead>
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<th>Hedged Items</th>
<th>Summary of Differences</th>
</tr>
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</table>
| Components   | IFRS 9 allows the following components to be designed as a hedged item in a hedging relationship:  
  - Any risk component of a non-financial item.  
  - Layer components of a nominal amount. |
| Groups of items | A greater range of groups of items can be designated as the hedged item in a hedging relationship under IFRS 9. |
| Aggregated exposures | IFRS 9 allows aggregated exposures, including aggregated exposures that include a derivative financial instrument, to be designated as the hedged item.  
  - IAS 39 precludes derivatives from being designated as part of a hedged item |

<table>
<thead>
<tr>
<th>Hedging Instruments</th>
<th>Time value of options, forward element of forward contracts (i.e. costs of hedging)</th>
</tr>
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</table>
|                     | Under IFRS 9, when only the intrinsic value of an option has been designated as the hedging instrument, the time value of the option is accounted for in other comprehensive income (OCI) and reclassified to profit or loss in a manner dependent on the hedged item.  
  - Under IFRS 9, when only the spot element of a forward contract has been designated as the hedging instrument, the forward element of the forward contract may be accounted for in the same way as the time value of an option (i.e., entity has the option to recognize the changes in forward points in OCI).  
  - Under IAS 39, the time value of an option or the forward element of a forward contract would either have been accounted for at fair value through profit or loss, or included in the hedging relationship causing hedge ineffectiveness. |
| Non-derivative financial instruments | IFRS 9 permits non-derivative financial assets and liabilities measured at fair value through profit or loss (FVTPL) to be designated as hedging instruments in cash flow and fair value hedges.  
  - IAS 39 only permits non-derivative financial instruments to be designated as hedging instruments for hedges of foreign currency risk. |
## Summary of Differences (cont’d)

<table>
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<th>Hedge Relationships</th>
<th>Effectiveness requirements and testing</th>
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<tr>
<td></td>
<td>• IFRS 9 replaces the 80%-125% hedge effectiveness rule of IAS 39 with objective-based requirements focused on:</td>
</tr>
<tr>
<td></td>
<td>• Assessing whether there is an economic relationship between the hedged item and the hedging instrument; and</td>
</tr>
<tr>
<td></td>
<td>• The relative effects of credit risk on the relationship compared to effects arising from the underlying variables of the hedging relationship.</td>
</tr>
<tr>
<td></td>
<td>• Under IFRS 9, retrospective analysis of existing hedging relationships is not required as they were under IAS 39. Instead, periodic assessments of prospective effectiveness are required.</td>
</tr>
<tr>
<td></td>
<td>• IFRS 9 addresses changes in the relationship between the hedged item and the hedging instrument through rebalancing the hedging relationship.</td>
</tr>
<tr>
<td></td>
<td>• Under IAS 39, hedging relationships are not rebalanced and, if they cease to meet the hedge effectiveness requirements, are discontinued.</td>
</tr>
<tr>
<td>Discontinuation</td>
<td>• Discontinuation of hedge accounting is permitted at any time under IAS 39 while IFRS 9 only permits discontinuation when the qualifying criteria are no longer met.</td>
</tr>
<tr>
<td></td>
<td>• IFRS 9 introduces the partial discontinuation of hedge accounting. Therefore, hedge accounting can continue for the remaining portion of the hedging relationship in the event of rebalancing, the change of risk management objectives, the partial termination, sale, or exercise of a hedging instrument, or if part of a hedged item no longer exists or is no longer expected to occur.</td>
</tr>
</tbody>
</table>

With the variety of hedged items and hedging instruments that can be designated in a hedging relationship under IFRS 9, entities can apply hedge accounting to certain hedging strategies that would not have qualified for hedge accounting under IAS 39. Some examples include:

- Hedging specific risk components of non-financial items;
- Hedges of certain net positions; and
- Hedges of inflation that is not specified within a contract.

### Objective of Hedge Accounting

Every entity faces risks from its business environment that can impact expected cash flows or the fair value of its assets and liabilities and, accordingly, have an effect on its earnings. An entity may face risks such as changes in the price or exchange rate for inputs required for its operations (e.g. labour or commodities), or changes in the costs of financing arising from changes in market interest rates. Consequently, it might undertake activities or transactions to manage the effect of these risks on its operations which is known as hedging.
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For example, an entity may enter into contracts to purchase the commodities necessary for its operations far in advance, locking in current prices and shielding itself from potential increases in commodity prices. Or an entity with variable rate debt could arrange to pay a fixed interest rate on a notional amount that coincides with its debt, in exchange for receiving variable interest on the same notional amount. Hence, it has insulated itself from the impacts that changes in market interest rates would have on payments towards its borrowings.

As per IFRS 9.6.1.1, "the objective of hedge accounting under IFRS 9 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". In other words, the goal is to ensure that offsetting gains, losses, revenues and expenses, including the effects of changes in cash flows, are recognized in profit or loss in the same period(s).

The following examples demonstrate how hedge accounting achieves this objective.

Example of the Effect of Hedging the Variability in Cash Flows

Lender A holds a portfolio of loan assets on which they receive interest based on the Bank of Canada prime rate. To hedge the cash flow risk from fluctuations in the prime rate over the next 3 years, Lender A purchases a 3 years pay-variable receive-fixed interest rate swap with a notional amount equal to that of the loan portfolio being hedged. On December 31, 20x1, the Bank of Canada increases the prime rate by 0.25%.

Assessment: The interest rate swap is a derivative liability accounted for at FVTPL. Therefore, the entire amount of the fair value loss on the derivative is recorded immediately in income. If Lender A does not apply hedge accounting, the impact of a higher interest rate on its portfolio of variable rate loan assets is only recognized as interest payments are received over future periods. Because the loss on the interest rate swap is recognized in the current year but the corresponding increase in earnings is recognized over future periods, this creates volatility in profit or loss for both current and future periods that the hedging strategy aims to avoid. As a result, this accounting treatment does not accurately reflect the entity’s risk management activities.

To prevent this accounting mismatch, Lender A can adopt hedge accounting to defer the loss on the derivative in the current period to the periods where the variable interest rates affect profit or loss. This is referred to as a cash flow hedge.

<table>
<thead>
<tr>
<th>Without Hedge Accounting</th>
<th>With Cash Flow Hedge Accounting</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Current Reporting Period</td>
</tr>
<tr>
<td>Loss on Derivative</td>
<td>(100)</td>
</tr>
<tr>
<td>Increase in Interest Revenue</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(100)</td>
</tr>
</tbody>
</table>

1 Or OCI for investments in equity instruments designated as measured at FVOCI.
Example of the Effect of Hedging Changes in Fair Value

Lender B holds a portfolio of loan assets bearing interest at a fixed rate of 5% which is accounted for at amortized cost. To hedge the risk of fair value changes due to fluctuations in the prime rate over the next 5 years, Lender B purchases a 5 years pay-fixed receive-variable interest rate swap with a notional amount equal to that of the loan portfolio being hedged. On December 31, 20x1, the Bank of Canada decreases the prime rate by 0.25%.

Assessment: The interest rate swap is a derivative liability accounted for at FVTPL. Therefore, the entire amount of the fair value loss on the derivative is recorded immediately in income. If Lender B does not apply hedge accounting, because the loan portfolio is accounted for at amortized cost, there is no change in the value of the loans and no impact on earnings. This creates volatility in Lender B’s earnings as the change in the fair value of the interest rate swap is recognized in the current year but not for the loan portfolio. As a result, this accounting treatment does not accurately reflect the entity’s risk management activities.

To prevent this accounting mismatch, Lender B can adopt hedge accounting to recognize the change in fair value of the loan portfolio in the same period as the derivative affects profit or loss. This is referred to as a fair value hedge.

<table>
<thead>
<tr>
<th></th>
<th>Without Hedge Accounting</th>
<th>With Fair Value Hedge Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Reporting Period</td>
<td>Subsequent Reporting Periods</td>
</tr>
<tr>
<td>Loss on Derivative</td>
<td>(100)</td>
<td>-</td>
</tr>
<tr>
<td>Gain in Fair Value of Loan</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Portfolio</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>(100)</td>
<td>100</td>
</tr>
</tbody>
</table>

Hedge accounting is optional and in order to apply it an entity is required to meet certain conditions, including the preparation of hedge documentation. Some entities find hedge accounting and the qualifying conditions too cumbersome. Consequently, entities may engage in hedging activities (i.e., acquire a financial instrument whose performance cancels that of a different financial instrument) but not necessarily apply hedge accounting.
Overview of Hedge Accounting

Key Terms

The following scenario introduces the common terms used when applying hedge accounting:

\textit{Scenario:}

Entity B, a Canadian entity, imports its inventory from the USA. It entered into a forward contract to hedge the foreign currency risk of its planned inventory purchases for December 20x0. Entity B has a specific supplier that they deal with. The parties typically enter into a binding agreement with prices, quantities and relevant dates, one to two months before the actual purchase.

<table>
<thead>
<tr>
<th>IFRS 9 Term</th>
<th>Definition/Explanation</th>
<th>Example from Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast Transaction</td>
<td>An uncommitted but anticipated future transaction.</td>
<td>The anticipated future purchases of inventory are a forecast transaction until it becomes a firm commitment.</td>
</tr>
<tr>
<td>Firm Commitment</td>
<td>A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date(s).</td>
<td>The future purchases of inventory once a contract have been entered into with the supplier that specifies the quantities, prices and relevant dates.</td>
</tr>
<tr>
<td>Hedged Item</td>
<td>In simple terms, it is the particular risk exposure being hedged.</td>
<td>The forecast transaction and/or the firm commitment relating to the anticipated inventory purchases.</td>
</tr>
<tr>
<td>Hedging Instrument</td>
<td>In simple terms, it is the instrument used to hedge a particular risk exposure.</td>
<td>The foreign currency forward contract.</td>
</tr>
</tbody>
</table>

IFRS 9 has detailed guidance about what can and cannot be designated as hedged items or hedging instruments. The above table is intended to only provide an example of a possible qualifying hedged item and hedging instrument. Refer to the \textit{Step 3: Determine the Eligible Hedged Items and Hedging Instruments} section of this guide for a description of what items may qualify as hedged items and hedging instruments.
### Types of Hedging Relationships

There are three types of hedging relationships as follows:

<table>
<thead>
<tr>
<th>IFRS 9 Term</th>
<th>Definition/Explanation</th>
<th>High-level Summary of Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair Value Hedge</strong> (see IFRS 9.6.5.8 –10)</td>
<td>Hedges the exposure to changes in fair value of a recognized asset/liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.</td>
<td>The change in the fair value of the hedged item that is attributable to the hedged risk is recognized in the current period as the change in the fair value of the hedging instrument. This results in earlier recognition of the fair value change in the hedged item than if hedge accounting was not applied.</td>
</tr>
<tr>
<td><strong>Cash Flow Hedge</strong> (see IFRS 9.6.5.11 –12)</td>
<td>Hedges the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognized asset/liability or a highly probable forecast transaction, and could affect profit or loss.</td>
<td>The effective portion of the change in the fair value of the hedging instrument is recognized in an equity reserve until the hedged item is recognized or affects profit or loss. This delays the recognition of the change in cash flows related to the hedging instrument. The ineffective portion of the change in the fair value of the hedging instrument is immediately recognized in profit or loss.</td>
</tr>
<tr>
<td><strong>Hedge of a Net Investment in a Foreign Operation</strong> (see IFRS 6.5.13 – 14)</td>
<td>Hedge of a reporting entity’s interest in the net assets of a foreign operation.</td>
<td>Accounted for similarly to a cash flow hedge.</td>
</tr>
</tbody>
</table>

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2 Foreign operations are defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates* and may include a monetary item that is accounted for as part of an entity’s net investment in the foreign operation (e.g. receivable from a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future).
Some common examples of cash flow and fair value hedges are:

**Common Fair Value Hedges**

- Hedge of the risk of changes in the fair value of fixed-rate financial instruments arising from changes in market interest rates with interest rate swaps or options
- Hedge of the risk of changes in commodity prices on a firm commitment to purchase or sell a commodity, or a product for which that commodity makes up a portion of the value, with forward purchase or sales contracts
- Hedge of changes in the fair value of inventory with forward purchase or sales contracts

**Common Cash Flow Hedges**

- Hedge of the risk of changes in cash flows of:
  - Variable-rate financial instruments arising from changes in the referenced market interest rate with interest rate swaps or options
  - Highly probable forecast transactions that will take place at market prices in the future with forward purchase or sales contracts
  - Highly probable forecast transactions denominated in a foreign currency with foreign currency forward purchase or sales contracts

**Note!** Credit Unions and other financial institutions often hold foreign cash to offset the effect of changes in foreign exchange rates on their foreign currency deposits. For example, a Credit Union may hold US dollars to offset the effect of changes in foreign exchange rates on US dollar denominated deposits. Any gaps are frequently addressed through the purchase or sale of foreign currency. Conversely, the Credit Union can purchase foreign exchange swaps to help manage their foreign currency risk. These transactions are typically accounted for as cash flow hedges.

