FINANCIAL REPORTING GUIDE TO IFRS 9

Financial Instruments

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INTRODUCTION

On the 24 July 2014, the International Accounting Standards Board (IASB) published the complete version of IFRS 9 which becomes mandatorily effective for periods commencing on or after 1 January 2018. Earlier application is permitted as long as the fact has been disclosed.

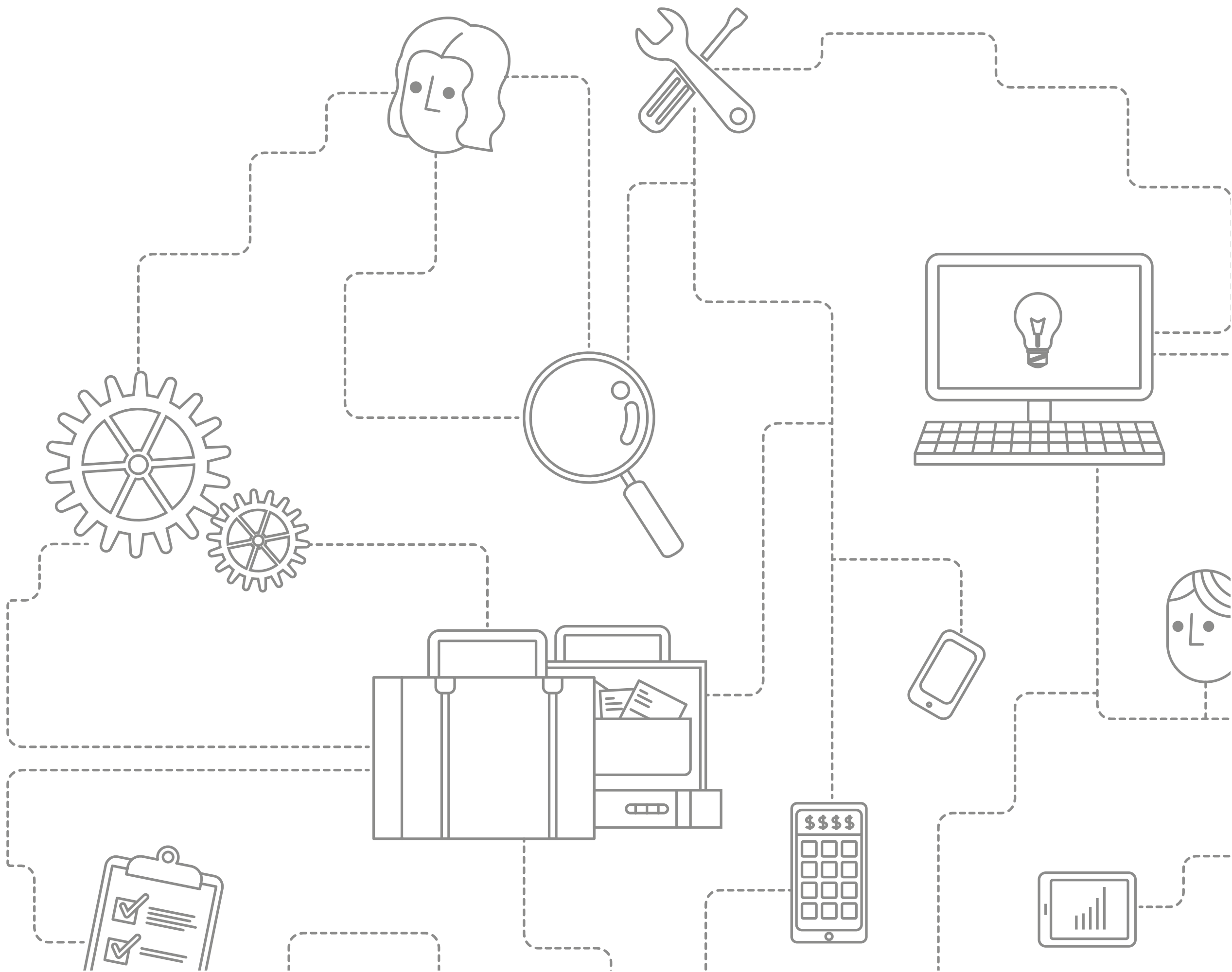
Why the change?

IFRS 9 replaces IAS 39, which is notorious for its complex financial reporting requirements. As well as being complex, changes in the way that modern businesses are operated and managed have rendered IAS 39 out of date. In addition, weaknesses in the standard's impairment model were identified during the financial crisis.

Significant changes

In this guidance we provide an overview of the most significant changes to the accounting for financial instruments and how these changes are likely to affect the financial statements including:

- The new criteria used to determine how financial assets should be classified and measured;
- how to apply the new impairment loss model; and
- how the changes introduced by IFRS 9 provide entities with an opportunity to reconsider the application of hedge accounting.



1 CLASSIFICATION MEASUREMENT OF FINANCIAL ASSETS

IAS 39 sets out four classification categories for financial assets: held–to maturity; available for sale; fair value through profit and loss; and loans and receivables. It is these classification categories that determined how the instruments were measured.

The requirements in IAS 39 were considered by many to be rules based, too complex and difficult to apply. Based on feedback, the IASB decided that the most effective way to address these issues and improve the financial information that is provided to users was to replace the existing classification and measurement categories.

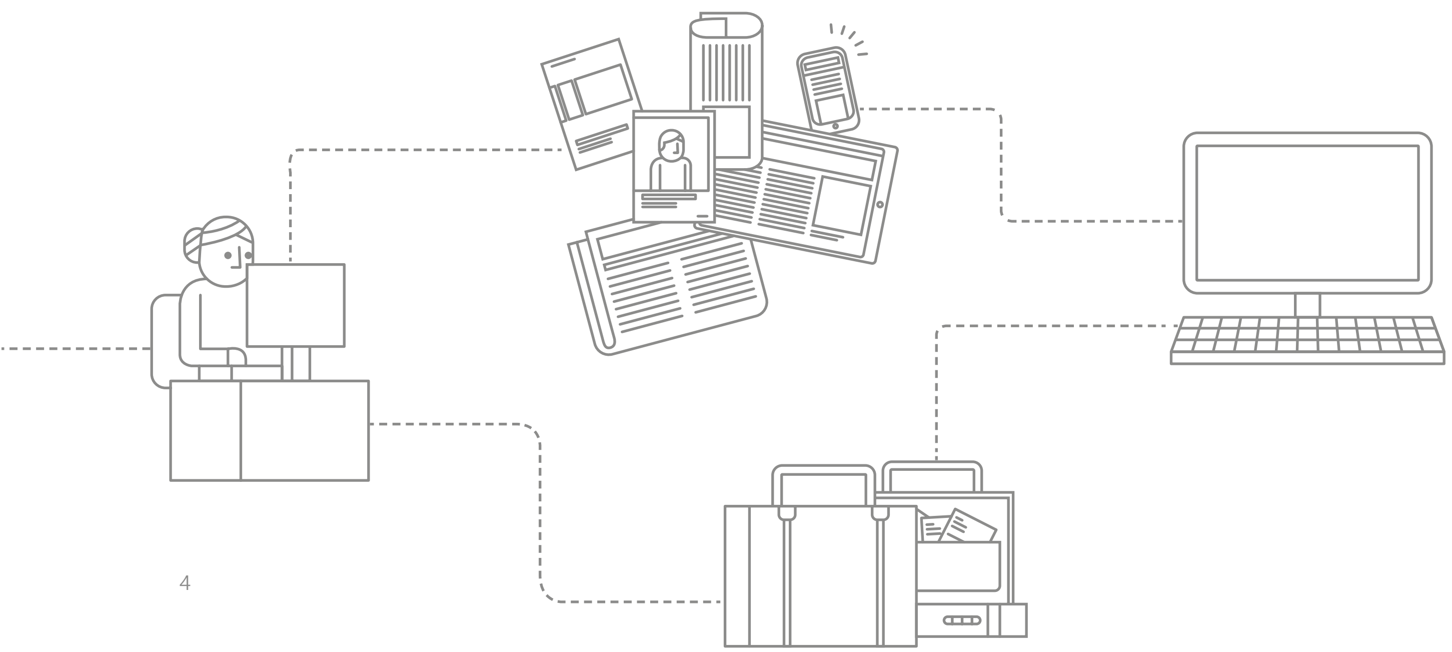
Classification and measurement

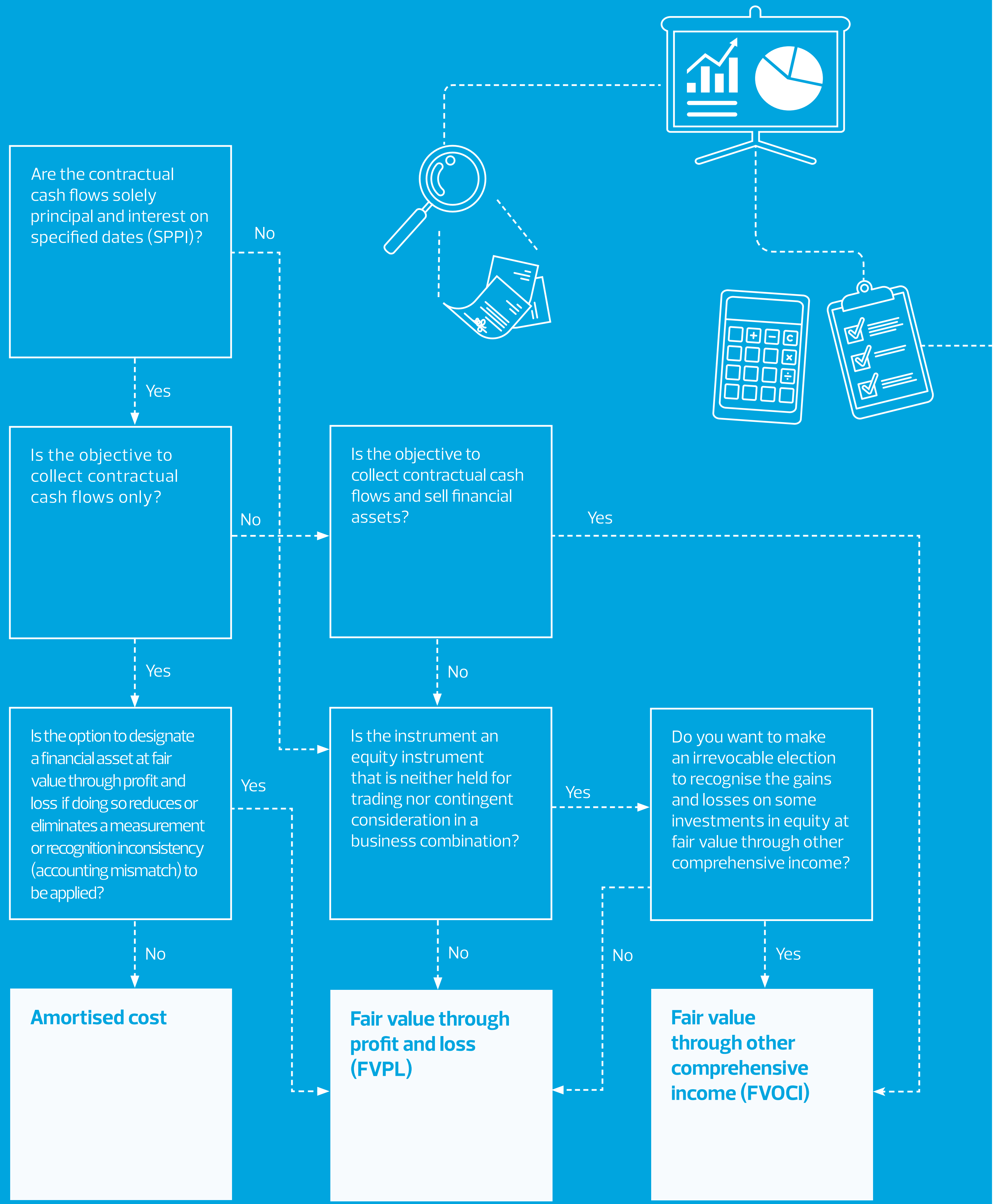
IFRS 9 applies two criteria to determine how financial assets should be classified and measured:

