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The new IFRS 9 hedging model

Please note – The audio for today's presentation will be transmitted through your computer speakers

June 18, 2014

Agenda

- Overview
- Eligible hedging items
- Eligible hedged items
- Hedge effectiveness requirements
- Accounting and disclosure for hedges
- Transition
- Q&A

Important caveats

- **This webcast does not provide official Deloitte interpretive accounting guidance.**
- **Check with your advisor before taking any action.**

Overview

Overview
IFRS 9 Financial Instruments – Where are we today?

IFRS 9 financial instruments

	Present	2014	2018
Classification and measurement	Final standard + Limited amendments ED	Expected final	Currently 1 Jan 2018
Impairment	ED	Expected final	
General hedge accounting	Final standard		
Macro hedge accounting		Public consultation	

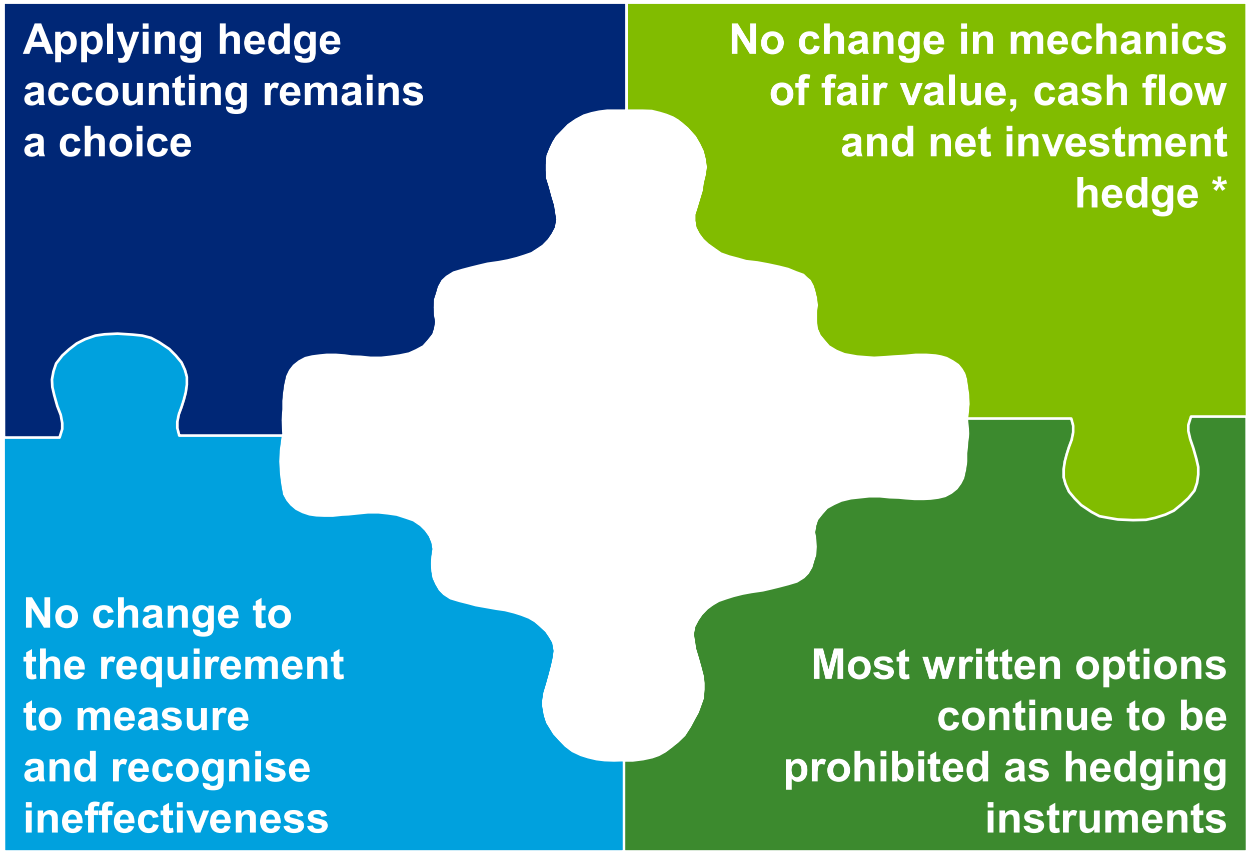
Overview (cont'd)
IFRS 9 transition matrix

IFRS 9 Version	Description	Early Adoption
IFRS 9 (2009) – Financial assets	Classification and measurement of financial assets	Can be adopted on its own
IFRS 9 (2010) – Financial assets and financial liabilities	Added classification and measurement of financial liabilities	Classification and measurement of financial assets must be adopted with classification and measurement of financial liabilities
IFRS 9 (2013) – Own credit risk	Presentation of gains and losses associated with own credit risk related to financial liabilities designated as FVTPL	Can be adopted on its own, without IFRS 9 (2009) or (2010) and without IFRS 9 (2013) – Hedge accounting
IFRS 9 (2013) – Hedge accounting	Added new hedge accounting requirements	Must be adopted with the rest of IFRS 9, i.e., all of the above

Effective date for standard as a whole is fiscal years beginning on or after January 1, 2018, at which point all elements of IFRS 9 must be adopted.