Cash flow and fair value hedging relationships will be discussed in more detail below. A hedge of a net investment in a foreign operation is accounted for similarly to a cash flow hedge but is not seen often in practice amongst MNP clients. As a result, this guide does not discuss such hedges in any further detail.
Qualifying Criteria for Hedge Accounting

The following diagram lays out the process to follow to ensure that a hedge meets the qualifying criteria in order to apply hedge accounting:

1. Define the risk management strategy
2. Define the risk management objective
3. Determine qualifying hedged item(s) and hedging instrument(s)
4. Determine if the hedge effectiveness criteria are met
   - Does an economic relationship exist between the hedged item and hedging instrument?
     - Yes
   - Does the effect of credit risk dominate value changes resulting from the economic relationship?
     - No
     - Yes
5. Determine hedge ratio based on actual quantities used
   - Does the hedge ratio reflect an imbalance creating hedge ineffectiveness?
     - Yes
   - Is an adjustment to the hedge ratio required?
     - No
     - Yes
6. Formally designate and document the hedging relationship
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Note! The following areas of the hedge accounting process requires an entity to apply judgment:

- Whether the hedge accounting documentation sufficiently links each individual hedging relationship and the related risk management objective.
- Whether the hedged item is transaction-related or time period-related.
- Whether the hedge effectiveness criteria are met.
- When rebalancing versus discontinuation of a hedging relationship is appropriate.

Each of these steps will be discussed in more detail below.

**Step 1: Define the Risk Management Strategy**

The first step is for an entity to define its risk management strategy. This identifies, at a high-level, the risks that an entity is exposed to and whether and how they will be managed. Typically, a risk management strategy is long-term and flexible so that it may respond to changing circumstances. Therefore, it represents the entity’s overarching approach to risk management.

The diagram below and the table in the next subsection contrasts an entity’s risk management strategy with its risk management objective.

![Diagram](image)

Note! Larger entities will likely have a formal risk management strategy documented within their policies to which they can refer when drafting their hedge documentation and required disclosures. Conversely, smaller and medium-sized entities may need to formalize their strategy prior to adopting hedge accounting under IFRS 9.
Step 2: Define the Risk Management Objective(s)

Risk management objectives are defined at a lower level than an entity’s risk management strategy and characterize the purpose for each hedging relationship. Specifically, a risk management objective describes how a specific hedging instrument is used to hedge the identified exposure of the hedged item. An entity can have many risk management objectives for each risk management strategy.

**Risk Management Strategy**

- Established at the highest level at which an entity determines how it manages its risks.
- Identifies the risks to which the entity is exposed and how the entity responds to them.

**Risk Management Objective(s)**

- Applies at the level of a particular hedging relationship (i.e., more detailed).
- Identifies the hedging instrument used to hedge the particular exposure (i.e., hedged item).
- Many risk management objectives may, taken together, form the foundation to executing a particular risk management strategy.

**Example of Risk Management Strategy and Objectives**

Bank XYZ maintains between 20% and 30% of its net loans (i.e., loan assets less interest-bearing deposits and debt) at a floating rate. The entity will decide, from time to time, where it positions itself within the 20% and 30% range based on current market rates and forward-looking expectations.

For 20x1, Bank XYZ decides to maintain 25% of its net loans at a variable rate, up from 20% in the prior year. To achieve this, the entity enters into pay-fixed receive-variable interest rate swaps. The next year, Bank XYZ decides to reduce the amount of net loans at a variable rate back to 20%. It determines that the most effective way to do so is to enter into pay-variable receive-fixed interest rate swaps.

**Assessment:** Bank XYZ’s risk management strategy is to maintain between 20% and 30% of its net loans at a floating rate. As its risk management strategy changes from 20% to 25% in 20x1, Bank XYZ enters into hedging relationships with the risk management objective of increasing the Bank’s exposure to changes in the benchmark interest rate. In the next year, when the Bank’s strategy changes from maintaining 25% of its net loans at a floating rate to 20%, it enters into new hedging relationships with a new risk management objective of decreasing the Bank’s exposure to changes in the benchmark interest rate.

**Note!** Careful consideration of the impact of a change in a risk management objective, or a specific action without a corresponding change in the risk management objective, is required to permit the continued application of hedge accounting.
Step 3: Determine the Eligible Hedged Items and Hedging Instruments

Hedged Items

a) What items qualify as hedged items?

A hedged item can be any reliably measurable:

- Recognized asset/liability;
- Unrecognized firm commitment;
- Highly probable forecast transaction; or
- Net investment in a foreign operation.

Hedged items can be any single qualifying item, a group of qualifying items or a component of a qualifying item or group of qualifying items. Aggregated exposures, those being combinations of an exposure and a derivative, also qualify as hedged items.

Note! Under IAS 39, it is not possible to hedge a derivative exposure but this restriction is lifted under IFRS 9.

To qualify for hedge accounting, the hedged item must be reliably measurable. For example, it is not enough to know that you will purchase some amount of a commodity in the future. The entity will need to know the type and quality of the commodity, the currency it will be purchased in, and other details of the forecast transaction for it to be reliably measurable.

b) Can transactions with internal parties be designated as hedged items?

At the consolidated financial statement level, only transactions with parties external to the reporting entity can be designated as hedged items. Therefore, hedge accounting can be applied to transactions between entities in the same group only within their individual or separate financial statements.

There are three exceptions to the above rule with respect to:

- The consolidated financial statements of an investment entity as transactions between such an entity and its subsidiaries are not eliminated.
- The foreign currency risk of an intragroup monetary item if the foreign exchange gains or losses are not fully eliminated on consolidation in accordance with IAS 21 The Effects of Changes in Foreign Exchange Rates (e.g. a payable or receivable between two subsidiaries who have different functional currencies).
- The foreign currency risk of a highly probable forecast intragroup transaction if the transaction will affect consolidated profit or loss.

c) Can a firm commitment to acquire a business in a business combination be a hedged item?

No. This is because the general business risks that an entity might seek to hedge cannot be specifically identified. However, there is an exception with respect to foreign currency risk since it can be specifically identified and measured.
d) Can investments in other entities be designated as a hedged item in a fair value hedge? How are they different from a net investment in a foreign operation for hedging purposes?

Investments accounted for under the equity method (e.g. an interest in an associate or joint venture) cannot be designated as a hedged item in a hedging relationship. This is because the equity method recognizes the investor’s proportionate share of the investee’s profit or loss rather than changes in the investment’s fair value. For a similar reason, an investment in a consolidated subsidiary or joint operation cannot be a hedged item in a fair value hedge. A hedge of a net investment in a foreign operation is different because it hedges a foreign currency exposure rather than changes in the fair value of the investment.

In our view, any recognized asset or liability, highly probable forecast transaction, or unrecognized firm commitment relating to an entity’s interest in a subsidiary or joint operation may qualify for hedge accounting so long as it is reliably measurable.

Most other equity investments (i.e. portfolio investments) would be measured at fair value through profit or loss under IFRS 9. Therefore, such equity investments would not be designated as the hedged item in a hedging relationship since any fair value changes would already be recognized in the current period. However, an entity may designate an equity investment that is measured at FVOCI as the hedged item in a fair value hedge. In such a situation, the gain or loss on the hedging instrument and hedged item is recognized in OCI.

**Hedging Instruments**

a) What items qualify as hedging instruments?

Hedging instruments can be:

- Derivatives; and
- Non-derivative financial assets and liabilities measured at FVTPL.

However, there are four exceptions:

- A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded within another financial instrument (e.g. a written option that is used to hedge a callable liability).
- Financial liabilities designated at FVTPL for which the fair value changes attributable to changes in the entity’s own credit risk are presented in OCI.
- The foreign currency risk component of a non-derivative financial asset or liability may be designated as a hedging instrument for a hedge of foreign currency risk, unless it is an investment in an equity investment designated as measured at FVOCI.
- Derivatives that are embedded within hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments.

Similar to the rules for hedged items, only contracts with parties external to the reporting entity can be designated as hedging instruments.

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3 IFRS 9.5.7.7 requires that when an entity irrevocably designates a financial liability, including entire hybrid contracts, to be measured at FVTPL, the amount of change in fair value attributable to its own credit risk is presented in OCI.

4 IFRS 9.5.7.5 permits an entity, on initial recognition, to elect to present in OCI any subsequent changes in fair value of an equity instrument that is neither held for trading nor contingent consideration recognized by an acquirer in a business combination to which IFRS 3 Business Combinations applies.
b) Can a component of a qualifying instrument be designated as a hedging instrument?

Typically, qualifying instruments must be designated in their entirety as a hedging instrument. However, there are four exceptions:

- The change in the intrinsic value (i.e., the difference between the strike price and underlying price) of an option can be separately designated as a hedging instrument but not the change in its time value (i.e., the premium a rational investor would pay for an option above its intrinsic value).
- The change in the value of the spot element of a forward contract can be separately designated as a hedging instrument but not the forward element.
- The foreign currency basis spread can be excluded with the remainder of the financial instrument designated as a hedging instrument.
- A part of an entire hedging instrument can be designated (e.g., 50% of the nominal amount). However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the period during which is remains outstanding.

c) Can an entity jointly designate more than one qualifying hedging instrument?

Yes. Any combination of the below can be designated jointly as a hedging instrument:

- Derivatives, or a proportion of them; and
- Non-derivatives, or a proportion of them.

This includes circumstances where the risk(s) arising from some hedging instruments offset those arising from others.

As previously noted, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option and it does not result in a net written option. Similarly, two or more instruments jointly designated as the hedging instrument cannot be, in effect, a net written option at the date of designation. Some entities enter into offsetting derivative contracts, purchasing an option that might effectively give it a cap on its risk to a certain exposure and then writing an option that gives it a floor on that same exposure.

Example of Derivatives Jointly Designated as the Hedging Instrument

Entity A wants to hedge its exposure to cash flow variability on a variable rate borrowing by setting up an interest rate band that creates both a cap and a floor for the interest to be paid on the borrowing.

**Assessment:** Entity A can enter into two interest rate “swaptions” (i.e., options giving the right, but not the obligation, to engage in a swap) that would protect it from both upwards and downwards movements in the referenced interest rate. So long as these swaptions are net purchased options, they can be jointly designated as the hedging instrument.

For a combination of a written and purchased option to not constitute a net written option:

- No net premium should be received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- The critical terms and conditions of the written and purchased option components, except for the strike price, must match and the notional amount of the written option component cannot exceed the notional amount of the purchased option component.
Step 4: Determine if the Hedge Effectiveness Criteria are Met

This section discusses how hedge effectiveness and potential sources of ineffectiveness can be assessed initially when designating the hedging relationship. As shown in step 4 of the diagram in the Qualifying Criteria for Hedge Accounting section of this guide, the hedge effectiveness criteria are made up of two parts:

1. An economic relationship must exist between the hedging instrument and the hedged item; and
2. The economic relationship must not be dominated by the effect of credit risk.

Note! Under IAS 39, hedge accounting is restricted to hedging relationships meeting a specific 80% to 125% threshold for effectiveness, both retrospectively and prospectively. This condition, particularly the requirement to perform the analysis retrospectively, is onerous.

Under IFRS 9, there only needs to be an economic relationship between the hedged item and hedging instrument. Consequently, more economic hedging relationships qualify for hedge accounting under IFRS 9. Furthermore, though IFRS 9 does not have a strict quantitative threshold to measure hedge effectiveness, an entity will aim to have a strong economic relationship to reduce the amount of hedge ineffectiveness that must be recognized in profit or loss.

IFRS 9 defines hedge effectiveness as the extent to which changes in the fair value or the cash flows of the hedging instrument and the hedged item offset each other. Hedge ineffectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument are greater or less than those of the hedged item.