- The entity's business model(s) for managing financial assets; and
- the contractual cash flow characteristics of the asset, assessed on an asset by asset basis.

There are three different measurement bases arising from the two criteria so the options available under IFRS 9 are:

- Amortised cost;
- fair value through profit and loss (FVPL); and
- fair value through other comprehensive income (FVOCI).





What constitutes a 'solely principal and interest' contractual cash flow?

For contractual cash flows to be 'solely payments of principal and interest' (SPPI), they must have features that are consistent with a basic lending arrangement.

Whilst the instrument itself does not need to take the legal form of a loan, the cash flows should only take into account:

- The time value of money;
- credit risk; and
- other basic lending risks and costs.

The cash flows must be assessed in the currency in which the asset is denominated and the principal is the fair value of SPPI: the asset at initial recognition

If this criterion is applied, it can be seen that payments with the following characteristics would not meet the definition of SPPI:

- Those that are linked to equity or commodity prices;
- those that are leveraged; and
- interest payments that increase when an equity index achieves a particular level (contingent event).

How do contingent events affect the classification?

Contingent events that create a change in the timing or amount of the cash flows are not determining factors in assessing if the cash flows are SPPI but may be an indicator and hence the assessment of contractual cash flows in many circumstances is unlikely to be that straight forward.

What is a business model and how should it be assessed?

IFRS 9 requires financial assets to be classified and measured on the basis of an entity's business model for managing financial assets, determined at a level that reflects how groups of assets are managed together to achieve a particular objective. For this reason, the business model is determined not on an individual asset basis but on a portfolio basis. It is therefore a matter of fact, rather than a choice or assertion, and should not depend on management's intentions. It is typically observable through the activities that the entity undertakes and judgement will need to be exercised because the assessment is not usually determined by a single factor or activity. Set out below are the three types of business model which influence the measurement of the portfolio of financial assets and evidence that may help determine the appropriate business model.

Evidence to consider when determining the appropriate business model

- How the assets in the portfolio are evaluated and reported to key management personnel;
- the risks that affect performance and how these are managed;
- how managers in the business are remunerated (ie are they incentivised by the fair values of the assets or on the amount of cash flows that are collected);
- what is expected to occur rather than worst case scenario; and
- the timing, frequency, amount and reasons for sales of financial assets.

BUSINESS MODEL 1

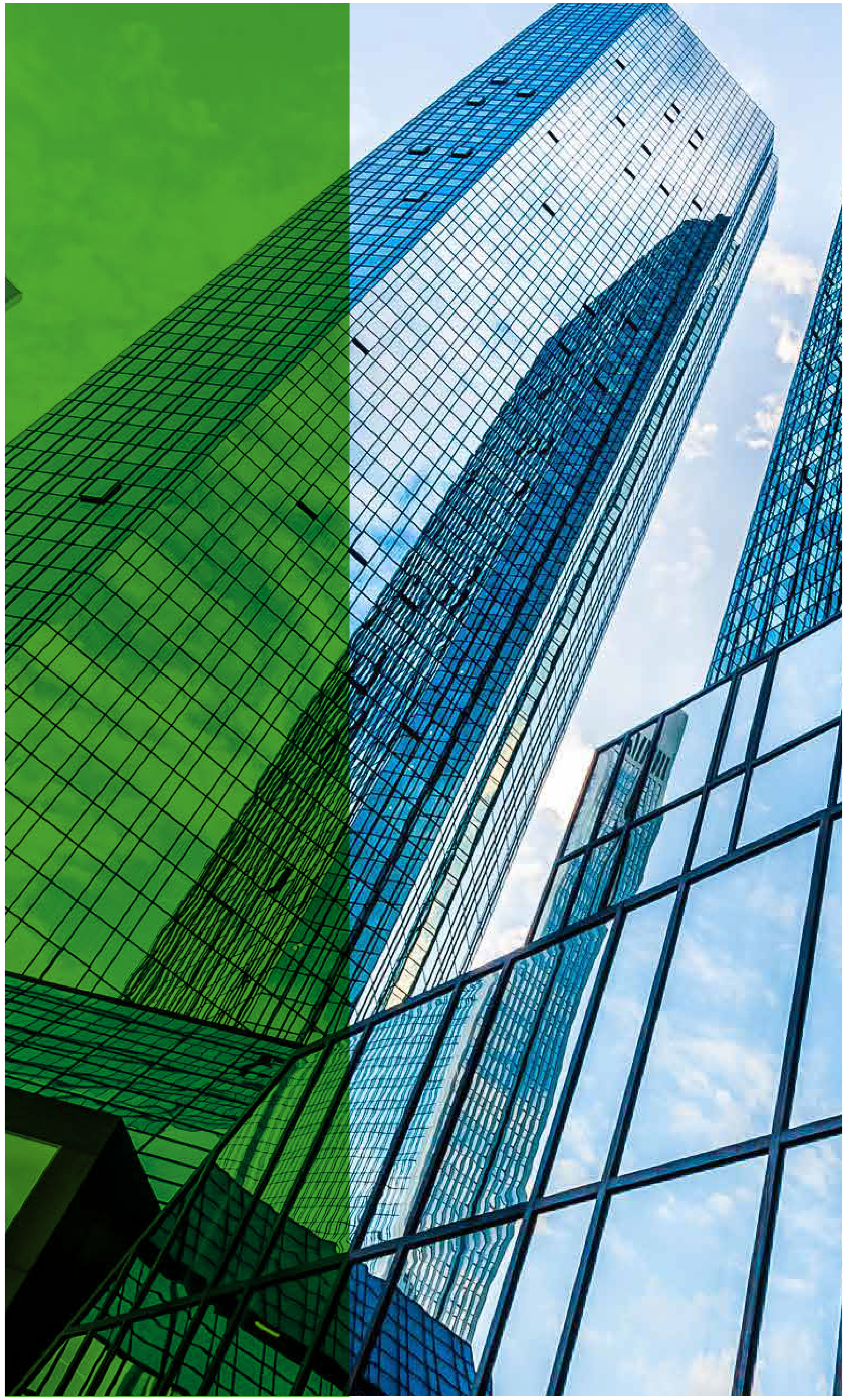
Objective to obtain a return by collecting the contractual cash flows

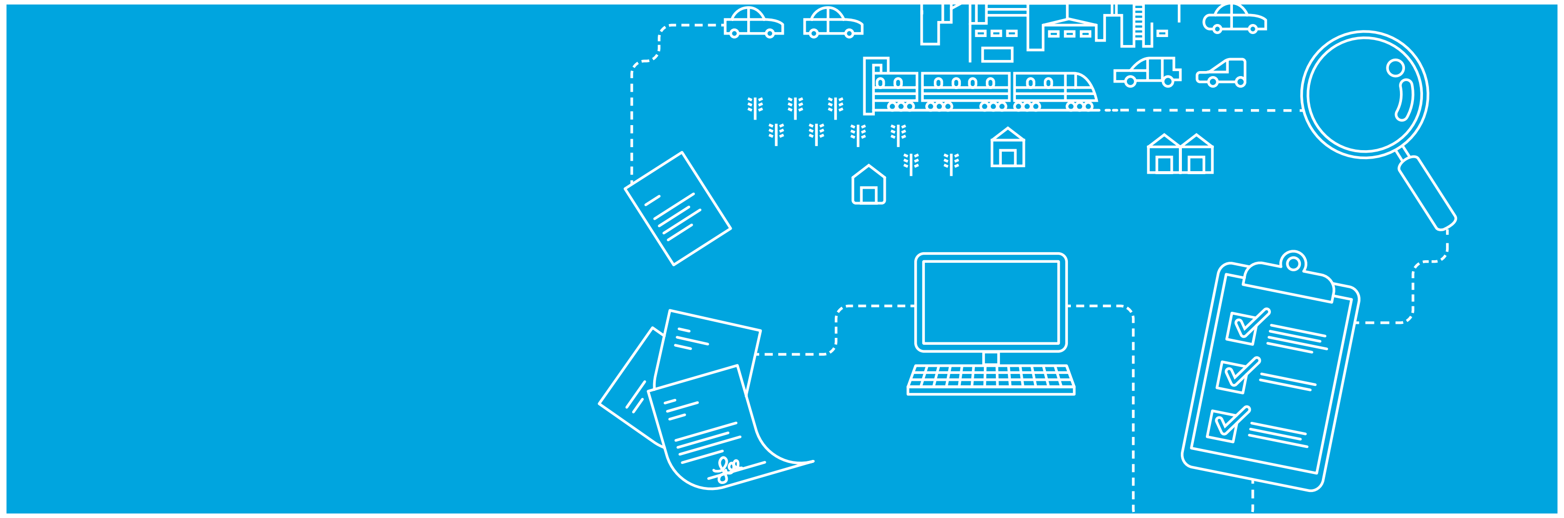
BUSINESS MODEL 2

Objective to obtain a return by selling the financial asset

BUSINESS MODEL 3

Objective to obtain a return from a combination of collecting the contractual cash flows and selling the assets





The business model should be assessed based on scenarios that are reasonably expected to occur. Therefore the assessment does not reflect the 'worst case' scenario.