Overview (cont'd)

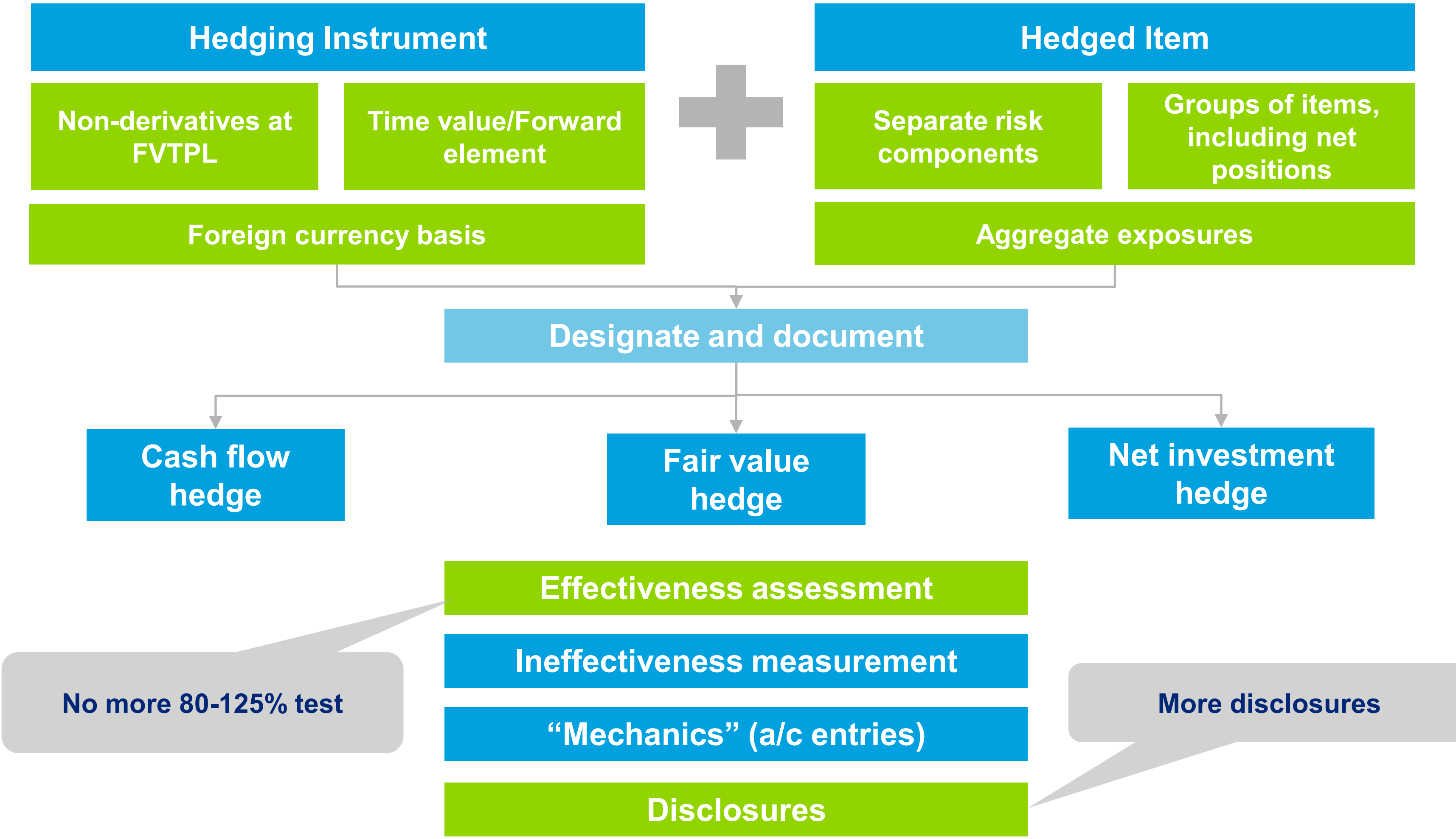
Key elements that have **not** changed from IAS 39…



* Except for fair value hedges of equity instruments for which the OCI option has been exercised