Hedge ineffectiveness is always recognized in some form. However, the way ineffectiveness is recognized depends on:

- The type of hedging relationship (i.e., a fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation); and
- Whether the changes in the fair value or cash flows of the hedging instrument are greater or less than those of the hedged item.

Information on how hedge ineffectiveness is recognized for each type of hedging relationship is discussed further in the Cash Flow Hedges and Fair Value Hedges sections of this guide.

Entities are required to analyze the sources of hedge ineffectiveness expected to affect a hedging relationship throughout its term, both at the inception of the relationship and on an ongoing basis, to ensure it continues to meet the hedge effectiveness requirements of IFRS 9. Subsequent assessments of hedge effectiveness and the measurement of hedge ineffectiveness for the purposes of accounting for a hedging relationship are discussed in the Subsequent Assessment of a Hedging Relationship section of this guide.

Note! Hypothetical derivatives may also be used in assessing whether a hedging relationship meets the hedge effectiveness requirements. The use of a hypothetical derivative is discussed further in the Use of a Hypothetical Derivative section of this guide.
Economic Relationship Between the Hedged Item and Hedging Instrument

There are two criteria for demonstrating that an economic relationship exists between a hedged item and hedging instrument:

1) Hedging instrument and hedged item values must systematically move in opposite directions in response to the hedged risk; and
2) The economic relationship must be supported by an analysis of possible behaviour throughout the hedging term to conclude that the hedging relationship is expected to meet the risk management objective.

To meet the first criteria, there must be an expectation that the fair value of the hedging instrument and hedged item will offset in response to movements in either:

- The same underlying (e.g. both the hedged item’s and hedging instrument’s values change in response to the prime rate).
- Underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged.

There may be situations where the underlyings of a hedged item and hedging instrument are not the same but share an economic relationship. This does not necessarily result in the first criteria being violated, if the values of the hedged item and hedging instrument are still expected to typically move in opposite directions when the underlyings move. IFRS 9 notes that the values of the hedged item and hedging instrument could move in the same direction if there is a movement in the price differential between the two related but not identical underlyings.

Example of the Values of the Hedged Item and Hedging Instrument Moving in the Same Direction

Company A uses forward sales contracts referenced to West Texas Intermediate (“WTI”) oil to hedge its highly probable forecast transaction for the sale of WCS crude at the market price. During the period, the price of both WCS and WTI decreased by $1/barrel due to common economic factors. However, changes to U.S. crude oil export regulations resulted in an increase of the spread (i.e., differences in prices) between WTI and WCS. As a result, at the end of the period, the price of WCS decreased by $1 and the price of WTI increased by $1.

Assessment:

<table>
<thead>
<tr>
<th>Hedged Item (Forecast Transaction)</th>
<th>Referenced to</th>
<th>Price Movement due to Narrowing of Spread Between WTI and WCS</th>
<th>Price Movement due to Common Economic Factors</th>
<th>Total Price Movement of Underlying</th>
<th>Effect on Hedged Item/Hedging Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>WCS</td>
<td>+ $0</td>
<td>- $1.00</td>
<td>- $1.00</td>
<td>Loss</td>
<td></td>
</tr>
<tr>
<td>Hedging Instrument (Forward Contract)</td>
<td>West Texas Intermediate</td>
<td>+ $2.00</td>
<td>- $1.00</td>
<td>+ $1.00</td>
<td>Loss</td>
</tr>
</tbody>
</table>
Example of the Values of the Hedged Item and Hedging Instrument Moving in the Same Direction (cont'd)

In the above table, a loss occurred on both the hedged item and hedging instrument. This occurs because the price for the hedged item (i.e., the forecast sales which will take place at the market price) decreased while the strike price for the hedging instrument (i.e., the forward contract referenced to WTI) stayed the same when the market price of the underlying has increased.

The total price movement of the underlyings appear to be contradictory to the requirement that the hedged item and hedging instrument move systematically in opposite directions in response to changes in the underlying. The hedging relationship does not appear effective, as Company A incurred a loss on both the hedged item and the hedging instrument. However, note that the price movement due to common economic factors (i.e., the economic relationship between the underlyings) is still stable. It is only the temporary conditions which caused a widening of the spread between the economically related variables that caused hedge ineffectiveness. As a result, on a prospective basis, the values of the hedged item and the hedging instrument are still expected to move in opposite directions when the underlying variable moves, and an economic relationship still exists.

Methods for Demonstrating an Economic Relationship

This relationship should be based on economic rationale rather than mere chance. In other words, an entity is required to demonstrate causation rather than mere correlation. However, statistical correlation may demonstrate the validity of an economic rationale.

Judgment is needed to determine the best method for determining whether a hedging relationship meets the hedge effectiveness requirements and to measure ineffectiveness. IFRS 9 does not specify any particular technique to be used.

As the table below demonstrates, the type of assessment required (whether quantitative or qualitative) to demonstrate an economic relationship also depends on the extent to which the critical terms of the hedging instrument and hedged item match.

<table>
<thead>
<tr>
<th>Extent of Critical Terms Matching</th>
<th>Guidance on Assessment Required to Demonstrate Economic Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Matched Perfectly</td>
<td>A quantitative assessment may not be necessary to support an economic relationship. Because the critical terms match, there will likely be no hedge ineffectiveness to be measured and recognized at each reporting date. The prospective analysis will be limited to a re-evaluation of the critical terms to ensure they still match and that changes in fair value from the hedged exposure are not dominated by the effect of credit risk.</td>
</tr>
<tr>
<td>Closely Aligned</td>
<td>In practice, it will often be difficult to find a hedging instrument with critical terms that precisely match with the hedged item. When the critical terms of the hedging instrument and hedged item are not perfectly matched, it is often impossible to rely on qualitative analysis alone to demonstrate the economic relationship. If the critical terms are still closely (but not perfectly) matched, a basic numerical analysis or simulation may be sufficient to demonstrate hedge effectiveness and to measure hedge ineffectiveness at each reporting date.</td>
</tr>
</tbody>
</table>
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

<table>
<thead>
<tr>
<th>Extent of Critical Terms Matching</th>
<th>Guidance on Assessment Required to Demonstrate Economic Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significantly Mismatched</td>
<td>When the critical terms of the hedging instrument and the hedged item are significantly mismatched, a more rigorous analysis may be required. This could entail the use of monte carlo simulations, regression analysis or other mathematical techniques to support the economic relationship.</td>
</tr>
</tbody>
</table>

**Note!** Critical terms will commonly include such items as the nominal amounts of a currency or commodity, maturity or execution dates of a contract, the dates of any rate resets, and the underlyings of any derivatives used.

**Examples of the Assessment of Critical Terms**

**Example 1:**
Entity A has issued a variable rate bond of $5 million at an interest rate of prime + 3% with interest rate resets on January 1st, April 1st, July 1st and October 1st of each year.

Entity A also entered into an interest rate swap with a notional amount of $5 million. The swap pays prime +3% in exchange for a fixed amount of 4% and the variable interest rate resets on the first day following every calendar quarter. The swap is on-market at the date of purchase (i.e., the prime lending rate at the time of the swap was 1%).

Both the bond and swap have a 5-year term.

**Assessment:** Since all critical terms match, there is likely no quantitative analysis required to demonstrate an economic relationship.

**Example 2:**
Assume the same case facts as in Example 1 but the interest rate swap resets on February 15th, May 15th, August 15th, and November.

**Assessment:** This would be a source of hedge ineffectiveness that may require a simple analysis to demonstrate hedge effectiveness. In a market with a relatively stable benchmark lending rate, there may be little variation between interest rates used in determining cash flows for the bond and the interest rate swap. However, in markets with greater volatility in benchmark lending rates, the mismatched reset dates may have a greater impact on hedge effectiveness.

If the swap was entered into for a different time frame than the bond, was off-market at the time of designation, or was referenced to an economically related but different underlyings, such as the 3-month treasury bill rate, a more formal statistical analysis may be required to corroborate the economic relationship.

**Note!** It is expected that an entity will be able to apply a qualitative test (e.g. critical terms test) for simpler hedge relationships while a more detailed quantitative analysis will likely be required for complex hedge relationships. Professional judgment will need to be applied to determine whether an economic relationship exists and what type of effectiveness test to apply (i.e., qualitative vs. quantitative) for complex hedge relationships.
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

The Effect of Credit Risk on an Economic Relationship

The hedge accounting model is based on a general notion of offsetting gains and losses of hedging instruments and hedged items. Because these instruments will require counterparties to make good on any obligations that arise, hedge effectiveness is determined not only by the economic relationship between those two items, but also by the effect of credit risk on the value of both the hedged item and hedging instrument. This can result in an erratic level of offset, regardless of the strength of the economic relationship.

Note! Entities should consider the effect of changes in a counterparty’s credit risk as well as its own credit risk when assessing hedge effectiveness. However, not all hedged items (e.g. inventory, forecast transaction, etc.) are exposed to credit risk. Also, certain hedged items will only be exposed to either counterparty or the entity’s own credit risk, but not both (e.g. financial liabilities bear the issuing entity’s own credit risk).

For a hedge to be effective, the effect of credit risk must not dominate value changes resulting from the economic relationship.

Example of the Effect of Credit Risk

A regional Credit Union that wishes to hedge a portfolio of consumer loans may be unable to utilize hedge accounting if deteriorating economic conditions in its region causes a sizable increase in credit risk which is not also reflected in the hedging instrument.

a) When is credit risk dominating the value changes in the underlyings of the hedged item and hedging instrument?

The standard considers significant changes in the underlyings when determining dominance of credit risk. A level of magnitude that gives rise to dominance is one that would result in the loss or gain from credit risk having a significant effect on the fair value of the hedging instrument or the hedged item when the changes in the underlyings were also significant.

This means that if during a particular period there are little changes in the underlyings, the fact that even small credit risk-related changes in the value of the hedging instrument or hedged item might affect the hedging relationship more than the underlyings does not result in violation of the hedge effectiveness requirements.

Example of the Determination of the Dominance of Credit Risk

Lender A applies fair value hedge accounting to hedge its exposure to changes in fair value of its $100,000 fixed rate loan using a pay-fixed receive-variable interest rate swap. A small change in interest rates resulted in a hedging adjustment to the loan of $1,000 and a change in the loan’s credit quality resulted in an adjustment to the loan of $1,000 (1% of the loan total).

Assessment: The effect of credit risk is significant in relation to the changes in the underlying (i.e., the effect of the change in credit risk impacted the loan equally as the change in the market interest rate). However, because the adjustments involved are so minimal in relation to the total size of the loan, the effect of credit risk does not dominate changes arising from the economic relationship. If the change in credit quality resulted in an adjustment to the loan of $15,000 (15% of the loan total), this would likely indicate that credit risk dominates the effect of the economic relationship.
When considering the impact of credit risk, an entity considers the effects of collateral, seniority of claims and any guarantees of liabilities.

**Step 5: Determine the Hedge Ratio**

The hedge ratio:

1) Is calculated from the quantity of the hedged item being hedged and the quantity of the hedging instrument being used to hedge that quantity of the hedged item.

2) Should not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (recognized or not) that results in accounting outcomes inconsistent with the purpose of hedge accounting.

**Example of Determining the Hedge Ratio**

**Example 1:**

Entity A wants to hedge an anticipated purchase of 50,000 bushels of corn and the unit of measurement of the relevant future contracts is 5,000 bushels. As such, Entity enters into 10 futures contracts with a notional amount of 50,000 bushels each.

**Assessment:** Often the notional amounts will perfectly match, as in this example, which means the hedge ratio is 1:1. However, there may be situations where the hedge ratio is different in order to reduce hedge ineffectiveness.

**Example 2:**

Entity B entered into futures contracts for $10 million in order to hedge firm commitments for sales totaling $6 million in anticipation of acquiring another $4 million of sales.

**Assessment:** Entity B would not be able to designate the entire $10 million as the hedging instrument with regards to its firm commitments. It would set the hedge ratio using $6 million of the futures (resulting in a hedge ratio of 1:1). Depending on whether the additional $4 million of firm commitments qualified as highly probable forecast transactions, it might be able to designate the remaining amount of the future contracts in another hedging relationship.

The standard requires use of the same hedge ratio for accounting purposes as is used for risk management purposes, unless doing so would create deliberate hedge ineffectiveness. However, the quantities used for the hedged items and hedging instruments do not need to match for risk management and accounting purposes. If an entity is hedging less than the full amount of an item, it should designate the hedging relationship using the hedge ratio that is the same as that resulting from that percentage of the exposure.

