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## Objective

1 The objective of this internal EFRAG secretariat paper is to present an alternative model to the definition of hedged item in a cash flow hedge of IFRS 9.

## EFRAG Secretariat proposed alternative model, "alternative model": overview

2 It follows from IFRS 9.6.3.7, IFRS 9.6.5.2(a), and IFRS 9.6.1.1 that the principal requirements for a hedged item in a fair value hedge is that the hedged item is separately identifiable, reliably measurable and exposes the entity to changes in fair value that could affect profit or loss.

3 Similarly, it follows from IFRS 9.6.3.7, IFRS 9.6.5.2(b), and IFRS 9.6.1.1 that the principal requirements for a hedged item in a cash flow hedge is that the hedged item is separately identifiable, reliably measurable and exposes the entity to changes in cash flows that could affect profit or loss.

4 All but one of the requirements relating to a hedged item in IFRS 9 (see IFRS 9 paragraph 6.1.1, paragraph 6.3.1 to 6.3.7, and paragraph B6.3.1 to B6.3.25) is consistent with or building on these principles.

5 The one requirement breaching the principal requirements for a hedged item is the requirement that if a hedged item is a forecast transaction, that transaction must be highly probable.

6 A forecast transaction is defined as an uncommitted, thus uncertain, future transaction. A forecast transaction will only expose the entity to changes in cash flows if it happens. If it does not happen then it does not expose the entity to changes in cash flows. This simple fact is true for any uncertain future transaction, independent upon its probability to occur. Very probable or very improbable, it only exposes the entity to changes in cash flows if it actually happens.

7 The proposed alternative model is to remove the requirement for a forecast transaction to be highly probable, and rather to make more it explicit that it must be identifiable.

8 This will allow for all future uncertain transactions to be hedged items in a cash flow hedge as long as they are identifiable.

9 Any mismatch between the volume or occurrence probability of the hedged item and the hedging instrument will be presented in profit or loss due to the lower of test in paragraph 6.5.11(a) of IFRS 9.

## EFRAG Secretariat proposed alternative model - proposals and reasoning

10 Amend in Appendix A (new text is underlined and deleted text is struck through)

*Forecast transaction*
*An <u>identifiable</u> ~~uncommitted but anticipated~~ future transaction <u>that is not a firm commitment</u>.*

11 This amendment achieves two things; (a) it removes the probability criterion currently implied in "anticipated" and (b) it allows committed future transactions that are not firm commitment to be hedged items.

**12 Delete paragraph 6.3.3 of IFRS 9:**

*~~If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.~~*

13 This deletion removes the highly probable criterion currently in IFRS 9. It aligns the requirements for a hedged item in a cash flow hedge with the principal requirements for a hedged item in IFRS 9.

14 This deletion will open for many new hedging relationships. The effectiveness of these hedging relations will be dependent upon the appropriateness of the hedging instrument(s). All hedge ineffectiveness will be recognised in profit or loss in the period when the hedge ineffectiveness occurs because of the lower of test in paragraph 6.5.11 of IFRS 9.

15 The fact that there will be an increased focus on the probability of the occurrence of the future transaction that is the hedged item will lead to more measurement of true economic ineffectiveness in all cash flow hedge accounting.

16 To the extent the amendment is opening for less effective hedging relationships to be subject to hedge accounting, users will benefit from the increased disclosures that accompanies hedge accounting.

17 Having deleted paragraph 6.3.3, some consequential amendments is required:

(a) the words "highly probable" before the word "forecast" will be deleted in paragraphs 6.3.5, 6.3.6, 6.5.2(b), B6.3.5, B6.6.9 and B6.6.10.

(b) minor deletions or amendments to the text in paragraph 6.3.4, B6.3.3(a) and B6.5.27 is recommended.

(c) paragraph 6.8.4 and the heading before it should be deleted.

18 **Amend paragraph 6.5.12 of IFRS 9:**

*When an entity discontinues hedge accounting for a cash flow hedge (see paragraph~~s~~ 6.5.6 ~~and 6.5.7(b)~~) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 6.5.11(a) as follows:*

*(a) if the <u>occurrence or non-occurrence of the future transaction is still identifiable</u> ~~hedged future cash flows are still expected to occur~~, that amount shall remain in the cash flow hedge reserve until the future cash flows occur or until paragraph 6.5.11(d)(iii) applies. When the future cash flows occur, paragraph 6.5.11(d) applies.*

*(b) if the <u>occurrence or non-occurrence of the future transaction is</u> ~~hedged future cash flows are~~ no longer <u>identifiable</u> ~~expected to occur~~, that amount shall be immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1). ~~A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.~~*

19 The probability criterions related to discontinuation of cash flow hedge accounting must and will successfully be replaced by the identification criterion.

## EFRAG Secretariat proposed alternative model – Expected consequences

20 The expected consequences of the alternative model are numerous and includes:

(a) Increased focus on hedge ineffectiveness.

(b) Increased focus on hedging strategy.

(c) Increased number of hedging relationships.

(d) Increased focus on controls relating to hedge relationships.

21 It is worth noticing that:

(a) The accounting for a fully ineffective hedging relationship will be equal to the accounting for a derivative, but without the additional disclosure requirements relating to hedge accounting.

(b) Designation of low effective hedges will increase the scrutiny of management and the risk management policy of the entity.

(c) The proposed solution will solve the issues related to PPAs being hedging instruments without any rule-based special regulation.

(d) The proposed solution will allow for load following swaps as hedging instruments.