Overview (cont'd)
Transition from IAS 39 to IFRS 9 hedge accounting

Key changes introduced by IFRS 9



Eligible hedging items

IFRS 9 hedge accounting

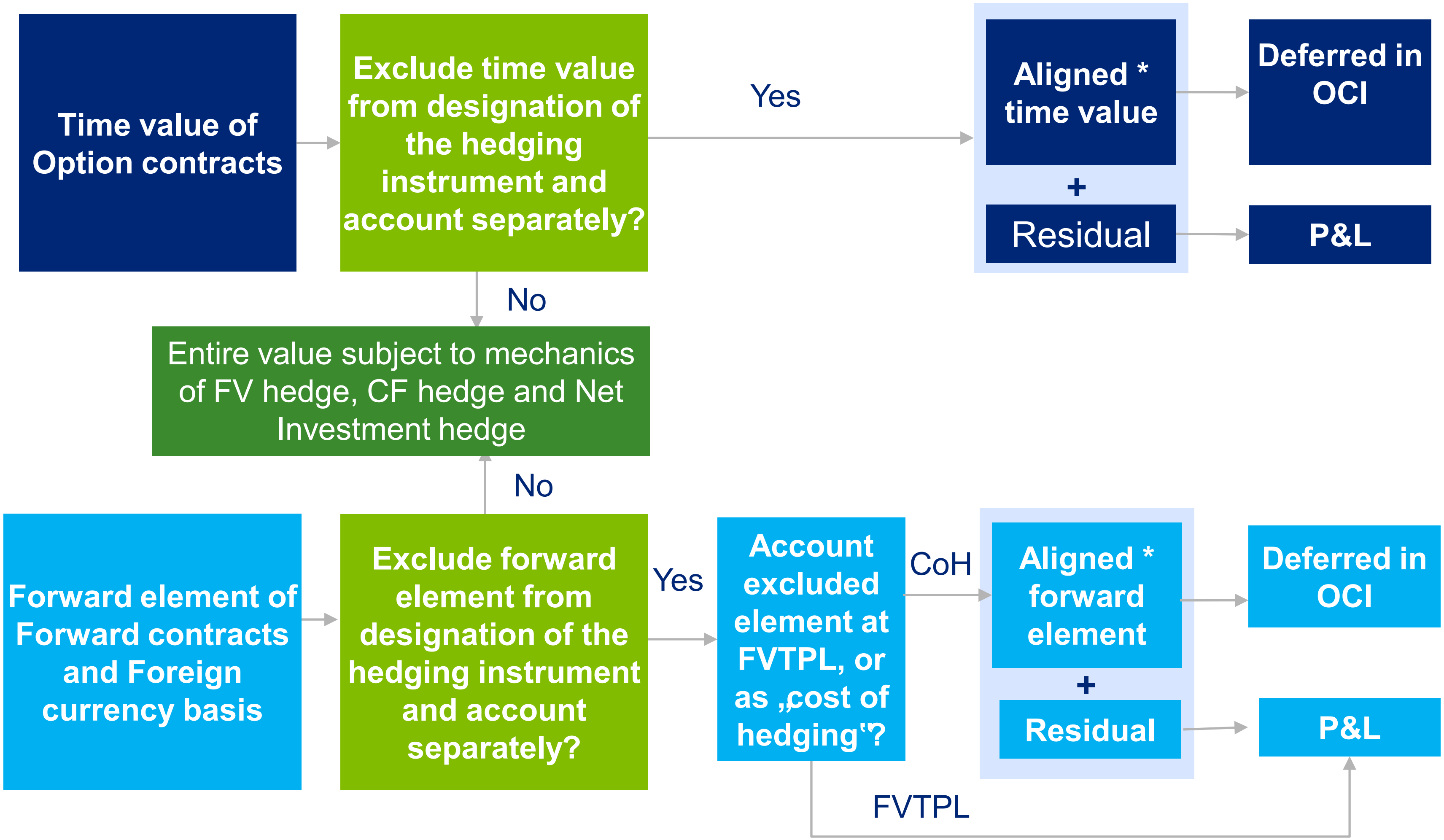
More possibilities to designate hedging instruments

Eligible hedging instruments	Designating hedging instruments
Non-derivatives • No longer limited to hedging of FX risk • Financial instruments measured at FVTPL now permissible*	**Time value, forward points foreign currency base** • Regarded as „cost of hedging"

* Except liabilities at FVTPL, for which changes in FV attributable to changes in credit risk are recognised in OCI

IFRS 9 hedge accounting (cont'd)

Accounting for the "cost of hedging"



* The aligned time value/forward element is that of a purchased option/forward contract with critical terms that perfectly match the hedged item.