**Example of Using the Same Hedge Ratio for Risk Management and Accounting Purposes**

Entity A enters into a hedging relationship where it hedges only 80% of a $5 million bond.

**Assessment:** Entity A would designate the hedging relationship using only a $4 million nominal component (80% x $5 million) of the bond as the hedged item so that the same hedge ratio is used for both risk management and accounting purposes.
IFRS 9 gives examples of relevant considerations in assessing the second criteria (i.e., whether the hedge ratio reflects an imbalance that results in accounting outcomes inconsistent with the purpose of hedge accounting). These examples are shown in the table below.

<table>
<thead>
<tr>
<th>IFRS Guidance</th>
<th>Example Situation</th>
<th>Criteria 2 Met?</th>
</tr>
</thead>
<tbody>
<tr>
<td>The hedge ratio has been established to avoid recognizing hedge ineffectiveness for cash flow hedges, or in the case of fair value hedges, achieving adjustments for more hedged items (with the aim of increasing the use of fair value accounting) without offsetting fair value changes to the hedging instrument.</td>
<td>An entity chooses to use a quantity of the hedging instrument that is insufficient to fully hedge the quantity of the hedged item designated, leaving an economic “gap” in its hedging. As a result, the entity can utilize fair value accounting for the entire hedged item in a fair value hedge, or avoid recognizing hedge ineffectiveness in a cash flow hedge.</td>
<td>No. This hedge ratio results in an accounting outcome that is inconsistent with the purpose of hedge accounting which is to accurately reflect the results of an entity’s risk management practices.</td>
</tr>
<tr>
<td>Commercial reasons could also influence particular weightings of the hedged item and hedging instrument, despite them causing hedge ineffectiveness.</td>
<td>It is not commercially possible to obtain notional contracts for volumes of goods or nominal amounts of currency that precisely match the item being hedged.</td>
<td>Yes. The entity uses the hedge ratio resulting from the actual amounts used because any hedge ineffectiveness arising from this mismatch is not inconsistent with the purpose of hedge accounting.</td>
</tr>
</tbody>
</table>

**Step 6: Designate and Document the Hedging Relationship**

To commence hedge accounting, IFRS 9 requires that there be formal designation and documentation of the hedging relationship, normally including:

- The entity’s risk management objective and strategy for undertaking the hedge;
- A comprehensive description of the hedged item and hedging instrument(s);
- The nature of the risk being hedged;
- How the entity will assess whether the hedging relationship meets the hedge effectiveness requirements, including:
  - Analysis of the sources of hedge ineffectiveness; and
  - The method of determining the hedge ratio.
Accounting for Qualifying Hedging Relationships

The mechanics of hedge accounting are largely unchanged from IAS 39.

There are three types of hedges:

- Cash flow hedges;
- Fair value hedges; and
- Hedges of net investments in self-sustaining foreign operations.

**Cash Flow Hedges**

Recap! A cash flow hedge is 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 recognized asset or liability or a highly probable forecast transaction, and could affect profit or loss.

Without hedge accounting, there is a mismatch in the timing of when the gains or losses arising from the change in cash flows of the hedging instrument and hedged item are reflected in profit or loss. The change in the cash flows of the hedging instrument is recognized prior to that for the hedged item. With hedge accounting, the gains or losses arising from the change in cash flows of the hedging instrument are accumulated and held in a separate component of equity until the hedged item is recognized. Therefore, a cash flow hedge delays the recognition of the change in cash flows related to the hedging instrument.

**Example of a Cash Flow Hedge**

ABC Credit Union provides member loans bearing interest at variable rates. The variable-rate member loans are measured at amortized cost. The Credit Union hedges its exposure to changes in market interest rates using an interest rate swap that pays out a variable interest rate in exchange for receiving a fixed interest rate.

**Assessment:** In effect, the Credit Union has converted the variable rate loan assets into fixed rate loan assets and hedged their exposure to changes in market interest rates.

If hedge accounting is not applied, a decrease in market interest rates would result in a gain on the swap which is recognized in profit or loss because the swap is a derivative. Since the member loans are measured at amortized cost there would be no change in their stated value. Accordingly, an earnings mismatch results. It is this mismatch that cash flow hedge accounting aims to address by recognizing the effective portion of the change in the swap in a separate cash flow hedge reserve in equity until the actual cash flows of the loan assets affects profit or loss.

When cash flow hedge accounting is applied, the effective portion of the gains or losses on the hedging instrument is recognized in OCI. These gains or losses are accumulated in a separate component of equity known as the cash flow hedge reserve. The ineffective portion of the gains or losses on the hedging instrument is recognized in profit or loss.

At each reporting date, the cash flow hedge reserve is adjusted to the lower of the following (in absolute amounts):

- The cumulative gain or loss on the hedging instrument from inception of the hedge.
- The cumulative change in fair value (i.e., present value) of the hedged item from inception of the hedge.

Any adjustment required to balance the cash flow reserve as calculated above is recognized in profit or loss. This adjustment reflects the ineffectiveness of the cash flow hedge.
Example of Accounting for a Cash Flow Hedge (Setting up the Reserve)

Company A entered into a $5 million fixed-for-variable swap to hedge its $5 million variable rate borrowings. During the reporting period, an increase in the benchmark interest rate affected both the hedging instrument and the hedged item.

At the reporting date, the change in the fair value of the hedged item (i.e., the variable rate debt) was a $250,000 loss, and the gain on the hedging instrument (i.e., the interest rate swap) was $300,000. This means that $50,000 of the change in the cash flows of the swap relates to hedge ineffectiveness because of the timing of interest payments, differences between actual and expected repayments, etc.

Assessment: The cash flow hedge reserve, presented as a separate component of equity, is adjusted to $250,000, this being the lesser of the gain on the hedging instrument ($300,000) and the change in fair value of the hedged item ($250,000). The effective portion of the gain on the hedging instrument ($250,000) is recognized in OCI and the remaining $50,000 (i.e., the ineffective portion of the gain on the hedging instrument) is recognized in profit or loss as per the following journal entry:

To recognize the change in the cash flows of the hedging instrument.

\[
\begin{align*}
\text{Dr Derivative asset} & \quad \text{Cr OCI} \\
& \quad \text{Cr Hedging gain}
\end{align*}
\]

\[
\begin{align*}
$300,000 & \quad $250,000 \\
& \quad $50,000
\end{align*}
\]

Conversely, if the change in fair value of the hedged item was a $300,000 loss and the gain on the hedging instrument was $250,000, the entirety of the $250,000 gain on the hedging instrument would be recorded to OCI as the change in value of the hedging instrument is less than the change in value of the hedged item. No amount would be recorded in profit or loss because the cash flow hedge reserve is adjusted only for the lower of the changes in the hedging instrument and the hedged item, which means that only hedge ineffectiveness where the change in fair value of the hedging instrument exceeds the change in value of the hedged item requires hedge ineffectiveness to be reported in profit or loss.

<table>
<thead>
<tr>
<th>Hedging relationship Component</th>
<th>Accounting Treatment at End of Each Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Instrument</td>
<td>The effective portion of changes in value are recognized as a cash flow hedge reserve in equity.</td>
</tr>
<tr>
<td>Hedged Item</td>
<td>No changes in value are recognized.</td>
</tr>
<tr>
<td>Hedge Ineffectiveness: Change in Hedging Instrument is Greater Than Change in Hedged Item</td>
<td>Recognized immediately in profit or loss.</td>
</tr>
<tr>
<td>Hedge Ineffectiveness: Change in Hedged Item is Greater Than Change in Hedging Instrument</td>
<td>Not recognized. This ineffectiveness will be recognized in profit or loss when the affected cash flows occur.</td>
</tr>
</tbody>
</table>

Eventually, cash flows relating to the hedged item will be recognized in profit or loss, either directly or through the recognition of an asset or liability that will affect profit or loss in future periods. As can be seen in the following table, the subsequent accounting for the cash flow hedge reserve depends on the item being hedged.
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

<table>
<thead>
<tr>
<th>Hedged Item</th>
<th>Subsequent Accounting for the Reserve</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged forecast transaction resulting in recognition of a non-financial</td>
<td>Remove and include in the initial cost or carrying amount of the asset and liability. Consequently,</td>
<td>An entity hedged a highly probable forecast transaction for a purchase of steel for use in its manufacturing process. Once the steel</td>
</tr>
<tr>
<td>asset or non-financial liability*</td>
<td>there is no impact on profit or loss until the financial asset or liability is amortized, sold or</td>
<td>was purchased and recognized as inventory, the cash flow hedge reserve was transferred out of equity and included in the cost of that</td>
</tr>
<tr>
<td></td>
<td>settled.</td>
<td>inventory. In effect, cost of sales (profit or loss) is affected as the sale of the inventory takes place.</td>
</tr>
<tr>
<td>All other hedged items</td>
<td>Reclassified to profit or loss in the same period(s) during which the hedged item’s cash flows</td>
<td>The cash flow hedge reserve, arising from the change in the value of an interest rate swap used to hedge coupon payments of a bond</td>
</tr>
<tr>
<td></td>
<td>affect profit or loss. This is referred to as a “reclassification adjustment” under IFRS.</td>
<td>that are tied to an interest rate benchmark, is recognized in profit or loss as those coupon payments are made.</td>
</tr>
</tbody>
</table>

*This accounting treatment also applies where a hedged forecast transaction for a non-financial asset or liability becomes a firm commitment for which fair value hedge accounting is applied (see IFRS 9.6.5.11(d)(i)).

Example of the Accounting for a Cash Flow Hedge of a Forecast Transaction Resulting in the Recognition of a Non-financial Asset

On September 30, 20x1, Company A entered into a futures contracts to purchase 20,000 tons of iron ore on January 15, 20x2 for $80/ton. Company A designated this contract as a hedging instrument to hedge its exposure to price risk in relation to its highly probable forecast purchase of 20,000 tons of iron ore on January 15, 20x2.

At December 31, 20x1, a futures contract for the January 15, 20x2 delivery of iron ore is priced at $85/ton, resulting in a gain of $100,000 (20,000 tons x [$(85 – $80)]). Because the critical terms of the arrangement match (i.e., the underlying, delivery date and nominal amounts are all identical), there is no hedge ineffectiveness.

**Assessment:** The following journal entries should be recognized:

**December 31, 20x1:**

*To recognize changes in the fair value of the futures contract hedging instrument.*

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Derivative asset</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cr OCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

On January 15, 20x2, the Company settles the futures contract net when the spot price for iron ore is $84.50/ton, receiving cash of $90,000 (20,000 tons x [$(84.50 - $80)] and recording an adjustment to the cash flow hedge reserve of $10,000 (20,000 tons x [$(85 - $84.50)]).
### Example of the Accounting for a Cash Flow Hedge of a Forecast Transaction Resulting in the Recognition of a Non-financial Asset (cont’d)

**January 15, 20x2:**

*To recognize the settlement of the futures contract hedging instrument.*

<table>
<thead>
<tr>
<th>Dr Cash</th>
<th>$90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr OCI</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cr Derivative asset</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

On January 15, 20x2, Company A also completes its purchase of iron ore for $1.69 million (20,000 tons x $84.50). The Company also records the adjustment of the cash flow hedge reserve to the carrying value of the inventory on initial recognition.

*To recognize the inventory purchase together with the adjustment to the cash flow hedge reserve.*

| Dr. Inventory | $1,600,000 |
| Dr. OCI | $90,000 |
| Cr Cash | $1,690,000 |

### Example of the Accounting for a Cash Flow Hedge When no Non-financial Asset or Liability is Recognized

**Part I:**

On September 30, 20x1, Company A entered into a futures contract to sell 20,000 tonnes of canola on January 15, 20x2 at a price of $480/tonne. The Company designated this contract as a hedging instrument to hedge its exposure to commodity price risk in relation to the first 20,000 tonnes of its highly probable forecasted sales of canola between January 15, 20x2 and April 15, 20x2.

At December 31, 20x1, a futures contract for the January 15, 20x2 delivery of canola is priced at $485/tonne, resulting in a loss of $100,000 (i.e., 20,000 tonnes x [$485/tonne - $480/tonne]). Using historical sales figures, estimated future prices and present value discounting, the Company determines that the gain on the hedged forecasted sales is $95,000, resulting in $5,000 of hedge ineffectiveness.

