Major overhaul of hedge accounting included in HKFRS 9 *Financial Instruments* amendments

The Institute has issued amendments to HKFRS 9 *Financial Instruments*, which completes another phase of the project to replace HKAS 39 *Financial Instruments: Recognition and Measurement*. This article addresses the features of the amendments.

The amendments, issued in December 2013 by the Institute, make three important changes to HKFRS 9:

a) A new chapter on hedge accounting has been added to HKFRS 9, which represents a major overhaul and puts in place a new model that introduces significant improvements principally by aligning the accounting more closely with risk management. There are also improvements to the disclosures about hedge accounting and risk management;
b) Changes have been made to address the so-called "own credit" issue that were already included in HKFRS 9 to be applied in isolation without the need to change any other accounting for financial instruments; and
c) The 1 January 2015 mandatory effective date of HKFRS 9 has been removed to provide sufficient time for preparers of financial statements to make the transition to the new requirements. The standard will now become effective at a later date to be announced later.

Hedge accounting

Qualifying criteria for hedge accounting

An objective-based model for testing hedge effectiveness, and which is performed on a prospective basis (that is if retrospective assessment of hedge effectiveness is no longer required), has replaced the 80-125 percent "bright line" test contained in HKAS 39. In order to be considered as an effective hedge, HKFRS 9 now requires:

- There is an economic relationship between the hedged item and the hedging instrument;
- The effect of credit risk does not dominate the value change in the hedge relationship; and
- A qualitative or a quantitative assessment to support that economic relationship may be needed, depending on the complexity of the hedge.

Hedged items

A key change brought about by HKFRS 9 is the ability to hedge a risk component of a non-financial item. Unlike HKAS 39, the hedge accounting model in HKFRS 9 allows greater flexibility, and which aligns the treatment of financial and non-financial items to also allow the hedging of risk components in non-financial items (for example, the oil price component of jet fuel price exposure), provided the component is separately identifiable and reliably measurable.

In this connection, it is expected that more entities, particularly non-financial institutions, will apply hedge accounting to reflect their actual risk management activities.

Accounting for the time value of options

Under HKAS 39, entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. This meant that the time value that was not designated was required to be presented similarly to financial instruments held for trading. This created a disconnect between the accounting treatment and the risk management view, whereby entities typically consider the time value of an option at contract inception (the premium paid) as a cost of hedging akin to a cost of buying protection (like insurance).

Consequently, HKFRS 9 aligns the accounting for the time value with the risk management perspective. For transaction-related hedged items, the cumulative change in the fair value of the option's time value should be accumulated in other comprehensive income and should be reclassified in a similar way to that for cash flow hedges.

In contrast, for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis.

The effect of this change is that the time value paid is treated like a cost of hedging rather than as held for trading with the resulting volatility recognized in profit or loss. This enables the costs of such a hedging strategy to be presented in a manner that reflects the inter-relation with the hedging relationship in which the option's intrinsic value is designated, and is consistent with risk management.

It also removes a potential disincentive against the use of options as hedging instruments and improves transparency of the costs of hedging. Similar changes have also been made to the accounting for the forward element of forward contracts and the foreign currency basis spread of hedging instruments.

Disclosures

Consequential amendments have been made to HKFRS 7 *Financial Instruments: Disclosures*, which introduce more disclosure requirements than currently required, and which will require all disclosures for hedge accounting to be presented in a single section in the financial statements.

Own credit

HKFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of an entity's own debt when

the entity has chosen to measure that debt at fair value under the fair value option. The fair value of an entity's own debt is affected by changes in the entity's own credit risk. This means, somewhat counter-intuitively, that when an entity's credit quality declines the value of its liabilities fall, and if those liabilities are measured at fair value, a gain is booked in profit or loss.

To address this issue, HKFRS 9 requires changes in the fair value of an entity's own debt caused by changes in its own credit quality to be recognized in other comprehensive income rather than in profit or loss. This change was included in HKFRS 9 in 2010. However, in order to apply this change entities were required to apply all of the requirements in HKFRS 9 that relate to the classification and measurement of financial instruments. This included changing how financial assets are classified.

The amendments made to HKFRS 9 in December 2013 allow an entity to change the treatment of the effects of changes in its own credit in isolation (that is, before applying any of the other classification and measurement requirements in HKFRS 9).

So, in effect, HKFRS now allows an entity to continue to measure its financial instruments in accordance with HKAS 39 but to benefit from the improved accounting for own credit in HKFRS 9.

Mandatory effective date of HKFRS 9

The date when entities would be required to apply HKFRS 9 was previously stated as 1 January 2015, with earlier application permitted. On the mandatory effective date, an entity would be required to apply the new requirements in HKFRS 9 for classification and measurement, impairment and hedge accounting. This means that entities would need to make systems changes to apply an expected credit loss impairment model in time for the mandatory effective date, which, at least for some, would be an extensive undertaking.

Because the impairment phase of the project is not yet completed, a mandatory effective date of 1 January 2015 would not allow sufficient time for entities to prepare to apply HKFRS 9. Accordingly, it would be necessary to have a later mandatory effective date that should be determined when HKFRS 9 is closer to completion.

The amendments made to HKFRS 9 in December 2013 remove the mandatory effective date from HKFRS 9. Entities may, however, still choose to apply HKFRS 9.

The International Accounting Standards Board is currently discussing some limited amendments to the classification and measurement requirements and is also discussing the expected credit loss impairment model.

Once those deliberations are complete, the IASB expects to publish a final version of the standard that will include all of the phases: Classification and Measurement; Impairment and Hedge Accounting.

A new mandatory effective date will be included upon completion of all the three phases of the project to replace HKAS 39.

This article is contributed by the Institute's Standard Setting Department.