Eligible hedged items

IFRS 9 hedge accounting

More flexibility with regard to hedged items or risks

From IAS 39	**Recognised asset or liability**	**Unrecognised firm commitment**	**Highly probable forecast transaction**	**Net investment in a foreign operation**
New in IFRS 9	**Risk components of non financial items**	**Aggregated exposure**	**Groups (restrictions removed)**	**Net positions (with some restrictions)**

Non-qualifying items

- An entity‟s own equity instruments
- Intragroup items (except for FX risk not eliminated on consolidation)
- Firm commitment to acquire a business in a business combination (except for FX risk)
- Fair value hedge of equity method investment
- Risks that have no impact on P&L (except for equity investments measured at FVTOCI)

Risk components of non-financial items

Example: "specifically identifiable and reliably measureable"

- Entity B hedges its future premium quality coffee purchases based on its production forecast up to 15 months in the future

- To manage price risk, entity B enters into
  - Shorter term supply contracts for Arabica coffee to be delivered
  - Exchange traded coffee futures contracts (for periods covered by the supply contracts and later periods)

- The ultimate purchase price paid depends on:
  - Coffee benchmark quality price
  - A quality premium, plus
  - Transport charges.

What relationships may be designated on a risk components basis?

Risk components of non-financial items (cont'd)
Example: "specifically identifiable and reliably measureable"

Potential hedged items	Considerations	Conclusion
Coffee supply contracts (current harvest)	Supply contracts fix the differential between Arabica coffee (the purchased quality) and benchmark quality (futures).	Coffee price risk reflecting benchmark quality is separately identifiable (i.e., in the contract) and reliably measurable; hedging the risk component is possible.
Forecast transactions – No supply contracts as yet (next harvest)	Since benchmark quality is not specified for purchases beyond the current harvest, analysis of market structure and pricing is needed for forecast transactions.	Analysis of how eventual deliveries of Arabica coffee are priced leads Entity B to conclude that forecast transactions also involve price risk reflecting benchmark quality as a risk component that is separately identifiable and reliably measurable; hedging the risk component is possible.

Risk components
Key take away

- IAS 39 does not permit hedge accounting for risk components related to non-financial items
- Hedge accounting may be available under IFRS 9 for more non-financial risks
- Consider risk management strategies involving derivatives related to
  - Agriculture, such as grains and oilseeds, livestock, forestry, cocoa, cotton, sugar, coffee
  - Energy, such as crude oil, natural gas, ethanol, heating oil, gasoline, gas oil, electricity, coal
  - Precious metals, base metals, ferrous metals
  - Others?

Aggregated exposure
Derivatives as hedged items

Hedged items

Aggregated exposure

Combinations of derivatives and exposures

- Combination of an exposure and a derivative creating an aggregated exposure which is managed as a single exposure
- Combined exposure considered for hedge effectiveness assessment and measurement

Aggregated exposure need not be in a hedge relationship

- Items continue to be accounted for separately
- Derivatives are always recognised as separate assets or liabilities measured at fair value
- Limited guidance on accounting mechanics

An example: Derivatives as hedged items

- Example: Entity A (functional currency CAD) enters into a CAD floating rate loan and then enters into a CAD/USD swap which swaps the principal into USD and the interest rate into USD floating rate. Entity A then wishes to hedge the aggregated USD floating interest rate risk which results from the combination of the loan and swap

CAD Floating rate loan (CAD functional entity)

Pay USD float/Receive CAD float swap

≠

Swap is not eligible for hedge accounting as there is no f/x risk in a CAD loan for a CAD functional entity

CAD Floating rate loan (CAD functional entity)

+

Pay USD float/Receive CAD float swap

=

Combination of the loan and the swap creates a USD floating rate aggregated exposure. This combined exposures is eligible for hedge accounting using another derivative

Groups and net positions

Hedged items

Groups and net positions

Cash flow hedges of FX risk only

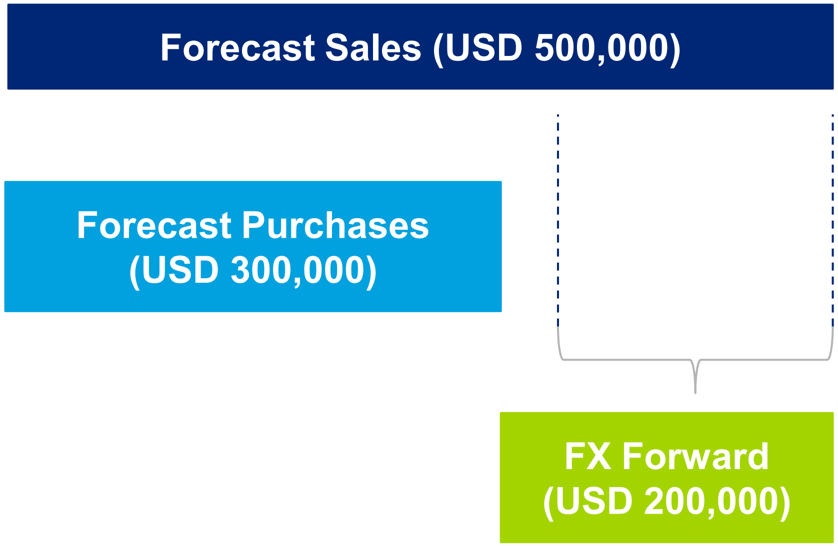
- Allows hedge accounting for forecast purchases and forecast sales together as a net position for FX risk only.