**Assessment:** The following journal entries should be recognized:

**December 31, 20x1:**

*To recognize changes in the fair value of the futures contract hedging instrument.*

| Dr OCI | $95,000 |
| Dr Hedging loss | $5,000 |
| Cr Derivative liability | $100,000 |
Example of the Accounting for a Cash Flow Hedge When no Non-financial Asset or Liability is Recognized (cont'd)

Part II:
On January 15, 20x2, the Company settles the futures contract net when the spot price for canola is $484.50/tonne, paying cash of $90,000 (20,000 tonnes x [$484.50 - $480.00]). The change in the price of the futures contract since year-end results in a gain of $10,000 (20,000 tonnes x [$485.00 - $484.50]). The Company calculated that $3,000 was hedge ineffectiveness as follows:

- Cumulative loss on the futures contract was $90,000 (previously recognized $95,000 Dr in Equity)
- Cumulative change in fair value of the forecast transaction was calculated to be $88,000.

Assessment: An entry to OCI is made to reduce the cash flow reserve by $7,000 (i.e., $95,000 - $88,000). The total change in the price of the futures contract since year-end is $10,000. Therefore, $3,000 hedge ineffectiveness.

January 15, 20x2:
To recognize the settlement of the futures contract hedging instrument.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Journal Entry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Derivative liability</td>
<td>Cr OCI $7,000</td>
</tr>
<tr>
<td></td>
<td>Cr Hedging gain $3,000</td>
</tr>
<tr>
<td>DR Derivative liability</td>
<td>Cr Cash $90,000</td>
</tr>
</tbody>
</table>

This leaves $88,000 in the cash flow hedge reserve to be recognized in profit or loss as the hedge item’s cash flows affect profit or loss.

Part III:
Company A makes sales of canola as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 25</td>
<td>5,000 tonnes</td>
</tr>
<tr>
<td>February 12</td>
<td>8,000 tonnes</td>
</tr>
<tr>
<td>March 24</td>
<td>4,200 tonnes</td>
</tr>
<tr>
<td>March 24</td>
<td>4,200 tonnes</td>
</tr>
<tr>
<td>April 4</td>
<td>8,000 tonnes</td>
</tr>
</tbody>
</table>

Assessment: At each date, Company A would record its sales net of the following adjustments for the cash flow hedge reserve:

<table>
<thead>
<tr>
<th>Date</th>
<th>Sales</th>
<th>Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 25</td>
<td>$22,000</td>
<td>($88,000 x (5,000/20,000))</td>
</tr>
<tr>
<td>February 12</td>
<td>$35,200</td>
<td>($88,000 x (8,000/20,000))</td>
</tr>
<tr>
<td>March 24</td>
<td>$18,480</td>
<td>($88,000 x (4,200/20,000))</td>
</tr>
<tr>
<td>April 4</td>
<td>$12,320</td>
<td>($88,000 x (20,000-5,000-8,000-4,200)/20,000)</td>
</tr>
</tbody>
</table>

*Note that only 2,800 tonnes are used in this calculation as this is the remaining amount of the original 20,000 tonnes of canola sales that were hedged. It is important for the purposes of calculating the cash flow hedge reserve adjustments to maintain records of the nominal amounts involved.*
Note! In the previous examples, depending on the date at which an adjustment was being recorded, the entity used either the forward price for delivery or the spot price for the purposes of calculating the adjustment. The price for forward delivery is used until calculating the final adjustment. It is important that the price used reflects the circumstances of the hedging relationship; calculations made for dates in the future should use information that reflects the market’s best estimate of prices that will exist at that date.

When the cash flow hedge reserve is in a loss (i.e., debit) position and an entity expects that all or a portion of that loss will not be recovered in the future, the amount which is not regarded as recoverable is immediately reclassified to profit or loss as a reclassification adjustment.

Example of Reclassification of Loss in OCI if not Recoverable in the Future

Company A has a loss in its cash flow hedge reserve account. This loss represents the cumulative loss from the hedge of the Company’s highly probable future purchase of inventory. This reserve will cause the amount of the inventory, when recognized, to exceed its net realizable value.

Assessment: As the Company doesn’t anticipate recovering the full cumulative loss in the cash flow hedge reserve account, any excess should immediately be reclassified to profit or loss.

Accounting for the Cash Flow Hedge Reserve on Discontinuation of the Hedging Relationship

When a cash flow hedge is discontinued, any accumulated cash flow hedge reserve is accounted for, as follows:

- If the hedged future cash flows are still expected to occur, the cash flow hedge reserve is maintained and only recognized in accordance with the accounting treatment previously discussed in this section (i.e., adjusted against the non-financial asset recognized, recognized into profit or loss when the cash flows of the original hedged item also impact profit or loss, etc.); or
- If the hedged future cash flows are no longer expected to occur, the cash flow hedge reserve is immediately reclassified to profit or loss as a reclassification adjustment.

A hedged future cash flow which is no longer considered highly probable to occur may still be expected to occur. However, it is no longer eligible to be designated as a hedged item in a hedging relationship.

Fair Value Hedges

Recap: A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or components of any such item, that is attributable to a particular risk and could affect profit or loss.

Fair value hedges recognize the change in fair value of the hedged item in the current reporting period to offset the change in the related hedging instrument. Therefore, there is earlier recognition of the fair value change in the hedged item than if hedge accounting was not applied.
An Overview of the New Hedging Requirements of IFRS 9 *Financial Instruments*

For example, inventory is ordinarily measured at the lower of net realizable value and cost. A farming company with cattle inventory could seek to hedge its commodity price risk with a forward contract for the sale of its cattle. This derivative would be measured at FVTPL. Any increase in the market price of the cattle would result in a loss on the derivative. However, without applying hedge accounting, the increase in the fair value of the cattle inventory would not be recognized until the physical inventory is sold. Conversely, designation of a fair value hedging relationship would allow the Company to record the impact of the change in market prices for the cattle in profit or loss on both the derivative and its physical inventory to accurately reflect the company’s risk management practices.

The following table summarizes fair value hedge accounting which applies if the hedge meets the qualifying criteria:

<table>
<thead>
<tr>
<th>Hedging relationship Component</th>
<th>Accounting Treatment at the End of Each Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Instrument</td>
<td>Recognize the change in fair value in profit or loss (which is the typical treatment for a derivative).</td>
</tr>
<tr>
<td>Hedged Item</td>
<td>Recognize the change in fair value attributable to the hedged risk in profit or loss* and recognize a corresponding adjustment to the carrying value of the hedged item on the balance sheet (if applicable).</td>
</tr>
</tbody>
</table>

*When the hedged item is a financial asset (e.g. debt investment), or component thereof, that is measured at FVOCI, the hedging gain or loss on the hedged item is recognized in profit or loss. However, there is one exception to this rule. Where the hedged item is an equity instrument for which changes in fair value are recognized in OCI, the gain or loss on the hedging instrument and hedged item is recognized in OCI.*

In a fair value hedge, hedge ineffectiveness is recognized automatically through any differences between the amount by which the hedging instrument and the hedged item are adjusted.

As can be seen in the following table, the accounting for the change in fair value relating to the hedged item depends on the item being hedged.

<table>
<thead>
<tr>
<th>Hedged Item</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>A firm commitment (or a component thereof) to acquire assets or assume liabilities</td>
<td>The change in fair value of the firm commitment is recognized during the life of the hedging relationship in the statement of financial position as an asset or liability with a corresponding entry to profit or loss. When the firm commitment is met, the cumulative fair value change of the firm commitment previously recognized is included in the initial carrying amount of the recognized asset or liability.</td>
</tr>
<tr>
<td>A financial instrument (or component thereof) measured at amortized cost</td>
<td>The change in fair value of the financial instrument is included in the carrying amount of the asset or liability and amortized into profit or loss through recalculation of the effective interest rate at the date amortization begins. Amortization may begin as soon as an adjustment exists, but must begin no later than when the hedged item ceases to be adjusted for hedging gains and losses.</td>
</tr>
</tbody>
</table>
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

<table>
<thead>
<tr>
<th>Hedged Item</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>A debt instrument measured at FVOCI</td>
<td>The change in fair value of the financial instrument is included in the carrying amount of the asset or liability. Amortization applies in the same manner as for a financial instrument measured at amortized cost, as described above. However, such amortization only applies to the amount of the debt instrument that represents the cumulative gain or loss previously recognized through profit or loss.</td>
</tr>
</tbody>
</table>

When a fair value hedge is discontinued, any remaining fair value adjustments previously recognized to the hedged item are amortized as described in the table above.

Example of the Accounting for a Fair Value Hedge of a Fixed Rate Loan

**Part I:**

On January 1, 20x1, ABC Credit Union entered into a 3-years interest rate swap paying 4% interest in exchange for the Bank of Canada prime interest rate plus 1%. The swap’s notional amount is $3 million and the prime interest rate at inception of the swap is 3% (i.e., the swap is on-market). The Credit Union designated the swap as the hedging instrument on the origination date of a $3 million fixed-rate loan asset bearing interest at 6% with a 3-years term. It encounters some hedge ineffectiveness due to the variations in maturity dates and payment options.

During 20x1, the Bank of Canada increases the prime interest rate to 3.5%.

**Assessment:** Using quoted prices, the Credit Union determines that the gain on the interest rate swap is $42,500. The credit union reviews its loan portfolio using an updated discount rate and determines that the loss on the fair value of its loan portfolio would be $37,500 if it was accounted for at FVTPL.

At the reporting date, the Credit Union records the following journal entries:

**December 31, 20x1:**

**To recognize the fair value adjustment on the hedging instrument during 20x1.**

Dr Derivative asset $42,500
Cr Hedging gain $42,500

**To recognize the fair value adjustment on the hedged item during 20x1.**

Dr Hedging loss $37,500
Cr Loan Assets $37,500
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

Example of the Accounting for a Fair Value Hedge of a Fixed Rate Loan (cont’d)

Part II:
The Credit Union decides to begin amortization of the fair value hedge adjustment of $37,500 immediately after its recognition on December 31, 20x1. Assume that the coupon payments on the loan asset are made annually on December 31, 20x1, 20x2 and 20x3, and that the principal will be repaid on December 31, 20x3.

Assessment: On December 31, 20x1, an adjustment to the carrying amount was made of $37,500 as a result of hedge accounting; thus, the loan assets’ revised carrying amount is $2,962,500 ($3 million - $37,500).

Accordingly, the entity uses the following amounts to recalculate the effective interest rate once it decides to begin amortization of the hedging adjustment:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying value at December 31, 20x1</td>
<td>$2,962,500</td>
</tr>
<tr>
<td>Coupon payment receivable at end of 20x2</td>
<td>$180,000</td>
</tr>
<tr>
<td>Coupon payment and repayment of principal receivable at end of 20x3</td>
<td>$3,180,000</td>
</tr>
</tbody>
</table>

The revised effective interest rate based on the above cash flows is 6.69% and should be used to calculate the amortized cost of the loan assets until the effective interest rate must be recalculated to reflect any subsequent hedging adjustment.

Hedges of a Net Investment in a Foreign Operation

Hedges of a net investment in a foreign operation, including hedges of monetary items accounted for as as part of the net investment, are accounted for similarly to cash flow hedges. The portion of the gain or loss on the hedging instrument that is deemed to be an effective hedge is recognized in OCI. The ineffective portion is recognized in profit or loss.

Upon disposal, or partial disposal, of the entity’s net investment in a foreign operation, the cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge is reclassified from equity (i.e., foreign currency translation reserve) to profit or loss as a reclassification adjustment.

Note! Hedges of net investments in foreign operations are not widely used among MNP’s clients. As a result, we have not included additional information in this publication. Should you require further information, please contact your local MNP representative.

Measuring Hedge Ineffectiveness

When applying hedge accounting, it is necessary to determine the amount of change in the value of the hedged item resulting from the particular risk exposure being hedged. Isolating the change in the value of the hedged item resulting from the risk being hedged for the purpose of measuring hedge ineffectiveness can be difficult. This is because there are many variables that can affect the value of the hedged item beyond that of the hedged exposure.

5 The reclassification adjustment is recognized in accordance with IAS 21.48 - 49.
When measuring hedge ineffectiveness for a given period, an entity must consider the time value of money. Consequently, an entity will determine the value of the hedged item on a present value basis and any change in the value of the hedged item will also include the effect of the time value of money.

**Use of a Hypothetical Derivative**

As a practical expedient, an entity is permitted to use a hypothetical derivative calibrated at the hedged price (or rate) level. This means that a hypothetical derivative must represent the risk of the hedge.