It is possible that an entity may have more than one business model and this may be observed by how performance of the assets is evaluated and reported to management for decision making purposes, the risks that affect performance and how they are managed. In addition, financial assets held in a business model to collect the contractual cash flows need not be held to maturity, but the timing, frequency, amount and reasons for sales of financial assets must be considered.

So what happens if some of the instruments in a portfolio are sold?

When assessing the business model, an entity will need to consider the sales activity. Sales that are infrequent or of insignificant value and sold in non-recurring circumstances will not necessarily preclude the assets from being classified as being held 'to collect the contractual cash flows' (and therefore measured at amortised cost).

Examples where sales of financial assets would not preclude them from being classified as held 'to collect the contractual cash flows' are:

- Close to maturity and the proceeds equate to collection of the remaining cash flows;
- so close to maturity or the financial asset's call date that future changes in the market rate of interest would not have a significant effect on the financial assets' fair value;
- in response to a change in tax law that significantly affects the tax status of the financial asset or a significant change in regulations, such as a requirement to maintain regulatory capital that directly affects the asset;
- in response to a significant internal restructuring or business combination;
- to execute a plan to address a liquidity crisis; or
- to fund capital expenditure.

Are investments in equity instruments always fair valued?

IFRS 9 does not apply to investments in subsidiaries, associates or joint ventures. However, other investments in equity instruments will always be measured at FVPL on the basis that the cash flows arising from them are not SPPI. This is different to IAS 39 when such instruments may have been classified as available-for-sale and hence measured at FVOCI.

IFRS 9 does, however, permit an entity to elect on initial recognition, to present gains and losses arising on an investment in a non-derivative equity instrument in OCI. Such exemption, however, is not available for equity investments that are:

- Held for trading; or
- contingent consideration in a business combination.

This election is made on an asset-by-asset basis and is irrevocable. It means that all gains and losses will go through OCI except for dividend income and, unlike other instruments measured at FVOCI, on disposal the cumulative gains and losses in OCI are not reclassified to profit or loss.

Is the accounting for embedded derivatives under IFRS 9 the same as under IAS 39?
Under IAS 39, non-closely-related derivatives embedded in non-derivative host contracts are bifurcated and accounted for separately. However, under IFRS 9, the two elements are not looked at separately. This means that the classification rules set out above are applied to all the terms of the financial asset. As a result, the whole instrument will most likely be measured at fair value through profit or loss whereas the host contract is usually measured at amortised cost under IAS 39. Separation may still be required when the host contract is outside the scope of IFRS 9, for example leases and insurance contracts.

Reclassification
Financial assets are only reclassified under IFRS 9 if the objective of an entity's business model for managing those assets changes and such changes are significant to the operations of the entity and demonstrable to third parties. IFRS 9 requires an entity to reclassify affected assets prospectively from the first day of the first reporting period following the change. However IFRS 9 does not define the term 'reporting period'. The timing of the reclassification therefore appears to differ depending on the frequency of the entity's reporting.

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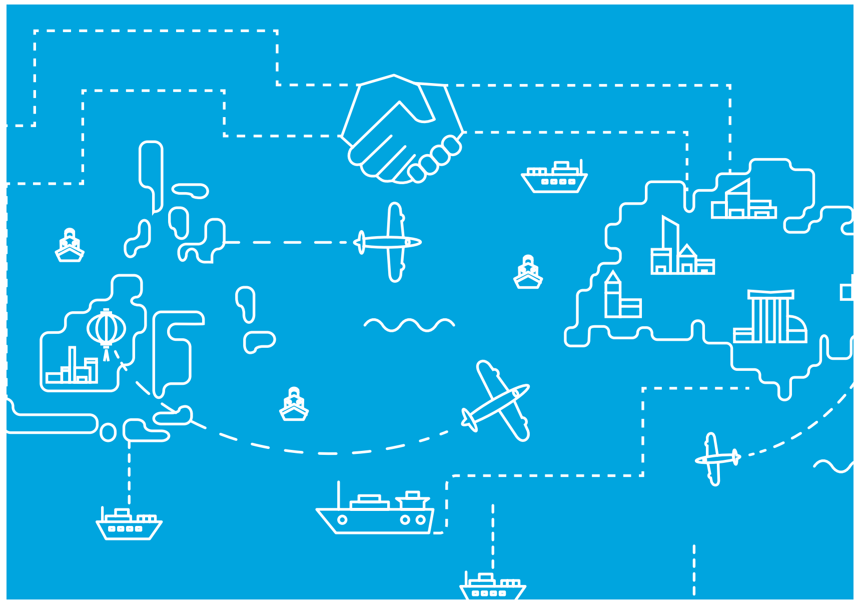
CLASSIFICATION MEASUREMENT OF FINANCIAL LIABILITIES

The classification and measurement provisions in IAS 39 remain largely unchanged in this area, including the requirement to separate derivatives embedded in host contracts if they are not 'closely related.'

IFRS 9 does introduce some new requirements for entities that apply the fair value option. IFRS 9 requires changes in fair value relating to the entity's 'own credit risk' to be recognised in OCI. This is to prevent entities recognising gains in profit or loss when their own credit quality declines. The implementation guidance that accompanies IFRS 9 sets out exactly how this is calculated and recognised.

Financial liabilities may not be reclassified.



3 APPLYING THE NEW IMPAIRMENT LOSS MODEL

IAS 39's impairment requirements are based on an incurred loss model. Weaknesses in this model were identified during the financial crisis because credit losses are not recognised in the financial statements until a loss event has occurred, even though management may have an expectation that the financial assets' carrying values will not be fully recovered.

To address this issue, IFRS 9 introduces an 'expected loss' model for the accounting for credit losses which applies to:

- Financial assets that are debt instruments recorded at amortised cost or at FVOCI;
- lease receivables and contract assets accounted for under IFRS 15 Revenue from Contracts with Customers; and
- loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss.

All equity instruments and financial assets at FVPL are excluded from the expected loss model.

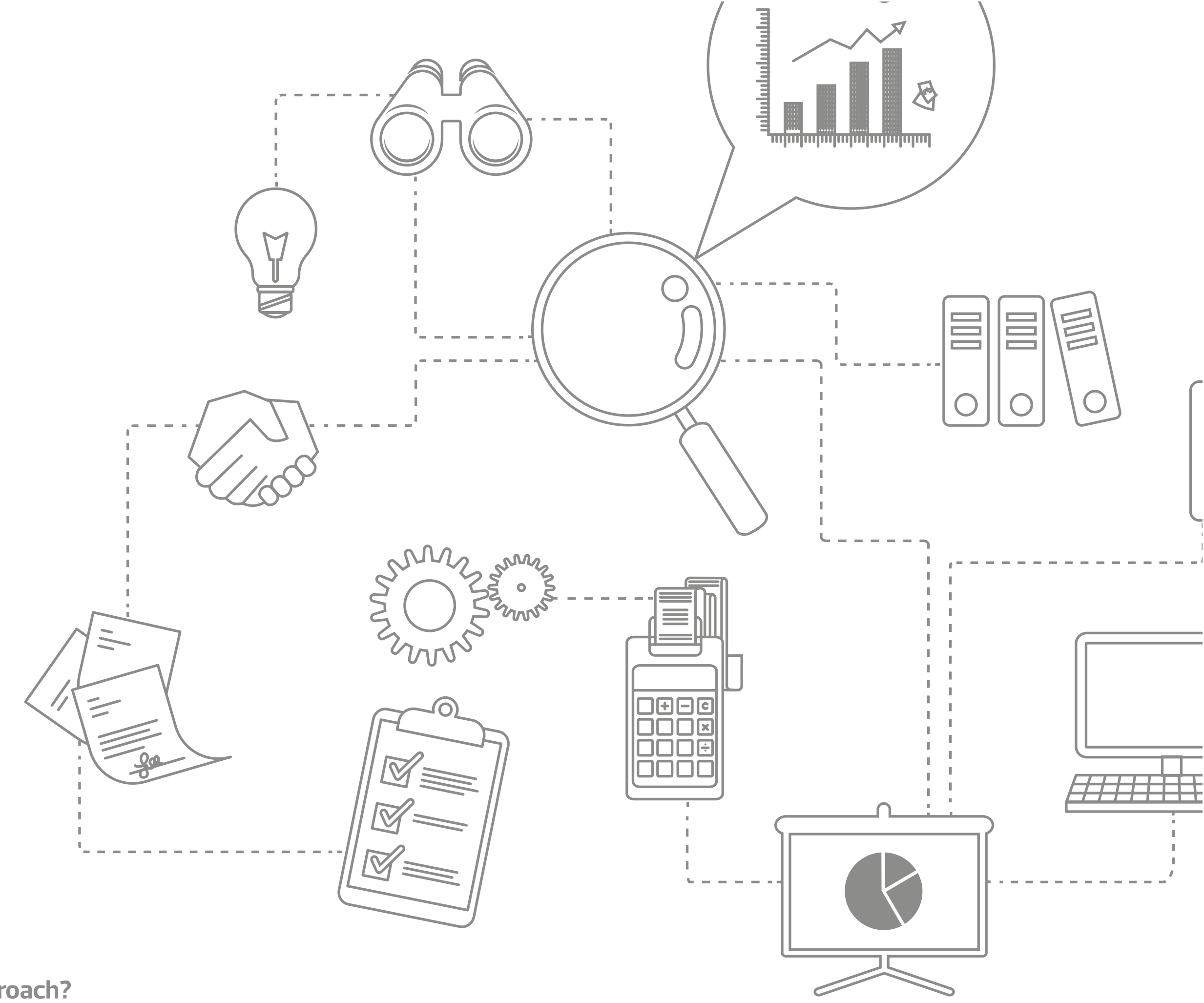
Approaches to recognising impairment

There are three approaches to recognising impairment under the expected loss model and the approach that is the most appropriate depends on the types of financial instruments that are being assessed.

THE GENERAL APPROACH

THE SIMPLIFIED APPROACH

CREDIT-ADJUSTED EIR APPROACH



What is the general approach?

The general approach requires the credit risk associated with the financial asset to be assessed at each reporting date.

The measurement of the impairment allowance will depend on the assessment of credit risk and whether it is has significantly increased during the period. No loss event is needed for an impairment allowance to be recognised and the loss allowance is updated at each reporting date to reflect changes in expected credit losses.