Fair value hedges

- Items in the group must be managed together on a group basis for risk management purposes
  - Elimination of the IAS 39 move in an “approximately proportional” criteria
  - Net positions may be hedged, as long as components of the group can individually obtain hedge accounting and items in the group are managed on a group basis for risk management purposes

Groups and net positions (cont'd)

Cash flow hedges of net positions for FX risk

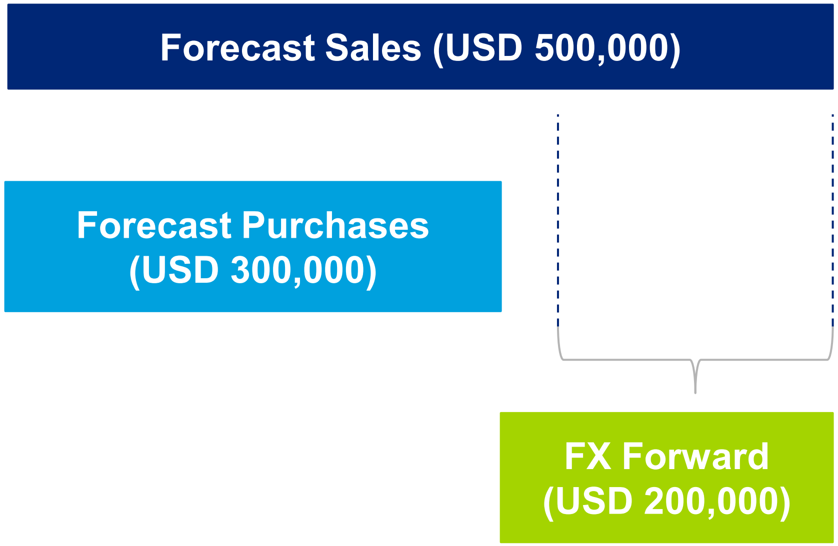


- Canadian functional currency entity has a highly probable forecasted transaction in 3 months time to:
  - Pay USD $300,000
  - Receive revenue of USD $500,000
- Foreign exchange risk is managed based on net exposures each month ("*matter of fact, not an assertion or documentation*").
- FX forward entered into to settle in 3 months time to pay USD $200,000 and receive CAD $192,000.

Can the entity apply hedge accounting to the FX forward of USD $200,000?

Groups and net positions (cont'd)

Cash flow hedges of net positions for FX risk (cont'd)



Can the entity apply hedge accounting to the FX forward of USD $200,000?

- Yes, because the entity is managing its FX risk on a net basis
- Hedge accounting can be applied to this group of items as a hedge of the net exposure of USD $200,000
- Fair value movement on full population of designated hedged items taken in to account in measuring ineffectiveness (sales as well as purchases)
  - Amounts recycled from equity when each item impacts the P/L (sales as well as purchases)
  - Hedging gains and losses shown in separate line from hedged items

Hedge effectiveness requirements

Hedge effectiveness requirements
Three-part test

Economic relationship	Credit risk not dominate	Hedge ratio
Values of hedged item and hedging instrument generally move in opposite direction	Credit risk can negate economic relationship	Generally the actual ratio
Qualitative vs quantitative assessment	Both own credit and counterparty credit	Cannot create ineffectiveness inconsistent with the purpose of hedge accounting
Prospective test only	Consider both hedged item and hedging instrument	Rebalancing of hedge ratio may be required

Ineffectiveness is still measured for financial reporting

Qualifying for hedge accounting
Hedge effectiveness requirements

Situation	Level of analysis	What is needed
Significant mis-match in terms of hedged item and hedging instrument	↑	**Robust numerical analysis necessary to demonstrate economic relationship**
Slight mis-match in terms of hedged item and hedging instrument	Level of analysis	**Numerical analysis may not be necessary to demonstrate economic relationship**
Critical terms match exactly		**Possible to demonstrate economic relationship through critical terms matching alone**

Transition from IAS 39 to IFRS 9 hedge accounting
Hedge ratios

Designation of the initial hedge ratio → **Rebalancing** → **Hedge relationship adjusted and continued**

- Permitted to adjust hedge ratio (designated quantities of the hedged or hedging instrument) of the hedging relationship so that it meets the qualifying criteria again
  – Only useful if the quantities in the hedge relationship lead to ineffectiveness after inception
- Risk management objective for the hedging relationship must remain the same
  – Link between risk management/treasury department and accounting important
- Continuation of original hedge relationship for updated hedged item → ineffectiveness recognized on rebalancing and documentation updated