**Note!** Hedges of two-sided risks could by represented by a hypothetical forward and a hedge of a one-sided risk could be represented by a hypothetical option.

A hedge of a one-sided risk would only protect the holder from a negative movement in the underlying without any corresponding offset to a positive movement. If a favourable gain on the hedged item occurred, there would be no offsetting negative movement in the value of the hedging instrument. This could be achieved through using options, whose value can never be negative (i.e., they are either in the money or their intrinsic value is $nil).

On the other hand, hedging a two-sided risk would effectively fix the value of the hedged item at a certain point (within the limits of hedge effectiveness). Any movement, positive or negative, in the value of the hedged item is offset by an opposing movement in the value of the hedging instrument, as is the case with a forward contract where the spot element of the contract can fluctuate between positive and negative values.

Hedges of a two-sided risk could also be achieved using offsetting options.

Hypothetical derivatives should not include features that only exist in the hedging instrument. For example, a hedging instrument may include a fee or charge for execution or early settlement that would not be included in the hypothetical derivative representing the hedged item.

**Subsequent Assessment of a Hedging Relationship**

**Subsequent Assessment of Effectiveness**

IFRS 9 requires that an entity assess at the inception of the hedging relationship, and on an ongoing basis, whether it expects the hedge to be effective. At a minimum, entities are required to perform this ongoing and forward-looking assessment at the earliest of:

- Each reporting date; or
- When a significant change in circumstances that could affect the hedging relationship’s ability to meet the hedge effectiveness criteria occurs.

A hedge could briefly become ineffective during a reporting period, for example, due to a period of market illiquidity. However, if the hedge was expected to be effective after the reporting date the requirements for hedge effectiveness would still be met.
A subsequent assessment of effectiveness may result in three different outcomes:

1) The hedging relationship continues to be effective – no changes are required.
2) Rebalancing – this entails adjusting the hedge ratio to reflect the change in the relationship between the underlyings.
3) Discontinuation – an entity must discontinue hedge accounting for a particular hedging relationship when:
   a) The risk management objective has changed;
   b) There is no longer an economic relationship between the hedged item and hedging instrument; or
   c) The effect of credit risk dominates the value changes that result from the economic relationship.

Rebalancing is discussed further in the next section of this guide while discontinuation of a hedging relationship is discussed in the Discontinuing a Hedging Relationship section of this guide.

The diagram below summarizes the prospective effectiveness assessment process:

Note! This represents a marked change from IAS 39, which requires an entity perform a retrospective assessment of the hedge’s effectiveness during the period. Under IFRS 9, the assessment relates to expectations about hedge effectiveness and thus, the test is only forward-looking (i.e., prospective).
Rebalancing

a) What is rebalancing?

As previously discussed, the hedge ratio is determined so that the hedging relationship does not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedging ineffectiveness. Without rebalancing, an accounting mismatch may arise resulting in an outcome inconsistent with the purposes of hedge accounting. This was the second criteria for setting the hedge ratio and is part of the hedge effectiveness criteria. This criterion needs to be continuously met so that the hedge can continue to qualify for hedge accounting.

**Note!** In practice, it is common for entities to adjust their hedge positions for any changes in the economic relationship between the hedged item and hedging instrument to improve hedge effectiveness (i.e., to achieve greater offset), especially if the hedging relationship extends for several years. When a hedge ratio is adjusted for risk management purposes, IAS 39 does not permit entities to adjust the quantities designated in the hedge relationship. Rather, entities must terminate the existing relationship and establish a new relationship. Conversely, IFRS 9 allows entities to rebalance its hedge ratio to continue the hedging relationship.

Rebalancing is performed in response to changes in the relationship between the hedged item and hedging instrument arising from underlyings or risk factors when the risk management objective is unchanged. Rebalancing refers to adjustments made to the designated quantities of hedged items and hedging instruments so that the hedge can continue to meet the hedge ratio criteria. Changes to the hedge ratio for other purposes do not constitute rebalancing. Rebalancing is performed prospectively.

**Examples of Rebalancing**

**Example 1:**

An entity using a forward contract to purchase exchange traded fund shares as a hedging instrument may need to rebalance the hedging relationship (i.e., adjust the quantities of the hedging instrument and/or hedged item) upon the inclusion of a new sector or stock into that fund.

**Example 2:**

An entity hedges its exposure to Chinese Yuan (“RMB”) using a derivative (e.g. a cross-currency swap) referenced to the United States Dollar (“USD”), as the People’s Bank of China regularly maintains an exchange rate of 6.5 RMB/USD. The entity may need to rebalance the hedging relationship if, during a period of economic turbulence, the People’s Bank of China begins maintaining the exchange rate at 6.7RMB/USD.

**Example 3:**

Western Canadian Select (“WCS”) crude oil regularly trades at a discount to its main competitor, West Texas Intermediate (“WTI”). An entity hedging its sales of WCS using derivatives referenced to WTI (e.g. a forward sales contract) might need to rebalance the hedging relationship if a new pipeline was constructed which reduced the discount at which WCS trades relative to WTI.
b) How does an entity assess whether rebalancing is required?

Not every change in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item’s fair value or cash flows will constitute a change in the economic relationship between them. An entity analyzes the sources of hedge ineffectiveness that it expected to affect the hedging relationship. Specifically, it evaluates whether changes in the extent of offset:

- Result from fluctuations around the hedge ratio which remains valid,
- Indicates that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

The above evaluation will require judgment.

The following table shows whether rebalancing is required, and how it is treated, in various circumstances.

<table>
<thead>
<tr>
<th>Description</th>
<th>Example</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in the fair value of the hedging instrument and the hedged item’s fair value or cash flows of the hedged item indicate that the hedge ratio remains valid (i.e., the hedge ratio does not create an imbalance between the weightings of the hedged item and the hedging instrument creating hedge ineffectiveness).</td>
<td>The price spread between Western Canadian Select (WCS) and West Texas Intermediate (WTI) crude oil fluctuates on a regular basis in response to natural variations in supply and demand. Changes in offset arising from temporary disruptions in storage of WCS that impact the price would not indicate an ongoing change in the hedging relationship.</td>
<td>No rebalancing is required</td>
</tr>
<tr>
<td>Changes in the fair value of the hedging instrument and the hedged item’s fair value or cash flows of the hedged item so that the hedge ratio no longer appropriately reflects the relationship (i.e., the hedge ratio creates an imbalance between the weightings of the hedged item and the hedging instrument creating hedge ineffectiveness).</td>
<td>The price spread between Western Canadian Select (WCS) and West Texas Intermediate (WTI) crude oil fluctuates on a regular basis in response to natural variations in supply and demand. Changes in offset arising from the commercial application of a new technique to more cheaply refine WCS without retrofitting existing refineries could create an offset that would require an updated hedge ratio.</td>
<td>Determine and recognize hedge ineffectiveness (using prior hedge ratio) and then adjust the hedge ratio.</td>
</tr>
</tbody>
</table>
## An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

<table>
<thead>
<tr>
<th>Description</th>
<th>Example</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity has changed its risk management objective</td>
<td>An entity previously used interest rate swaps relating to its risk management objective to keep 25% of its net loans at a variable rate and the remainder fixed. The risk management objective was subsequently changed to a target of 30%.</td>
<td>Rebalancing does not apply in this situation. Instead, hedge accounting is discontinued for the hedging relationship designated under the old objective. The entity may designate a new hedging relationship using revised quantities of hedging instruments and hedged items to meet the new objective.</td>
</tr>
</tbody>
</table>

**Note!** Fluctuations around a constant hedge ratio cannot be reduced by adjusting the hedge ratio as they are a result of natural mismatches and volatility. Accordingly, in such circumstances the change in the extent of offset is dealt with by measuring and recognizing hedge ineffectiveness.

c) **How is rebalancing performed?**

A hedging relationship can be rebalanced in a variety of ways. To increase the relative weighting of the hedged item or decrease the relative weighting of the hedging instrument:

- Increase the volume of the hedged item being designated; or
- Decrease the volume of the hedging instrument.

Alternatively, to increase the relative weighting of the hedging instrument or decrease the relative weighting of the hedged item:

- Increase the volume of the hedging instrument; or
- Decrease the volume of the hedged item.

**Note!** Increasing or decreasing the amount of the hedged item designated would not reflect the usual risk management practices of most entities and would necessitate the tracking of various quantities of the hedged item to continue to account for pre-existing cash flow hedge reserves or fair value adjustments. Therefore, it will most often be more cost-effective to adjust the amount of the hedging instrument designated in a hedging relationship.

d) **How is rebalancing accounted for and what else needs to be documented?**

Rebalancing is accounted for as a continuation of the pre-existing hedging relationship. When rebalancing, hedge ineffectiveness is measured and recognized immediately before adjusting the hedging relationship.

The documentation of the hedging relationship and the sources of hedge ineffectiveness expected to affect the hedging relationship for its term is updated upon rebalancing.

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Note: This communication contains a general overview of the topic and is current as of August 31, 2017. The application of the principles addressed will depend upon the particular facts and circumstances of each individual case. Accordingly, this publication is not a substitute for professional advice and we recommend that any decisions you take about the application or not of any of the information presented be made in consultation with a qualified professional who can address any variance that may be required to reflect your circumstances. Please contact your local MNP representative for customized assistance with the application of this material. MNP LLP accepts no responsibility or liability for any loss related to any person's use of or reliance upon this material. © MNP LLP 2017. All rights reserved.
The following table notes how rebalancing is accounted for:

<table>
<thead>
<tr>
<th>Method of Rebalancing</th>
<th>Accounting Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase to the Volume of the Hedged Item</td>
<td>▪ Changes in the fair value of the hedging instrument are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ Measurement of changes in the fair value of the volume of the hedged item previously designated are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ From the date of rebalancing, changes in the value of the hedged item will also include the change in value of the additional volume of the hedged item.</td>
</tr>
<tr>
<td>Decrease to the Volume of the Hedged Item</td>
<td>▪ Changes in the fair value of the hedging instrument are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ Measurement of changes in the fair value of the volume of the hedged item that continues to be designated are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ From the date of rebalancing, the volume by which the hedged item was decreased is no longer accounted for as part of the hedging relationship.</td>
</tr>
<tr>
<td>Increase to the Volume of the Hedging Instrument</td>
<td>▪ Changes in the value of the hedged item are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ Measurement of the changes in the fair value of the hedging instrument related to the previously designated volume remain unaffected.</td>
</tr>
<tr>
<td></td>
<td>▪ From the date of 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.</td>
</tr>
<tr>
<td></td>
<td>▪ Changes in the value of the additional volume of the hedging instrument are measured starting from, and by reference to, the date of rebalancing and not the date on which the hedging relationship was designated.</td>
</tr>
<tr>
<td>Decrease to the Volume of the Hedging Instrument</td>
<td>▪ Changes in the value of the hedged item are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ Measurement of the changes in the fair value of the hedging instrument related to the volume that continues to be designated are not affected.</td>
</tr>
<tr>
<td></td>
<td>▪ From the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship.</td>
</tr>
</tbody>
</table>

**Discontinuing a Hedging Relationship**

Hedge accounting is discontinued prospectively once the qualifying criteria are no longer met.

Under IFRS 9, hedge accounting can only be discontinued when the hedging relationship no longer meets the:
- Risk management objective on the basis of which it qualified for hedge accounting (i.e., the entity has changed risk management objectives); or
- Qualifying criteria after considering any rebalancing.

**Note!** Under IAS 39, entities could elect to discontinue hedge accounting for any hedge relationship at any time.
Discontinuation of hedge accounting can result in either full discontinuation of a hedging relationship or discontinuation of only a part of the relationship, with hedge accounting continuing to be applied to the remainder. The following table provides a non-exhaustive list of common scenarios resulting in either full or partial discontinuation of a hedging relationship:

<table>
<thead>
<tr>
<th>Type of Discontinuation</th>
<th>Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Discontinuation</td>
<td>The hedging relationship no longer meets the risk management objective on the basis of which it qualified for hedge accounting.</td>
</tr>
<tr>
<td></td>
<td>The hedging instrument(s) has(ve) expired, or been sold, terminated or exercised.</td>
</tr>
<tr>
<td></td>
<td>There is no longer an economic relationship between the hedged item and hedging instrument.</td>
</tr>
<tr>
<td></td>
<td>The effect of credit risk has started to dominate the value changes resulting from the economic relationship.</td>
</tr>
<tr>
<td>Partial Discontinuation</td>
<td>Rebalancing has resulted in a certain quantity of the hedged item or hedging instrument no longer being part of the hedging relationship.</td>
</tr>
<tr>
<td></td>
<td>The occurrence of a certain volume of the hedged item that was (or was a component of) a highly probable forecast transaction is no longer highly probable.</td>
</tr>
</tbody>
</table>

An entity can designate a new hedging relationship involving the hedging instrument or hedged item of a previous hedging relationship for which hedge accounting was discontinued. However, this is not a continuation of a hedging relationship but represents the start of a new relationship.