The table below sets out a summary of how the impairment allowance would be measured in the three different circumstances that may exist at the reporting date and how any finance income should be calculated going forward.

SITUATION AT EACH REPORTING DATE	MEASUREMENT OF IMPAIRMENT ALLOWANCE	CALCULATION OF INTEREST
Credit risk has not significantly increased.	Measured at an amount equal to the 12-month expected credit losses*.	Multiply the gross carrying amount of the financial asset by the effective interest rate.
Credit risk has significantly increased but no loss event occurred.	Based on expected credit losses arising from possible default events that are expected to occur over the expected life of the instrument.	Multiply the gross carrying amount of the financial asset by the effective interest rate.
Credit risks has significantly increased and a loss event has occurred.		Multiply the effective interest rate by the net carrying amount of the financial assets (gross carrying amount – impairment allowance).

*12 month expected credit losses are the portion of the estimated lifetime losses that arise from possible default events within 12 months of the reporting date. The amount will not be the same as the cash shortfalls or actual losses expected in the 12 months following the reporting date.

What is the simplified approach?
The simplified approach is required to be applied in some circumstances and is optional in others. This will result in a bigger day one loss than using the general approach.

MANDATORY

- Trade receivables or contract assets that result from transactions within the scope of IFRS 15 that do not contain a significant financing component; or
- trade receivables or contract assets that contain a significant financing element but the practical expedient for contracts with a maturity of one year or less has been applied.

OPTIONAL

- Trade receivables;
- contract assets that result from transactions within the scope of IFRS15 that contain a significant financing component; and
- lease receivables.

Under the simplified approach, a loss allowance is recognised for the total expected loss from possible default events that may arise over the expected life of the financial asset. This means that a loss allowance might be recognised for amounts that are not overdue at the reporting date.

However, the benefit of this approach is that the loss allowance is measured in this way right from initial recognition and there is therefore no need to keep track of the credit risk associated with the financial asset(s) on an annual basis.

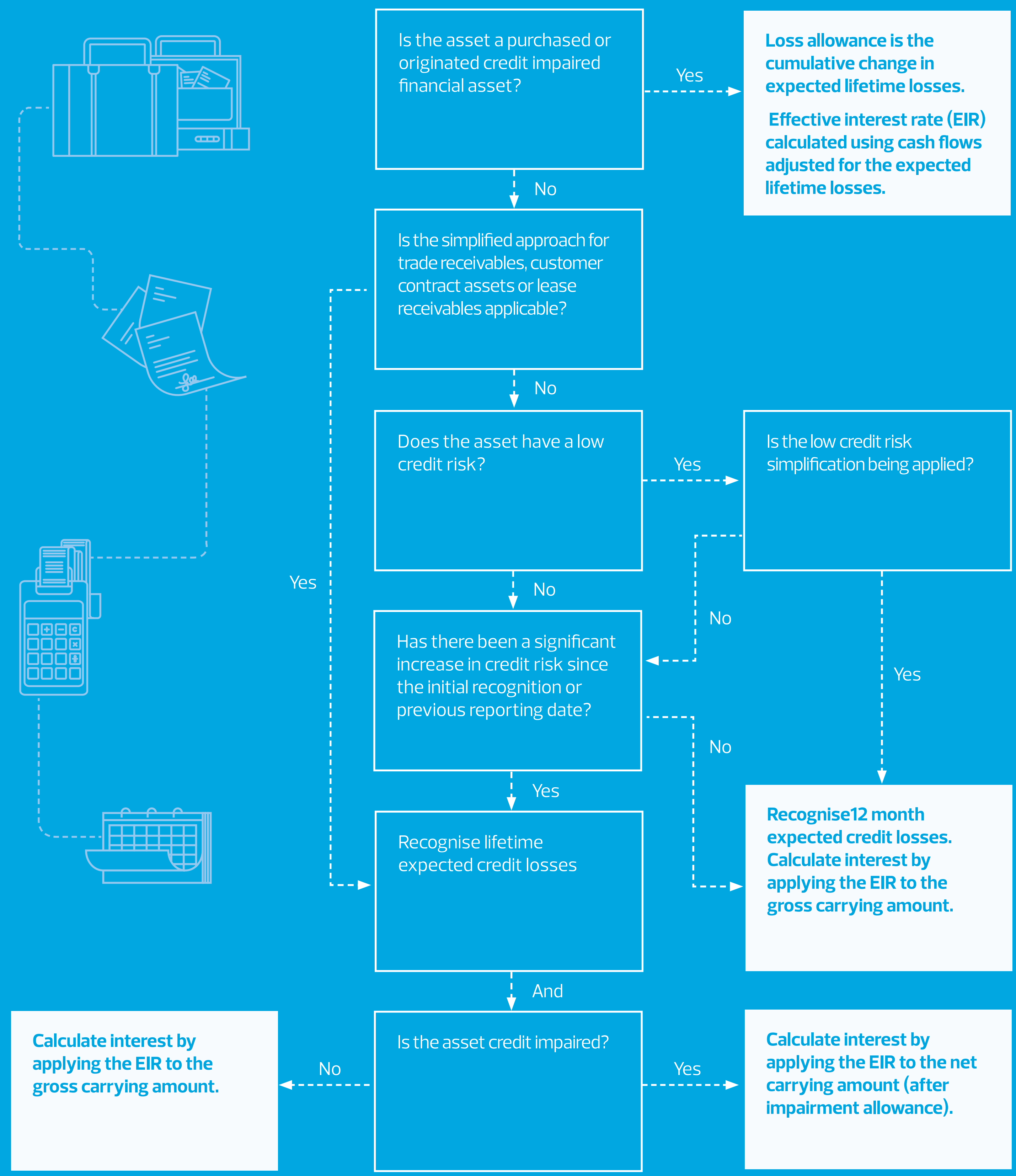
What is the credit-adjusted EIR approach?
This method is applied to purchased or originated credit-impaired financial assets.

A financial asset is deemed to be credit-impaired on initial recognition if one or more events have occurred that have a negative impact on the estimated future cash flows of that asset and there is observable data about such events. IFRS 9 gives a list of examples of such events and this list is substantially the same as the examples that are set out in IAS 39.

For such instruments that are measured at amortised cost, the effective interest rate is calculated at initial recognition using future estimated cash flows that take into account the lifetime expected credit losses. This means there will be no day one credit loss to recognise.

At each reporting date, the amount of lifetime expected credit losses is re-estimated and if changed, an impairment loss or gain is recognised in profit or loss. This means that if the re-estimated cash flows exceed the original estimated cash, an impairment gain will arise even though no impairment allowance has ever been recognised.

Applying the different impairment loss models



What constitutes a significant increase in credit risk?

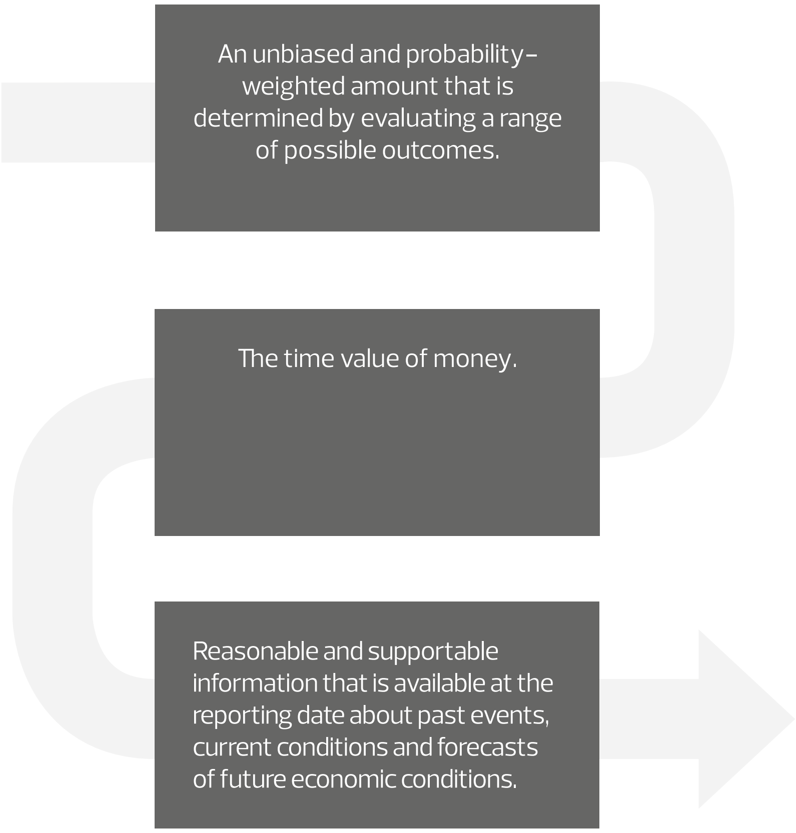
When determining whether there has been a significant increase in credit risk at the reporting date, an entity should consider the increased risk of default occurring over the expected life of the asset rather than the estimated amount of losses expected to occur.