Finding the right balance on initial designation

Example 1	Example 2	Example 3
• Entity X produces fridges and uses copper in its production process. • To hedge a forecasted purchase of 1,000 tonnes of copper in three months, it enters into a 800 tonnes 3-M-forward for copper. • The risk management objective of the hedge is to eliminate 80% of the exposure. ⬇ • Entity X has to designate 80% of the forecast copper purchase.	• Entity Y wants to cash flow hedge expected FX revenues of 97M USD. • The standard contract size for FX forwards is 100M USD. • As a result, Y purchases 100M USD notional forward contracts. ⬇ • Entity Y can designate the 100M USD forward contracts in full.	• Entity Z has fixed rate loans with a nominal of 200M CAD. • To cover its interest rate risk it purchases an IRS with a nominal of 100M CAD in accordance with its risk management objective of hedging 50% of the interest rate risk exposure. • Z would like to designate the 100M IRS with 105M CAD to improve their hedge effectiveness test result. ⬇ • Entity Z can only designate 100M CAD of its fixed rate loans. • Designating more would result in an inappropriate imbalance.

A balancing act

Designation (initial hedge ratio) → **Rebalancing (adjusting the hedge ratio)** → **Discontinuation**

How is the rebalancing performed?

- Same principles apply as for initial determination of the hedge ratio
- Determine and recognise any ineffectiveness before rebalancing

$$Hedge\ ratio = \frac{Quant\ (Hedged\ item)}{Quant\ (Hedging\ instrument)}$$

- **Increase weighting of the hedged item** either by
  - **Increasing** the volume of the **hedged item**; or
  - **Decreasing** the volume of the **hedging instrument**
- **Increase weighting of the hedging instruments** either by
  - **Increasing** the volume of the **hedging instrument**, or
  - **Decreasing** the volume of the **hedged item**
- Value changes of the adjusted quantity take effect from the date of rebalancing (ie, no retrospective adjustment)
- Update of ineffectiveness sources required and to be documented

Transition from IAS 39 to IFRS 9 hedge accounting
De-designations/discontinuation

The hedging relationship…

…continues unchanged

Has the **risk management objective** changed?

Has the **hedging instrument** been sold or terminated?

Does either:
- An **economic relationship** still exist between the hedged and hedging item?

Or
- **Credit risk now dominate** the value changes?

No

Yes

The hedging relationship…

…is discontinued

No voluntary de-designation like in IAS 39!

Accounting and disclosure for hedges

Common hedge accounting models

	Hedged item	Hedging instrument
Fair Value Hedge Accounting	The gain or loss on the **hedged item** • attributable to the hedged risk is recognised in **profit or loss**	Recognition and measurement of the hedging instrument follows the general requirements for that instrument and is **not changed** when applying hedge accounting
Cash Flow Hedge Accounting (incl. Net Investment Hedges)	Recognition and measurement of the hedged item follows the general requirements for that instrument and is **not changed** when applying hedge accounting	The gain or loss on the **hedging instrument** • attributable to the hedged risk • that is determined to be effective is recognised in **other comprehensive income**

Hedge accounting disclosures
Transparency of the effect of hedge accounting

Risk management strategy	• Explanation of risk management strategy for each hedge • Disclosures on hedging risk components • How economic relationship determined • How hedge ratio determined
Effect on cash flows	• Quantitative information about hedging instruments • Description of sources of hedge ineffectiveness by risk
Effect on financial statements	• Quantitative disclosures of amounts arising from hedge accounting (including line item location) • For example: hedge ineffectiveness; amounts deferred in OCI; amounts reclassified from OCI; amounts related to time value of options and forward points of forwards

Example: Hedging instrument tabular format disclosure

IG13C Paragraph 24A of IFRS 7 requires that an entity discloses amounts related to items designated as hedging instruments in a tabular format. The following example illustrates how that information might be disclosed.

	Nominal amount of the hedging instrument	Carrying amount of the hedging instrument		Line item in the statement of financial position where the hedging instrument is located	Changes in fair value used for calculating hedge ineffectiveness for 20X1
		Assets	Liabilities		
Cash flow hedges					
Commodity price risk – Forward sales contracts	xx	xx	xx	Line item xx	xx
Fair value hedges					
Interest rate risk – Interest rate swaps	xx	xx	xx	Line item xx	xx
Foreign exchange risk – Foreign currency loan	xx	xx	xx	Line item xx	xx

Example: Hedged item tabular format disclosure

IG13D Paragraph 24B of IFRS 7 requires that an entity discloses amounts related to items designated as hedged items in a tabular format. The following example illustrates how that information might be disclosed.