Refer to the *Cash Flow Hedges* and *Fair Value Hedges* sections of this guide for guidance on how to account for the accumulated cash flow hedge reserve or adjustments to hedged items when a cash flow hedge or fair value hedge, respectively, is discontinued.

**More Complex Hedge Accounting Relationships**

This section introduces other more complex hedges and the related IFRS 9 requirements. IFRS 9 should be consulted for more detailed requirements and guidance.

**Aggregated Exposures as a Hedged Item**

An entity will often be exposed to more than one type of risk on its assets, liabilities, firm commitments or forecast transactions. For example, an entity may enter into a fixed rate foreign currency loan which exposes it to both interest rate and foreign currency risk during the term of the loan. IFRS 9 permits an entity to designate aggregated exposures as hedged items to manage more than one risk for different time periods.
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

Note! The ability to designate an aggregated exposure as a hedged item allows entities to more accurately reflect their risk management activities within their financial statements and represents a marked departure from the approach under IAS 39.

Entities commonly hedge multiple exposures of a single asset, liability, firm commitment or highly probable forecast transaction; however, under IAS 39, it is not possible to designate a derivative as a hedged item, or to designate aggregated exposures. Therefore, the outcome under IAS 39 is the discontinuation of a previously designated hedging relationship and re-designation of the original hedging instrument jointly with another derivative in a new relationship to hedge the aggregated exposure. This often leads to hedge ineffectiveness since the original hedging instrument no longer has a fair value of zero.

An aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk(s). If this is the case, the entity may designate the aggregated exposure as the hedged item.

Examples of an Aggregated Exposure as a Hedged Item

Example 1:

Entity A has entered into a firm commitment to purchase wheat in US dollars. It has managed its commodity price risk by entering into a forward contract for the purchase of the wheat in Canadian dollars. It then also purchases a foreign currency forward contract to manage its foreign currency risk.

Assessment: The entity can designate the following hedging relationship:

- Hedging relationship 1: The firm commitment for the purchase of the wheat (hedged item) and the forward contract for the purchase of the wheat in Canadian dollars (hedging instrument).

Hedging relationship 2: The aggregated exposure made up of the firm commitment and the forward contract in Canadian dollars (hedged item) and the foreign currency forward contract (hedging instrument).
Examples of an Aggregated Exposure as a Hedged Item

**Example 2:**

Credit Union A has term deposits denominated in U.S. dollars paying interest at a fixed rate. It wishes to hedge its exposure to both foreign currency risk and fair value risk, as changes to either would affect the fair value of the deposits.

First, the Credit Union enters into foreign currency swaps with various swap dates based on the maturity of its term deposits to hedge its foreign currency risk. It then enters into pay-variable receive-fixed interest rate swaps to hedge its interest rate exposure with notional amounts based on the now fixed Canadian dollar term deposits.

**Assessment:** Under IAS 39, the Credit Union must designate only the U.S. denominated term deposits as the hedged item in its hedging relationship with the interest rate swaps. This creates hedge ineffectiveness as the notional amounts of the interest rate swaps are based on the now fixed Canadian dollar term deposits while hedge effectiveness is calculated on the value of the term deposits based on the fluctuating exchange rate.

Under IFRS 9, the Credit Union can designate its aggregated exposure of the U.S. denominated term deposits together with the foreign currency swaps as a joint hedged item.

- Hedging relationship 1: The Credit Union’s term deposits (hedged item) and the foreign currency swaps (hedging instrument).

Hedging relationship 2: The aggregated exposure made up of the Credit Union’s term deposits and foreign currency swaps (hedged item) and the pay-variable receive-fixed interest rate swaps (hedging instrument).

Additional information on hedging aggregated exposures is available in the application guidance of IFRS 9; see paragraphs IFRS 9.B6.3.3 - 3.4.
Hedging Groups of Items

IFRS 9 permits the designation of a group of items as the hedged item in a hedging relationship if certain criteria are met. A group of items is eligible to be designated as the hedged item in a hedging relationship only if:

▪ The group consists of items (including components of items) that are, individually, eligible hedged items;
▪ The items in the group are managed together on a group basis for risk management purposes; and
▪ In the case of a cash flow hedge for a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:
  • It is a hedge of foreign currency risk; and
  • The designation of that 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.

Under IFRS 9, hedge accounting could be applied to groups of items such as:

▪ Multiple equity investments
▪ Loan assets and deposits
▪ Firm commitments or highly probable forecast transactions for sales and purchases of materials that will be used for those sales
▪ The net of expected foreign currency transactions

Additional information on the designation of a group of items as the hedged item in a hedging relationship is available in the application guidance of IFRS 9; see IFRS 9.B6.6.1 – B6.6.8.

Hedging a Component of an Item

An entity may designate a component of an item, or group of items, as the hedged item in a hedging relationship. A component comprises less than the entire change in cash flows or fair value of an item.

There are a variety of ways to designate a component of an item as a hedged item. They can be broken up into:

▪ Changes in the cash flows or fair value of an item attributable to a specific risk(s);
▪ One or more selected contractual cash flows; or
▪ Components of a nominal amount (i.e., a specified part of the amount of an item).

Note! Discussions with other departments, such as the sales or purchasing departments, may be required to determine whether a contract consists of various components.

Risk Components

To qualify as a hedged item:

▪ The risk component must be a separately identifiable component of a financial or non-financial item; and
▪ The item’s cash flow or fair value changes attributable to changes in that risk component must be reliably measurable.
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

Note! It may not always be economically possible to hedge all risks that an entity is exposed to. In fact, in practice, the management of risks regularly occurs at the individual risk level rather than for an item in its entirety.

Although IAS 39 allows the hedging of a risk component for financial items, it only allows a non-financial item to be designated as the hedged item for its foreign currency risk (or all of its risks in their entirety). This may result in certain risk management activities not qualifying for hedge accounting under IAS 39 or increasing the amount of hedge ineffectiveness.

IFRS 9 allows a risk component of either a financial or non-financial item to be designated as a hedged item so long as the risk component is separately identifiable and reliably measurable.

There are two types of risk components:

1) Contractually specified risk components – those that are explicitly specified in a contract.
2) Non-contractually specified risk components – those that are implied in the fair value or cash flows of an item and can relate to items that are not a contract (e.g. forecast transactions) or contracts that do not explicitly specify the risk component (e.g. firm commitment with only one single price vs. a pricing formula that references different underlyings).

Example of a Contractually Specified Risk Component

Entity B has a firm commitment to purchase crude oil under a contract that references the quoted price for Western Canadian Select, plus a variable logistics and delivery charge based on a published market survey of transportation costs. The contract sets out a range of minimum and maximum purchase quantities for every month.

Assessment: The entity wants to hedge itself against changes in the price for crude oil. If it were to hedge the entirety of the forecasted purchases, the logistics and delivery charge would become a source of hedge ineffectiveness.

Instead, Entity B enters into futures contracts for the purchase of Western Canadian Select crude oil for the relevant months, and designates them as the hedging instrument in a cash flow hedge of the benchmark Western Canadian Select price risk component of the firm commitment. This eliminates the requirement for Entity B to assess the impact of changes in the market survey on its logistics and delivery charges for the purposes of calculating hedge effectiveness.

Note! The assessment of whether a risk component qualifies for hedge accounting must be within the context of the particular market structure to which the risk(s) relate and the hedging activity takes place.
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

Example of a Non-contractually Specified Risk Components

Lender A has highly probable forecast transactions to make loans to customers at fixed rates in the coming months. The rates charged will be based on a variety of factors, including but not limited to, the prime lending rate at the time the loan is made, local economic conditions, the lending market and the consumers’ credit risk.

Lender A evaluates the market structure for the loans it makes and analyzes the way fixed interest rates are determined. It determines that it has exposure to variability in future cash flows arising from changes in the prime lending rate (i.e., the fixed rate granted to a borrower in the future depends on the level of the prime rate), and that while the effect this rate will have on its future interest income is not contractually specified, it is separately identifiable and measurable.

**Assessment:** As a result, Lender A can specify the variability in its cash flows arising from changes in the prime lending rate as the hedged item in a hedging relationship. It can choose to hedge this risk with a variety of hedging instruments, including interest rate swaps or collared options. Changes in the fixed interest rate eventually charged to consumers that arise from factors other than the prime lending rate are excluded from consideration of the hedging relationship.

Additional information on the designation of risk components as the hedged item in a hedging relationship is available in the application guidance of IFRS 9; see IFRS 9.B6.3.8 – B6.3.15.

Layer Components

IFRS 9 allows a layer component to be designated as a hedged item of a fair value hedge. A layer component may be specified from either a defined, but open, population or a defined nominal amount.

Example of Hedge of a Layer Component

Credit Union XYZ holds a portfolio of variable rate loans with a nominal amount of $400 million. The borrowers are eligible to prepay the first 30% of their loans at par, and the Credit Union expects that the full $120 million amount eligible will be prepaid.

**Assessment:** To hedge its cash flow risk related to the amount not eligible for prepayment, the Credit Union enters into a pay-variable receive-fixed interest rate swap for a notional amount of $280 million and designates it as the hedging instrument with the bottom layer of $280 million (i.e., the amount not eligible for prepayment) of its loan portfolio as the hedged item in the cash flow hedge.

Additional information on designation of a layer component as the hedged item in a hedging relationship is available in the application guidance of IFRS 9; see IFRS 9.B6.3.16 – B6.3.20.

**Note!** A prepayment option may be included as part of a layer component if:

1) The prepayment option’s fair value is not affected by changes in the hedged risk; or
2) The designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

This communication contains a general overview of the topic and is current as of August 31, 2017. The application of the principles addressed will depend upon the particular facts and circumstances of each individual case. Accordingly, this publication is not a substitute for professional advice and we recommend that any decisions you take about the application or not of any of the information presented be made in consultation with a qualified professional who can address any variance that may be required to reflect your circumstances. Please contact your local MNP representative for customized assistance with the application of this material. MNP LLP accepts no responsibility or liability for any loss related to any person’s use of or reliance upon this material. © MNP LLP 2017. All rights reserved.
Accounting for the Time Value of an Option, Forward Element of a Forward Contract or Foreign Currency Basis Spread of a Financial Instrument

IFRS 9 allows for an entity to designate only the intrinsic portion of an option or the spot element of a forward contract, or to separate the foreign currency basis spread of a financial instrument, when designating a hedging instrument. This allows an entity to ignore the time value of money in its analysis. This time value will still be considered when calculating gains or losses on the hedging instrument; however, it will not factor into the entity’s hedge effectiveness analysis.

Time Value of Options

When the intrinsic and time values of an option contract have been separated and an entity designates only the change in intrinsic value of an option as a hedging instrument, the time value of the option contract is recognized in other comprehensive income and accumulated in a separate component of equity. The cumulative gain or loss from the change in fair value of the time value of the option is subsequently accounted for using specific rules according to the type of item being hedged (i.e., either a transaction or time-period related hedged item). The cumulative change in the fair value of a transaction related hedged item is accounted for similarly to the reserve in a cash flow hedge. Conversely, the cumulative change in the fair value of a time-period related hedged item is amortized on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss. See IFRS 9.6.5.15 and IFRS 9.B6.5.29 – B6.5.33 for more guidance on how to account for the time value of options.

Note! If an entity designates an entire option contract as the hedging instrument, hedge ineffectiveness will occur if the corresponding hedged item does not have a time value component as well. If only the intrinsic value of an option is designated, the change in the option’s time value is recognized in OCI to the extent that it relates to the hedged item. Therefore, if the critical terms (i.e., nominal amount, expiry date and underlying) of the option and hedged item match, the impact of the time value on profit or loss is deferred. Conversely, if the critical terms do not match, any time value of the option in excess of that which perfectly matches the hedged item is taken to profit or loss.

The application of the IFRS 9 guidance on accounting for the time value of options will likely result in less volatility in profit or loss than IAS 39 as IAS 39 requires the change in the time value be recognized in profit or loss over the life of the option.