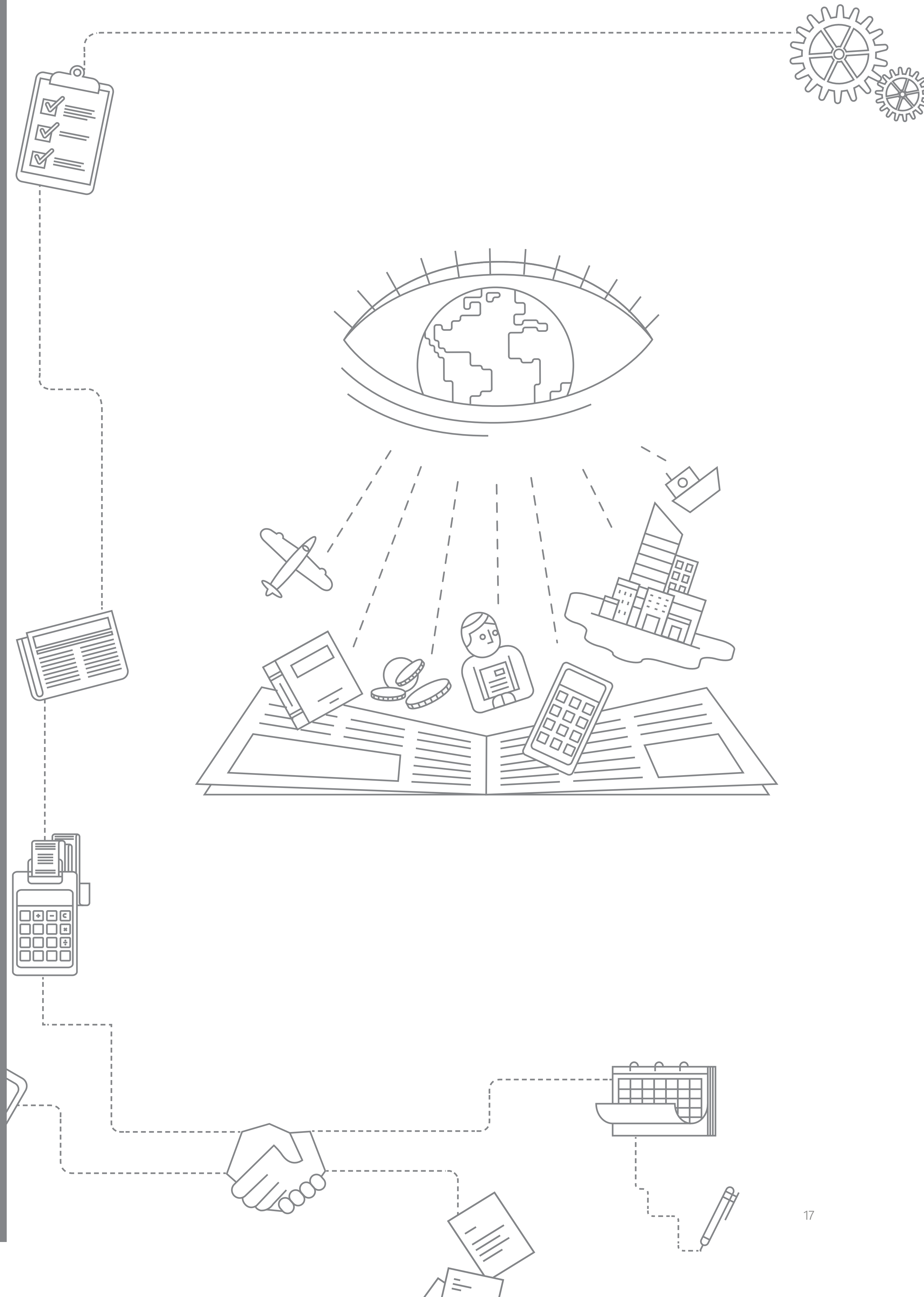
To do this, management should consider reasonable and supportable information (including using forward-looking information) that is available without undue cost or effort to compare the risk of default occurring at the reporting date to the risk of default at initial recognition.

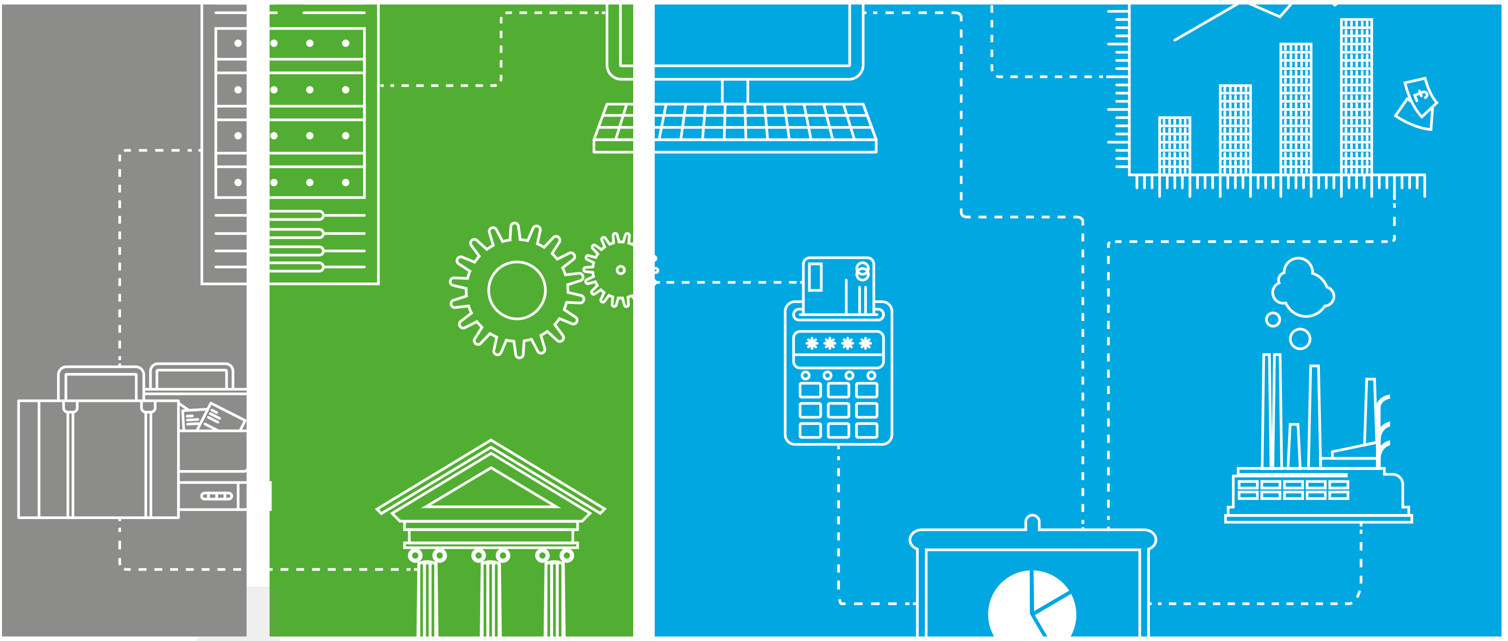
Irrespective of the way that an entity assesses this, there is a rebuttable presumption that credit risk has significantly increased when contractual payments are more than 30 days past due.

How do I calculate expected credit losses?

Expected credit losses should be measured reflecting 3 factors, as set out in the diagram below.







4 HEDGE ACCOUNTING

The hedge accounting requirements of IAS 39 have historically been perceived as being prescriptive, prohibitive and complex. The requirements have been heavily criticised because the accounting conclusions reached don't necessarily reflect the substance of the commercial hedges that entities enter into.

The hedging provisions of IFRS 9 are therefore a welcome change, as they aim to align the hedge accounting impact in the financial statements with the entity's own risk management activities.

The changes introduced by IFRS 9 amend and remove some of the key provisions and prohibitions of IAS 39 and therefore provide entities with an opportunity to reconsider the application of hedge accounting.

Entities can alternatively continue to apply the requirements of IAS 39 for the time being (until the IASB project on macro hedging is completed).

Hedging relationships

Whilst the three types of hedging relationships under IAS 39 have been retained in IFRS 9 some changes have been made, in particular to the recognition of gains and losses.

Fair value hedges

The definition of a fair value hedge and the overall recognition of gains and losses remain unchanged under IFRS 9. This means that fair value movements on the hedging instrument are recognised in profit and loss, whilst the hedged item is adjusted for the fair value changes attributed to the risk being hedged.

However, as IFRS 9 permits an irrevocable election to recognise the gains and losses on investments in equity within other comprehensive income, and such gains and losses are not reclassified to profit or loss on de-recognition, fair value gains and losses arising on the hedging instrument are also not reclassified to profit or loss.

Under IAS 39, an entity cannot designate an overall net position as a hedged item. However, under IFRS 9, a net position might be eligible for hedge accounting, but only if an entity manages the group of items together for risk management purposes. This is a matter of fact, so an entity cannot apply hedge accounting on this basis solely to achieve a particular accounting outcome. Net position hedging must form part of an established risk management strategy and would normally be approved by key management personnel. The group of items must also be individually eligible for hedge accounting.

Cash flow hedges

The definition of a cash flow hedge and the overall recognition of gains and losses remain unchanged under IFRS 9 ie the effective portion of the fair value attributed to the hedged risk arising on the hedging instrument is recognised in OCI.

However, under IFRS 9, when an entity enters into a hedge of a highly probable forecast transaction that results in the recognition of a non-financial asset (for example, purchase of property or inventories), the fair value gains or losses recognised in OCI are adjusted against the carrying value of the property or inventory. Under IAS 39 there was an accounting policy choice as to where the fair value gains or losses previously recognised in OCI could be recognised. Entities could choose to adjust the carrying value of the non-financial asset or recognise in profit or loss.

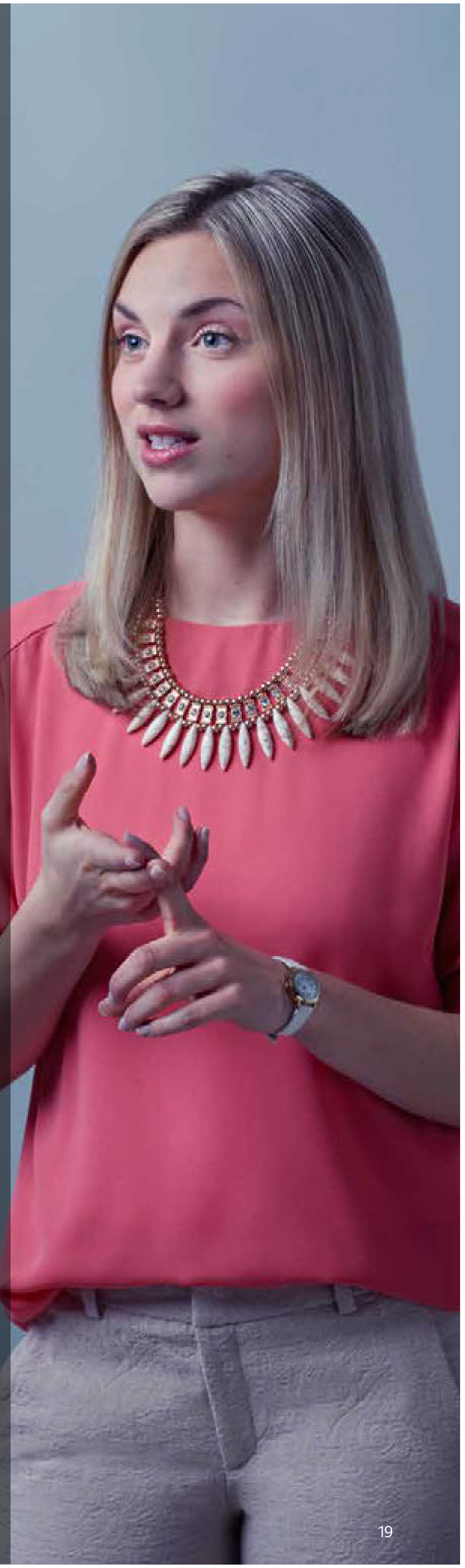
Under IAS 39, the same accounting policy choice was available in respect of a hedge of a highly probable forecast transaction for a non-financial asset or liability that became a firm commitment and to which fair value hedge accounting was to be applied. IFRS 9 similarly removes this accounting policy choice, requiring gains and losses recognised in OCI to be adjusted against the carrying value of the non-financial item.