	Carrying amount of the hedged item		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Line item in the statement of financial position in which the hedged item is included	Change in value used for calculating hedge ineffectiveness for 20X1	Cash flow hedge reserve
	Assets	Liabilities	Assets	Liabilities			
Cash flow hedges							
Commodity price risk							
– Forecast sales	n/a	n/a	n/a	n/a	n/a	xx	xx
– Discontinued hedges (forecast sales)	n/a	n/a	n/a	n/a	n/a	n/a	xx
Fair value hedges							
Interest rate risk							
– Loan payable	_	xx	_	xx	Line item xx	xx	n/a
– Discontinued hedges (loan payable)	_	xx	_	xx	Line item xx	n/a	n/a
Foreign exchange risk							
– Firm commitment	xx	xx	xx	xx	Line item xx	xx	n/a

Transition

Transition from IAS 39 to IFRS 9 hedge accounting

New requirements will apply prospectively…..

Qualified hedging relationships under IAS 39 at the date of initial application	Qualified hedging relationships under IFRS 9 from the date of initial application	Transition requirements at the date of initial application
✓	✓	**Continuing hedging relationships** (after rebalancing on transition)
X	✓	**A new hedge relationship could be documented prospectively**
✓	X **Should be rare!**	**Mandatory discontinuation of the hedge relationship on transition**

With specific exceptions with regard to time value of money and forward elements…

Transition from IAS 39 to IFRS 9 hedge accounting (cont'd)

With limited exceptions…

Time value of the options	• Retrospective application if only the change in the intrinsic value was designated as the hedging instrument under IAS 39	Only for hedging relationships existing at the beginning of the earliest comparative period or designated after
Forward element of forward contracts	• Retrospective application permitted_if only the spot element was designated as the hedging instrument under IAS 39 • Option to be applied consistently for all hedging relationships	

Transition from IAS 39 to IFRS 9 hedge accounting (cont'd)

- Planning for early adoption
- Strategy for dual designations
- Demonstrating the economic relationship
- Is rebalancing applicable to every hedge strategy?
- Managing the interpretative areas of IFRS 9 hedging

Documentation requirements

IAS 39 vs. IFRS 9…

Prior to entering into the hedging relationship	**Risk Management Strategy and Objective** 1) Nature of Risk Exposure(s) 2) Approved hedging strategies a. Type of instruments b. Type of risk
At the beginning of the hedging relationship	**Contemporaneous Hedge Documentation for Each Hedging Relationship** 1) Identify and document risk exposure; 2) Verify eligibility and document the hedging relationship: a. Identification of the hedged and hedging item b. Term of the hedging relationship c. Type of hedge **d. Determination of hedge ratio** 3) Select and document effectiveness assessment and measurement method and frequency **– including an analysis of sources of hedge ineffectiveness** 4) Select and document method of accounting; 5) Perform and document prospective effectiveness test; 6) Assess and document probability of occurrence for anticipated transactions.
Throughout the term of the hedging relationship	**Effectiveness Assessment and Measurement** 1) Perform and document **effectiveness assessments**; ~~**a. Retroactively**~~ b. Prospectively (inception and on at least a quarterly basis) 2) Assess and document **high probability of occurrence** for anticipated transactions. 3) Incorporate **creditworthiness into effectiveness testing, along with an assessment on ability to perform under the terms of the contract**.

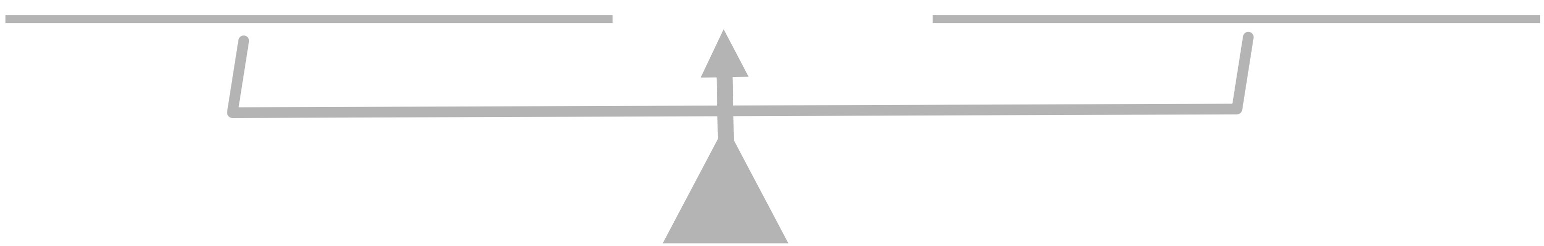
Early adoption vs. mandatory adoption?