Forward Elements of Forward Contracts and Foreign Currency Basis Spreads of Financial Instruments

When an entity separates the forward element and the spot element of a forward contract and designates only the change in value of the spot element of the forward contract or strips the foreign currency basis spread from a financial instrument and excludes it from the designation of the financial instrument as a hedging instrument the entity may account for the forward element or the foreign currency basis spread as if it were the time value of an option.

Additional information on accounting for the forward element of a forward contract or the foreign currency basis spread of a financial instrument is available in the application guidance of IFRS 9; see IFRS 9.B6.5.34 - B6.5.39.
Designating a Credit Exposure at FVTPL

When an entity uses a credit derivative that is measured at FVTPL to manage the credit risk of all, or a part of, a financial instrument (credit exposure), it may designate that financial instrument, to the extent it is so managed, as measured at FVTPL if:

- The name of the credit exposure (e.g., the borrower) 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.

In practice, an entity might choose to hedge its credit exposure related to a financial instrument such as a junk grade bond using a credit default swap. Ordinarily, the bond might meet the criteria to be measured at amortized cost (i.e., cash flows from the instrument are comprised solely of payments of principal and interest and the entity’s business model is such that it will hold the bond to maturity). However, because the entity uses the credit default swap to manage its credit exposure to the counterparty, hedge accounting allows the entity to measure the bond at FVTPL to alleviate the accounting mismatch that would otherwise occur.

This designation can be made regardless of whether the financial instrument being managed for credit risk is ordinarily within the scope of IFRS 9. For example, an entity may designate loan commitments outside the scope of IFRS 9. The entity can designate the financial instrument at, or subsequent to, initial recognition, or while it is still unrecognized. The entity must document the designation concurrently.

Additional information on the designation groups of relationship credit exposure at FVTPL is available in the application guidance of IFRS 9; see IFRS 9.6.7.1 to 6.7.4.

Presentation and Disclosure

Presenting Groups of Hedged Items and Hedging Instruments

Presentation of hedging gains or losses in the financial statements of an entity depends on the group of items being hedged and the hedging relationship.

Cash Flow Hedges

When items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of profit or loss and other comprehensive income (e.g., revenue and cost of sales).

Where a group of items being hedged in a cash flow hedge does not have offsetting risk positions, then the reclassified hedging instrument gains or losses are apportioned to the line items affected by the hedged items on a systematic and rational basis that does not result in the grossing up of the net gains or losses arising from a single hedging instrument.

Where a group of items being hedged do have offsetting risk positions, then an entity must present the hedging gains or losses in a separate line item in the statement of profit or loss or OCI. This is to avoid the grossing up of a single instrument’s gains or losses into offsetting gross amounts and recognizing them in different line items.

Fair Value Hedges

For fair value hedges of a group made up of assets and liabilities hedged together, gains or losses in the statement of financial position on individual assets and liabilities are recognized as adjustments of the carrying amount of each respective individual item.
When recognizing hedging gains or losses in a fair value hedge of a net position, they must be presented in a separate line item in the statement of profit or loss and OCI. This is to avoid the grossing up of a single instrument’s net gains or losses into offsetting gross amounts and recognizing them in different line items.

Disclosures

With the release of IFRS 9, IFRS 7 Financial Instruments: Disclosures has been updated to require detailed disclosures regarding an entity’s use of hedge accounting. The disclosures may be presented in a single note or a separate section of the financial statements. Conversely, the information could be contained in another document such as a management commentary or risk report. If the information required for the hedge accounting disclosures is otherwise available, it need not be duplicated so long as it is incorporated in the financial statements by cross-reference and it is available to users of the financial statements on the same terms and at the same time as the financial statements.

IFRS 7 requires certain disclosures be separately presented by risk category. The entity must determine each risk category on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. Risk categories must be determined consistently for all disclosures.

The entity should apply professional judgment when deciding on the level of detail to be disclosed, the amount of emphasis to be placed on different requirements, the appropriate levels of aggregation or disaggregation and whether users of the financial statements require additional explanations of the quantitative data disclosed. However, the entity must use the same level of aggregation or disaggregation for the disclosure requirements of related information under IFRS 7 and IFRS 13 Fair Value Measurement.

Note! The disclosures are only required to be made if they are quantitatively or qualitatively material. Many of the hedge accounting disclosures are required to be made for each separate risk (e.g. interest rate risk, foreign currency risk, commodity risk, etc.) that the entity is exposed to and by each type of hedge (i.e., fair value hedge, cash flow hedge and net investment hedge).

<table>
<thead>
<tr>
<th>Disclosure Category</th>
<th>Disclosure Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Management Strategy</td>
<td>Entities will need to explain their risk management strategy for each risk category of risk exposures being hedged and for which hedge accounting is applied, allowing users to evaluate:</td>
</tr>
<tr>
<td></td>
<td>▪ How each risk arises;</td>
</tr>
<tr>
<td></td>
<td>▪ How each risk is managed, including whether the entity hedges an item in its entirety or hedges a risk component(s) of an item and why;</td>
</tr>
<tr>
<td></td>
<td>▪ The extent of risk exposures that the entity manages.</td>
</tr>
<tr>
<td></td>
<td>The risk management strategy disclosures should include, at minimum, a description of:</td>
</tr>
<tr>
<td></td>
<td>▪ The hedging instruments used, and how they are used, to hedge risk exposures;</td>
</tr>
<tr>
<td></td>
<td>▪ How the economic relationship between the hedged item and hedging instrument is determined for assessing hedge effectiveness; and</td>
</tr>
<tr>
<td></td>
<td>▪ How the hedge ratio is established and the sources of hedge ineffectiveness.</td>
</tr>
</tbody>
</table>
### Risk Management Strategy (cont'd)

When designating a specific risk component as a hedged item, additional qualitative or quantitative information is required regarding:
- How the entity determined the risk component designated as a hedged item, including a description of the nature of the relationship between the hedged risk component and the item as a whole; and
- How the risk component relates to the item in its entirety.

### Amounts, Timing and Uncertainties of Future Cash Flows

An entity must disclose, by risk category, quantitative information that allows users of the financial statements to evaluate the terms and conditions of hedging instruments and how they affect the future cash flows of the entity. To do so, the entity must disclose:
- A profile of the timing of the nominal amount of the hedging instrument; and
- If applicable, the average price or rate (e.g. strike or forward prices) of the hedging instrument.

When an entity commonly resets (i.e., discontinues and restarts) its hedging relationships because both the hedging instrument and hedged item frequently change, the entity is exempt from providing the above information. However, it must disclose:
- Information about the entity’s ultimate risk management strategy in relation to those relationships;
- A description of how it reflects its strategy by designating those specific relationships using hedge accounting; and
- An indication of the frequency at which hedging relationships are reset.

When the volume of hedging relationships that reset is unrepresentative of normal volumes during the period (e.g. if the volume at the reporting date is higher or lower than the norm during the period due to business cycle or seasonal fluctuations), an entity discloses that fact and the reason it believes the volumes are unrepresentative.

Entities are also required to disclose, by risk category:
- A description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.
- If other sources of hedge ineffectiveness emerge, those sources together with an explanation of the resulting hedge ineffectiveness.

For cash flow hedges, any forecast transaction for which hedge accounting had been used in a prior period, but which is no longer expected to occur, must be disclosed.

### Effects on Financial Position and Performance

Entities are required to disclose, in a tabular format, the following amounts related to hedging instruments separately by risk category for each type of hedge:
- The carrying amount of the hedging instruments, presenting financial assets separately from financial liabilities;
- The line item(s) in the statement of financial position that includes the hedging instruments;
- Changes in fair value of the hedging instruments used to calculate hedge ineffectiveness; and
- The nominal amounts, including physical volumes, of the hedging instruments.
### Effects on Financial Position and Performance (cont’d)

<table>
<thead>
<tr>
<th>For hedged items, entities are required to disclose, in a tabular format, the following by risk category:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For fair value hedges:</strong></td>
</tr>
<tr>
<td>- The carrying amount of the hedged items, presenting assets separately from liabilities;</td>
</tr>
<tr>
<td>- The accumulated amount of fair value hedge adjustments included in the carrying amount of the hedged items, disclosed separately for assets and liabilities;</td>
</tr>
<tr>
<td>- The line item(s) in the statement of financial position that includes the hedged items;</td>
</tr>
<tr>
<td>- The change in value of the hedged items used to calculate hedge ineffectiveness; and</td>
</tr>
<tr>
<td>- The accumulated amount of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses.</td>
</tr>
<tr>
<td><strong>For cash flow hedges and hedges of a net investment in a foreign operation:</strong></td>
</tr>
<tr>
<td>- The change in value of the hedged items used to calculate hedge ineffectiveness;</td>
</tr>
<tr>
<td>- The balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges; and</td>
</tr>
<tr>
<td>- The balances remaining in the above-noted reserves for any discontinued hedging relationships.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>An entity must also disclose, in a tabular format, the following amounts separately by risk category:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For fair value hedges:</strong></td>
</tr>
<tr>
<td>- Hedge ineffectiveness recognized in profit or loss or OCI, if applicable; and</td>
</tr>
<tr>
<td>- The line item in the statement of comprehensive income that includes the recognized hedge ineffectiveness.</td>
</tr>
<tr>
<td><strong>For cash flow hedges and hedges of a net investment in a foreign operation:</strong></td>
</tr>
<tr>
<td>- Hedging gains or losses of the reporting period recognized in OCI;</td>
</tr>
<tr>
<td>- The amount of hedge ineffectiveness recognized in profit or loss;</td>
</tr>
<tr>
<td>- The line item in the statement of comprehensive income that includes the hedge ineffectiveness;</td>
</tr>
<tr>
<td>- The amount reclassified from the cash flow hedge reserve or foreign currency translation reserve into profit or loss, differentiating between the amount recycled because:</td>
</tr>
<tr>
<td>- The hedged future cash flows are no longer expected to occur; and</td>
</tr>
<tr>
<td>- The hedged item affected profit or loss;</td>
</tr>
<tr>
<td>- The line item in the statement of comprehensive income containing the reclassification adjustments; and</td>
</tr>
<tr>
<td>- For hedges of net positions, the hedging gains or losses recognized in a separate line item in the statement of comprehensive income.</td>
</tr>
</tbody>
</table>
An Overview of the New Hedging Requirements of IFRS 9 Financial Instruments

Effects on Financial Position and Performance (cont’d)

Entities are required, under IAS 1 Presentation of Financial Statements, to provide a reconciliation of each component of equity and an analysis of OCI. A separate reconciliation should be presented for each risk category and should differentiate between:

- Hedging gains or losses recognized in OCI, and those reclassified from the cash flow hedge reserve or foreign currency translation reserve into profit or loss (i.e., the gross amounts should be disclosed separately rather than netted against each other);
- Amounts removed from the cash flow hedge reserve and included directly in the carrying amount of a recognized asset or liability and loss amounts not expected to be recovered;
- Amounts associated with the time value of options that hedge transaction related hedged items and those that hedge time-period related hedged items; and
- Amounts associated with the forward elements of forward contracts and foreign currency basis spreads of financial instruments that hedge transaction related items and those that hedge time-period related hedged items.

The disaggregation by risk of the disclosures directly above may be presented in the notes to the financial statements.

Credit Exposures Measured at Fair Value Through Profit or Loss

When an entity designates a financial instrument, or a proportion thereof, as measured at FVTPL due to the use of a credit derivative to manage the financial instrument’s credit risk, it shall disclose:

- For the credit derivative, a reconciliation of each of the nominal amount and the fair value at the beginning and end of the period;
- The gain or loss recognized in profit or loss on designation of all, or a proportion, of such a financial instrument;
- On discontinuation of measuring all, or a proportion, of such a financial instrument at FVTPL, the fair value that has become the new carrying amount and the related nominal or principal amount.

Additional Resources

External Resources

- IFRS 9 can be found in Part I of the CPA Canada Handbook - Accounting.
- The IASB’s Project Summary provides an overview of the new standard.
- The IASB’s Project Summary provides information on the ongoing project on accounting for dynamic risk management (macro hedging)

Other MNP Technical Guidance

- IFRS 9 Snapshot
- An Overview of the New Financial Asset Classification and Measurement Requirements of IFRS 9 Financial Instruments
- An Overview of the Impairment Requirements of IFRS 9 Financial Instruments
- An Overview of the Transition Requirements of IFRS 9 Financial Instruments

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