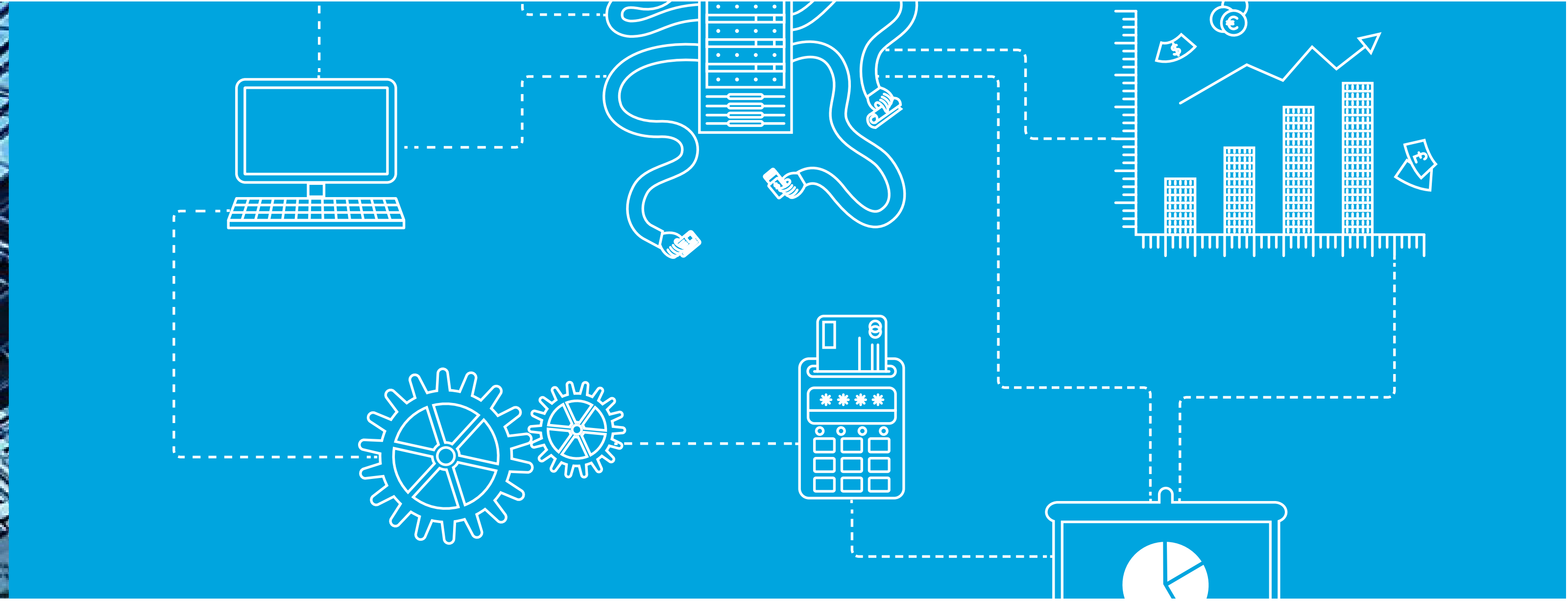
As mentioned previously, an entity cannot designate a net position as a hedged item under IAS 39. However, under IFRS 9, this is permissible, subject to the same conditions which apply to fair value hedges along with some further restrictions. Net positions can only be eligible hedge items for a hedge of foreign currency risk and only if 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 the nature and volume that are expected to affect profit and loss in each period.

For all hedges of net positions, hedging gains and losses must be presented in a separate line in the Income Statement and OCI.

Hedges of net investments

There are no changes to the treatment of hedges of net investments by comparison with IAS 39.





The qualifying criteria for hedge accounting

Under IFRS 9, the criteria for determining whether a hedging relationship qualifies for hedge accounting are fundamentally the same as IAS 39, except for the criteria around the hedging relationship and effectiveness.

CRITERIA BROUGHT FORWARD	CRITERIA THAT HAS BEEN REMOVED	CRITERIA THAT HAS BEEN ADDED
• Formal designation and documentation in place at inception of hedge. • Hedging relationship consists only of eligible hedging instruments and hedged items. • For cash flow hedges, a forecast transaction must be highly probable.	• Hedge is expected to be highly effective ie between 80–125%. • The effectiveness of the hedge can be reliably measured. • The hedge is assessed on an ongoing basis and actually determined to have been highly effective during the relevant financial reporting periods.	• There is an economic relationship between the hedged item and hedging instrument. • The effect of credit risk does not dominate the value changes that result from the economic relationship. • The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity the hedged item.

Hedge documentation

Both IAS 39 and IFRS 9 require formal designation and documentation to be in place at the inception of the hedging relationship, setting out the following:

- The risk management objective and strategy for undertaking the hedge;
- the hedging instrument;
- the hedged item;
- the nature of the risk being hedged; and
- the methods used to assess effectiveness / ineffectiveness.

What is different is that under IAS 39, an entity needed to document how it would determine the hedging instruments effectiveness in offsetting the exposure to changes in the hedged item's fair value and cash flows attributable to the hedged risk. Under IFRS 9, an entity must now document how it will assess whether the hedging relationship meets the hedge effectiveness requirements and also include an analysis of the sources of hedge ineffectiveness and how it will determine the hedge ratio.

The requirement to perform the retrospective effectiveness test has also been removed, which will also affect the documentation.

Eligible hedging instruments

Under IAS 39, non-derivative financial assets or liabilities could only be designated as hedging instruments in the hedge of a foreign currency risk. IFRS 9 has removed this restriction, thereby permitting any type of financial asset or liability measured at fair value through profit or loss to be designated as a hedging instrument, except financial liabilities where the change in fair value attributable to credit risk is recognised in OCI.

Time value of options

If an entity designates an option as the hedging instrument in a hedging relationship, IAS 39 and IFRS 9 provide it with a choice to either designate the option in its entirety or to separate out the time value and designate the change in intrinsic value only. It is common practice for the intrinsic value to be designated only and under this approach the movement in fair value relating to the time value component is recognised in profit and loss, thereby creating significant volatility.

IFRS 9 has new requirements for accounting for the time value component of the fair value when hedge accounting is applied and the intrinsic value of the option is designated as the hedging instrument. It is usual for companies to take out options and pay a premium because they provide protection against downside risk but retain the upside risk. In substance this is a protection cost, similar to the cost of insuring an asset, and the new approach reflects this in the accounting.

When determining how to account for the time value, the nature of a hedged item must be assessed and categorised as either:

- A transaction related item (eg forecast sale or purchase); or
- a time period related item (eg hedging price changes affect the value of a recognised asset or liability).

In both circumstances, the cumulative change in fair value related to the option's time value is recognised in a separate component of OCI. However, for transaction related hedged items, the amount is removed from OCI and recognised either in the carrying amount of the hedged item or in the absence of a recognised hedged item, reclassified to profit or loss (if the transaction affects the profit or loss). For time period related hedged items, the amount is reclassified to profit or loss on a systematic and rational basis in order to amortise the original time value of the option over the term of the hedging relationship.

IFRS 9 provides additional guidance when the critical terms of the option and the hedged item do not match.

Forward element of forward contracts

IFRS 9 provides guidance on how to account for the forward element of a forward contract and the approach applied is consistent with the approach taken in respect of the time value of options.

Eligible hedged items

Items that were eligible for hedge accounting under IAS 39 continue to be eligible under IFRS 9.

However, as well as certain net positions, in certain circumstances, IFRS 9 permits aggregated exposures comprising a derivative and a non-derivative exposure, risk components of financial items, and portions or layers of components of items to be designated as hedged items.

Aggregated exposures

An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item. This is a significant change from IAS 39, which prohibited derivatives from being eligible hedged items.

Risk components of financial items

Under IAS 39, non-financial items can only be designated as a hedged item for foreign currency risk or all risks in their entirety. IFRS 9 removes this restriction, thereby permitting a wider range of risk components to be eligible for hedge accounting and reducing ineffectiveness. The risk component must be separately identifiable and capable of reliable measurement.

Portions or layers of components

IFRS 9 permits a layer component of a nominal amount to be designated as a hedged item in a fair value hedge as long as:

- It is consistent with the entity's risk management objective;
- the layer component designated from a defined nominal amount is specified; and
- the nominal amount from which the layer component is defined is tracked in order to determine whether the layer component must be recognised in profit and loss.

This also applies to components of eligible groups of items, provided the designation is consistent with the entity's risk management objective.

A percentage of a population and the last layer of a population can be designated as hedged items.

Groups of net positions

Whilst similar assets or similar liabilities can be aggregated and hedged as a group under IAS 39, net positions ie similar assets less similar liabilities are precluded.

IFRS 9 permits net positions (and nil positions) to be designated as hedged items in certain circumstances, allowing hedge designation in a manner that is consistent with an entity's risk management strategy.