Early adoption

- IFRS 9 must be adopted in aggregate
- More opportunities for hedging (e.g., components of non-financial items)
- Significant documentation
- May result in potential lack of comparability among peers (temporarily)
- Increased costs as having to be one of the first dealing with application issues

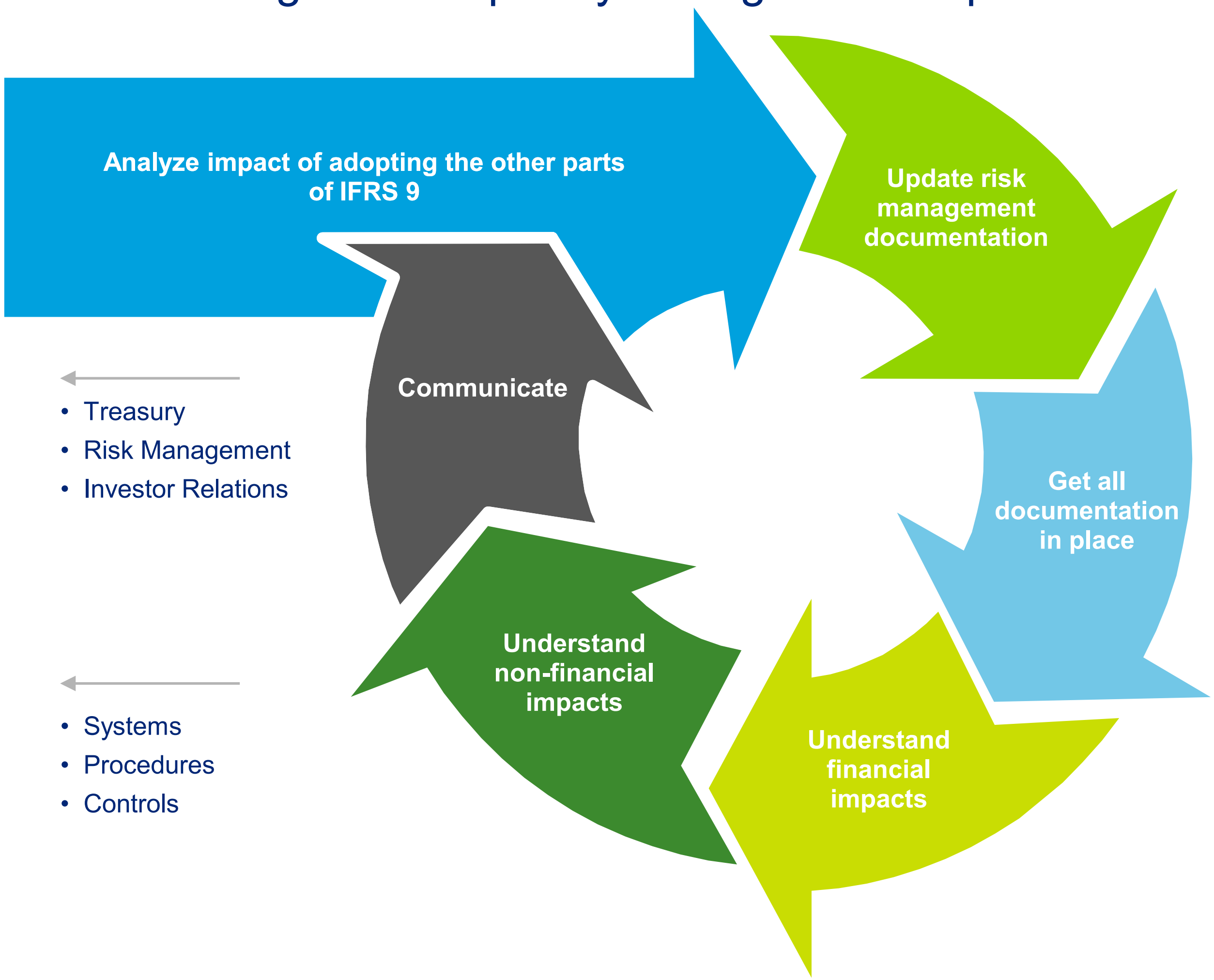
Adopting when mandatory

- Interpretations and application issues already potentially addressed
- Minimizing number of times changes to risk management and accounting strategies are required
- May result in potential lack of comparability among peers (temporarily)



Next steps
Early adoption

Consider the following 'next steps' if your organization plans to early adopt IFRS 9



- Define strategy and objective

- Identification
- Nature of the risk
- Hedge effectiveness

- F/S
- Ratios
- Performance

- Systems
- Procedures
- Controls

- Treasury
- Risk Management
- Investor Relations

Considerations for early adoption

Consider early adopting IFRS 9 if:

- **Entity's current risk management activities are not eligible for hedging under IAS 39**
- **Entity is currently engaging in hedging but not able to apply hedge accounting under IAS 39**
- **Entity participates in a significant amount of commodity purchases and/or sales**
- **Entity manages foreign currency risk on a net or group basis**
- **Entity has a number of options and/or forward contracts**

IFRS 9

Q&A