Hedged risk

Economic relationship

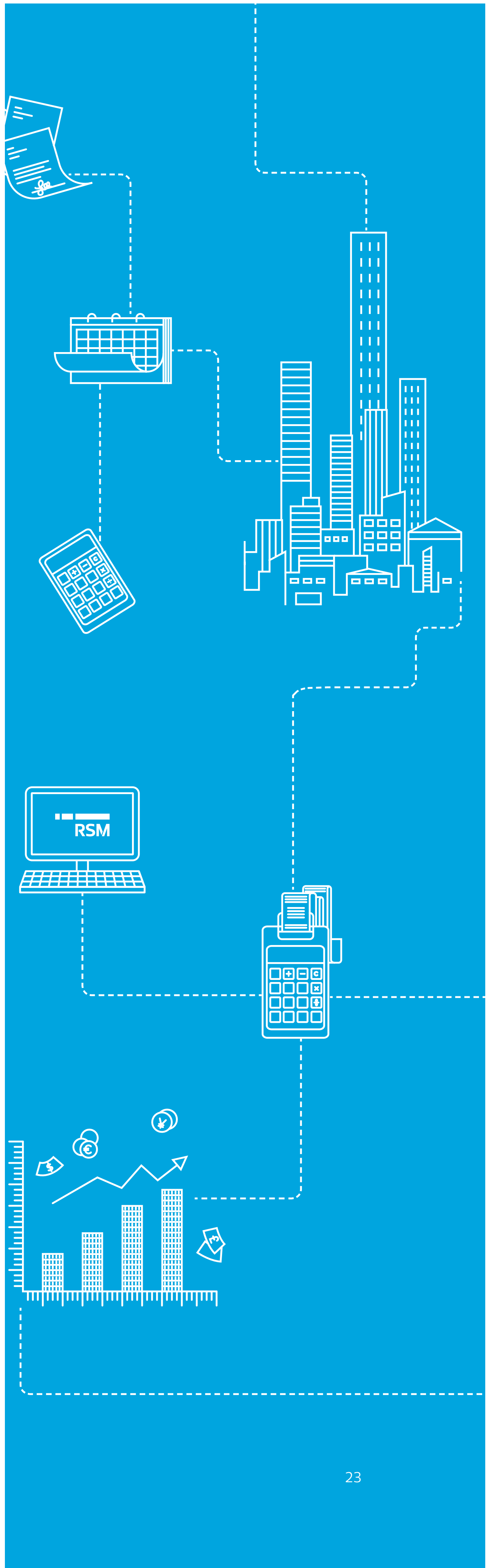
An economic relationship exists between the hedging instrument and the hedged item if their values generally move in the opposite direction because of the same risk, which is the hedged risk. IFRS 9 requires an on-going analysis of the possible behaviour of the hedging relationship during its terms to determine whether it can be expected to meet the risk management objective. This new requirement will therefore mean that the hedging documentation will need to be updated on a regular basis.

The effect of credit risk

Changes in fair values of hedged items and instruments are affected by factors other than changes in the underlying risk that is usually being hedged ie credit risk associated with the counterparties to the contract. Because the economic relationship is determined by the expected changes in the fair value of the hedged item and hedging instrument, IFRS 9 requires the fair value movements not to be unduly influenced by changes in credit risk; otherwise the level of offset may become erratic.

Hedge ratio

IFRS 9 defines this as the relationship between the quantity of the hedging instrument and the quantity of the hedge item in terms of their relative weighting and requires the ratio used for accounting purposes to be the same as that used for risk management purposes. In addition, the hedge ratio should reflect the actual quantity of hedging instrument to hedge the actual quantity of hedged item (ie consistent with the ratio used for risk management purposes), provided this does not deliberately attempt to achieve an inappropriate accounting outcome.



Assessing hedge effectiveness

The requirements to measure hedge effectiveness and ineffectiveness remain unchanged. IFRS 9 does not specify the method that must be used to determine whether the hedge effectiveness requirements have been met. However, a method that captures the relevant characteristics of the hedging relationship including the sources of ineffectiveness must be used. These factors will affect whether the method needs to be qualitative or quantitative.

Under IFRS 9, the assessment is forward looking only and must be performed at inception and on an on-going basis at each reporting date or, if earlier, in the event of a significant change in circumstances. This means that the need to perform quantitative testing on a prospective and retrospective basis has been eliminated, along with the need for actual hedge effectiveness to be in the 80%–125% parameter.

This is a welcome change. The bright line test was considered to be one of the many weaknesses of IAS 39 because it meant that many companies could not apply the accounting requirements to valid economic hedges.

Measuring hedge ineffectiveness

IFRS 9 provides additional guidance on how hedge ineffectiveness should be measured requiring the value of the hedged item to be calculated on a present value basis thereby taking into account the time value of money. It states that a derivative with the same critical terms as the hedged item may be used to determine the change in value of the hedged item when assessing hedge ineffectiveness. This is often referred to as a hypothetical derivative. The same method may also help determine whether the hedging relationship meets the hedge effectiveness criteria.

Rebalancing

Rebalancing is a new concept under IFRS 9 and whilst it will only occur in certain circumstances, it relates to existing hedging relationships to which hedge accounting is being applied.

When the economic relationship between the hedged item and hedging instrument changes (due to the underlying or risk variables) an adjustment can be made to the hedge ratio on a prospective basis. This means that the hedging relationship can continue.

It only affects the expected relative sensitivity between the hedging instrument and the hedged item going forwards, because any ineffectiveness arising from previous changes are recognised in profit and loss in the periods in which they arise.

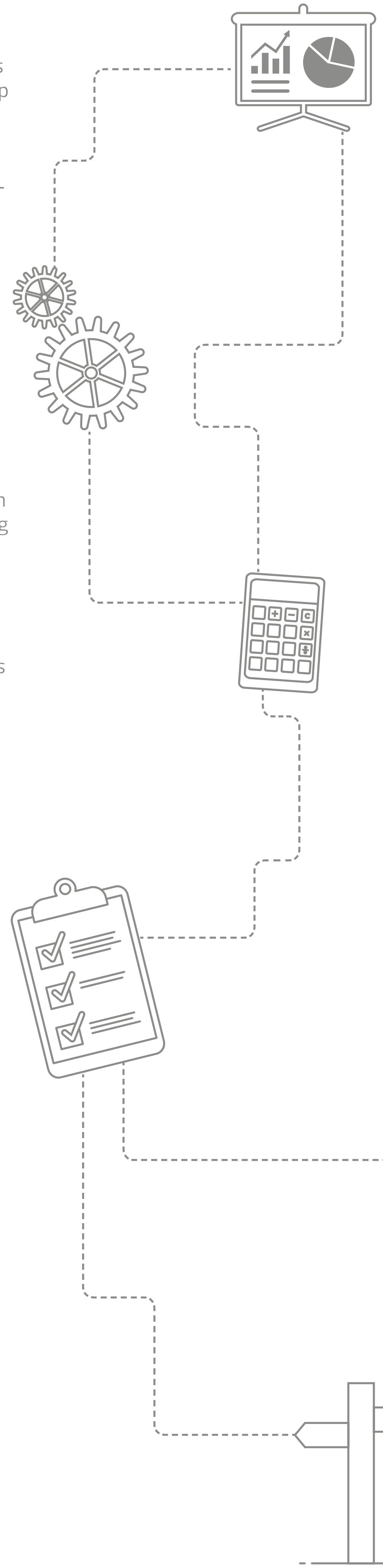
Any other changes made to the quantities of the hedged item or hedging instrument would not be rebalancing adjustments.

An entity must rebalance a hedging relationship if that relationship has an unchanged risk management objective but no longer meets the hedge effectiveness requirements for the hedge ratio.

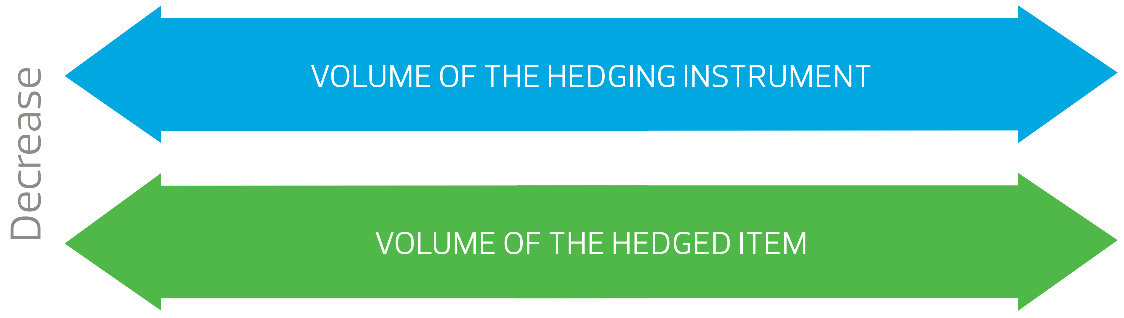
Hedge ineffectiveness and hence the changes to the hedge ratio may be caused by factors other than changes in the underlying or risk variables. In such circumstances rebalancing is not permitted.

Rebalancing is only applied in limited circumstances. It is worth noting that under IFRS 9 the hedge relationship is still required to be discontinued when:

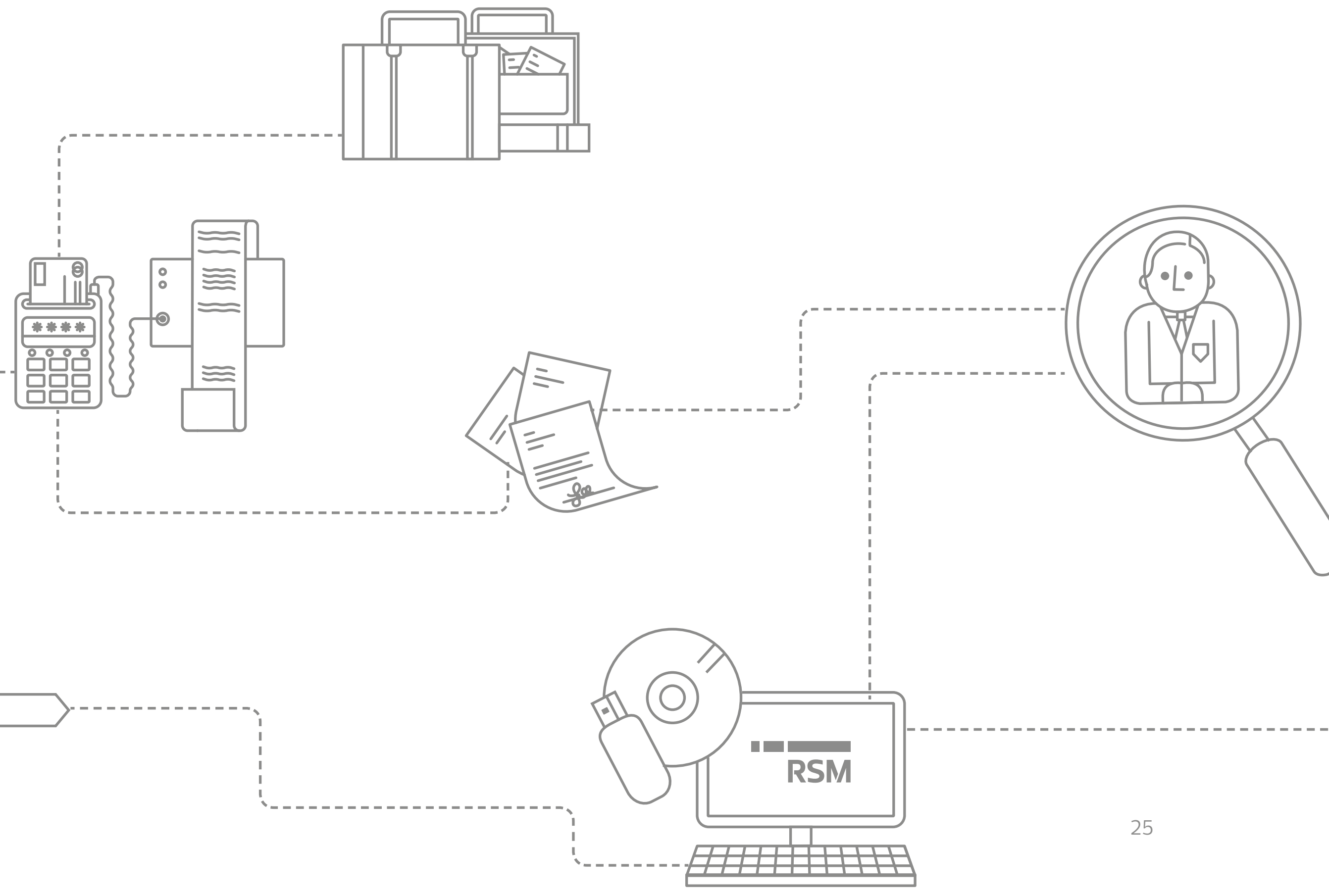
- The risk management objective has changed;
- the economic relationship no longer exists; or
- credit risk dominates the relationship.

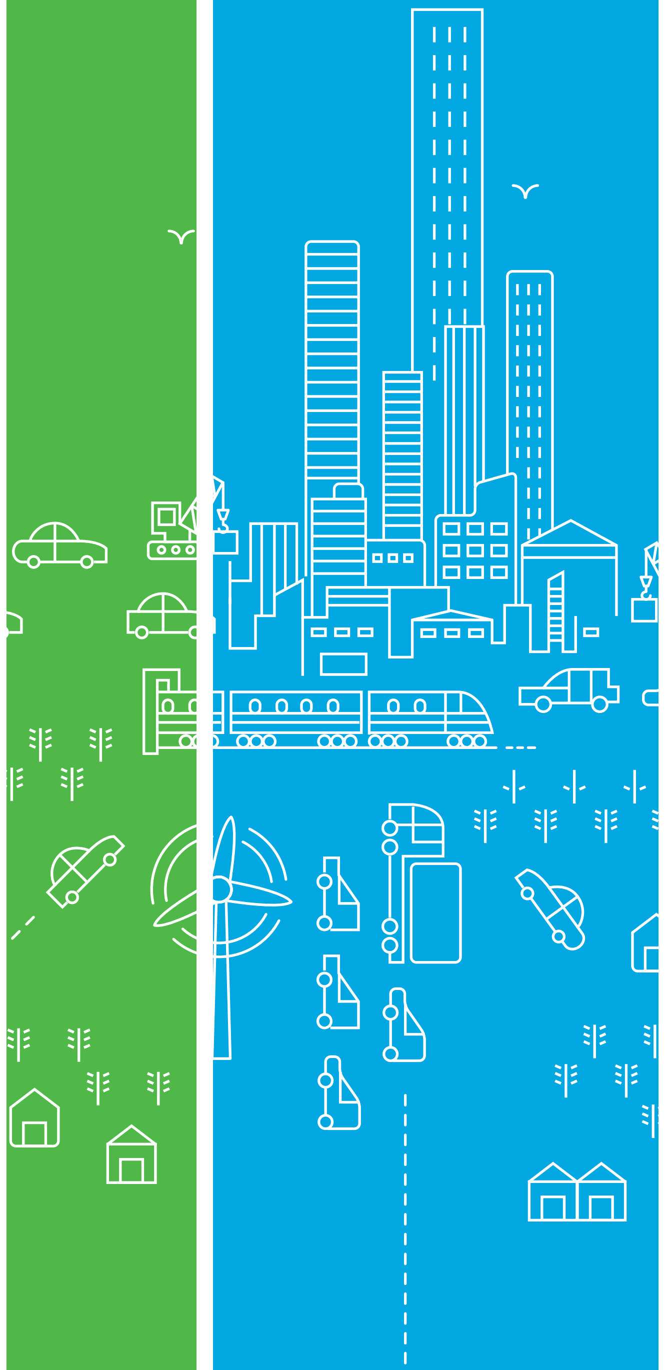


How to achieve rebalancing



Irrespective of whether the hedging ratio is being rebalanced, the changes in fair value of the hedging instrument and hedged item must be calculated retrospectively, because any ineffectiveness that has arisen in the period must be recognised in profit and loss. Rebalancing only changes what has effectively been designated in respect of a particular hedging relationship and hence will only impact on the ineffectiveness going forward.





Discontinuation of hedge accounting

The accounting treatment under IAS 39 and IFRS 9 when an entity discontinues hedge accounting is the same.

However, unlike IAS 39, voluntary discontinuation under IFRS 9 is prohibited. The scenarios below set out when discontinuation will occur and how:

SCENARIO	DISCONTINUATION
Risk management objective has changed	Full / partial
Economic relationship no longer exists	Full
Credit risk dominates the relationship	Full
Reducing the amount of the hedged item or hedging instrument on rebalancing	Partial

What constitutes a change in the risk management objective?

IFRS 9's application guidance provides three examples of what constitutes a change in the risk management objective. For the purpose of determining whether there has been a change, it is important to distinguish between risk management objective and strategy.

An entity's risk management strategy is set at a very high level and normally sets outs how an entity manages its risk, typically identifying the risks the entity is exposed to and how it will respond to them. Such a strategy tends to be in place for a long period of time and is communicated and cascaded down the chain of command through more specific policies and procedures.

Risk management objectives are considered to be more specific and are set to achieve the overall risk strategy. They are generally set at a specific hedging relationship level. This means that a specific risk management objective for a particular hedging relationship can change whilst the entity's overall risk management strategy remains unchanged.

Transition and disclosures

On transition, the standard proposes the prospective application of the new hedging requirements and hence no restatement of comparatives and no requirement to give the new hedge accounting disclosures for comparative purposes.

Alongside the new hedging requirements, new improved disclosures are also required. Going forward, entities will need to explain details about its risk management strategy and the effect that hedge accounting has had on the financial statements, in addition to details about derivatives that have been entered into and their effect on future cash flows. The new requirements also remove the need to disclose information by the type of hedge. This is because users of the financial statements said that it was confusing, as the terms were only used for accounting purpose and not relevant to an entity's process for managing the risks and returns of the business.

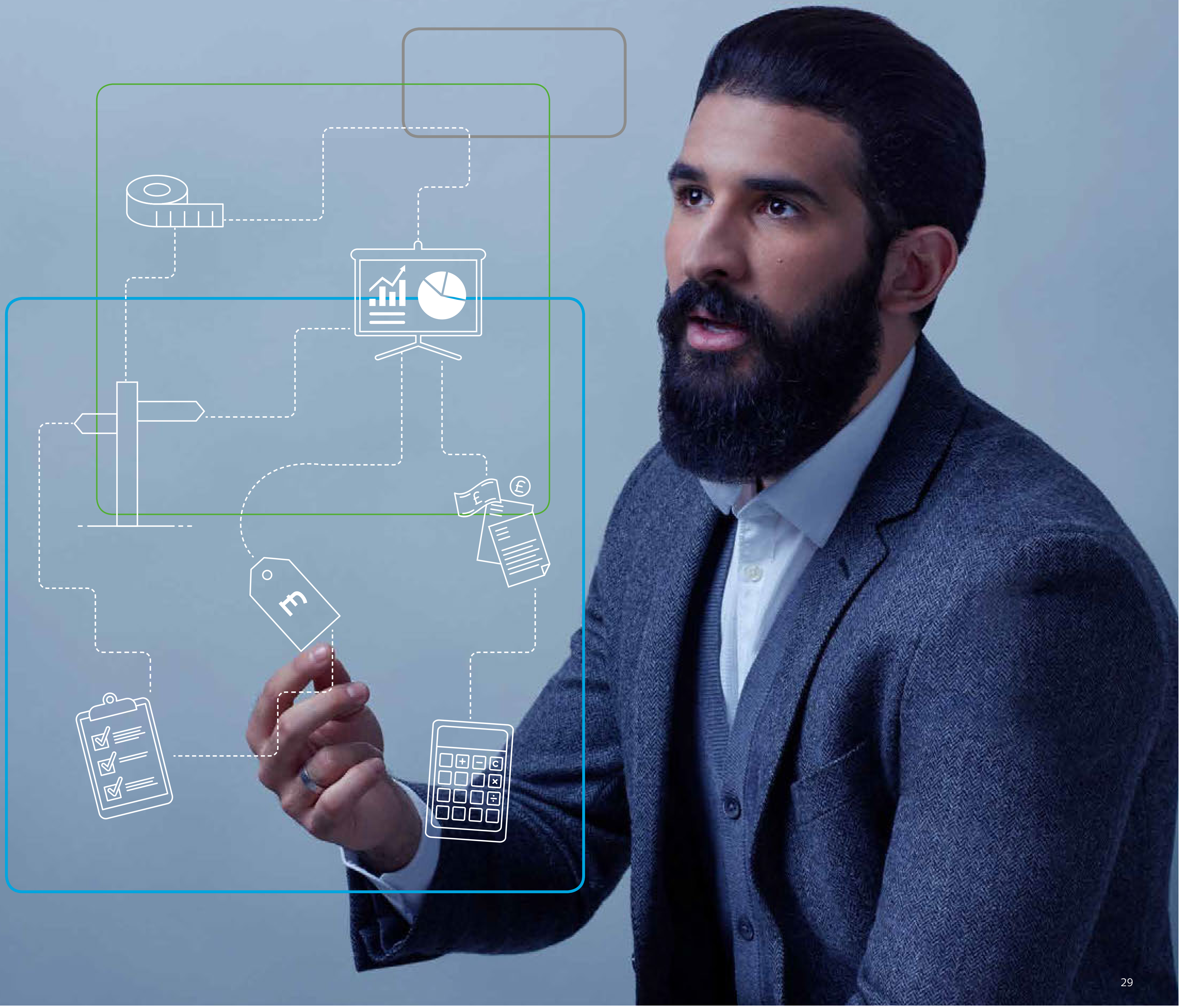
HOW CAN RSM HELP?

Assess the impact of the new standard on your financial statements, tax cash flows and distributable profits.

Assess the available options for the presentation of fair value gains or losses, the impact these will have and the actions that will need to be taken.

Value your financial instruments.

Assess whether hedge accounting could be applied and if so develop procedures for measuring hedge effectiveness.



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