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Hedge accounting amendments – Issues paper

Objective

1 The objective of this agenda paper is to:

(a) present a summary of the comment letters received by the IASB and the IASB staff considerations and proposals based on this feedback;

(b) present an EFRAG Secretariat analysis of the proposals.

Structure of the paper

2 This issues papers contains:

(a) IASB's tentative decisions (paragraph 4 to 6);

(b) ED proposals (paragraph 7 to 8);

(c) Feedback to the ED proposals and IASB staff analysis (paragraph 9 to 43); and

(d) EFRAG Secretariat assessment (paragraph 44 to 49).

3 Question to EFRAG FR TEG is in paragraph 12 of agenda paper 03-01.

IASB's tentative decisions

4 The IASB tentative decisions are presented in paragraphs 4 and 5 of the cover note but repeated here in paragraph 5 for ease of reference.

5 In October 2024, the IASB tentatively decided to finalise the proposed hedge accounting requirements set out in the Exposure Draft, subject to minor changes:

(a) to clarify to which particular requirements in Section 6.3 of IFRS 9 *Financial Instruments* the proposed amendments relate;

(b) to clarify that an entity would be permitted to align the amount of forecasted transactions designated as the hedged item with the variable amount of nature-dependent electricity expected to be delivered by the facility referenced in the hedging instrument;

(c) to clarify that, if the cash flows of the hedging instrument are conditional on the occurrence of the hedged forecast transaction, the 'highly probable' assessment would not be relevant; and

(d) to add qualitative examples to illustrate the application of the proposed amendments.

6 The IASB also tentatively decided not to add any additional guidance for the purpose of the 'highly probable' assessment.

ED proposals

7 The ED Contracts for Renewable Electricity included the proposals allowing an entity to designate a variable nominal volume of forecast electricity transactions (either sales or purchases) as the hedged item, if, and only if:

(a) the hedged item is specified as the variable volume of electricity to which the hedging instrument relates; and

(b) the variable volume of forecast electricity transactions designated in accordance with (a) do not exceed the volume of future electricity transactions that are highly probable, except if an entity designates forecasted sales (which are not required to be highly probable).

8 The ED also contained proposal requiring an entity to measure the hedged item using the same volume assumptions as those used for measuring the hedging instrument.

Feedback to the ED proposals and IASB staff analysis

9 Information on this section is prepared based on the IASB staff agenda paper AP3A Hedge Accounting Requirements

Relationship between proposed amendments and current requirements

Feedback to the ED proposals

10 Some respondents asked for clarification on the relationship between the proposed amendments and the current hedge accounting requirements in IFRS 9. In particular, they seek clarification on whether, and if so the extent to which, the proposed amendments supersede or simply supplement the current requirements

IASB staff analysis

11 The IASB staff clarified that proposed amendments provide an alternative accounting treatment only to the current requirements as specified in the proposals. With regards to the hedge accounting requirements, reference is made specifically to Section 6.3 of IFRS 9, being the designation of the hedged item. Therefore, all other hedge accounting requirements in IFRS 9 continue to apply to hedging relationships to which the proposed amendments are applied. The IASB staff proposed to clarify this in the final version of the amendments.

Designating and identifying the hedged item

Feedback to the ED proposals

12 Some respondents asked for clarification on how to:

(a) document with sufficient specificity the variable notional volume of electricity designated as the hedged item. More specifically, whether the variable notional volume should be designated and documented as an absolute (but different) volume for every delivery interval during which the entity is expected to buy or sell electricity;

(b) identify whether the hedged transactions occurred. They noted that this would be needed to reliably measure the hedged item and determine the amount to be reclassified from the cash flow hedge reserve. Respondents asked whether the hedged transactions are identified for example based on an even distribution during the period, the first transactions to occur or with hindsight based on the volume of electricity for which settlement is made on the hedging instrument.

13 Some respondents asked whether an entity could apply an approach that is similar to the 'net purchaser' requirement used for the own-use amendments, to support an evenly distributed volume of the hedged item if the exact amount cannot be determined at a reporting period end.

14 A few stakeholders didn't agree with permitting a purchaser to apply the amendments. They were of the view that a 'contingent hedge' could result in the entity continuing being exposed to cash flow variability during a hedge period. For example, if purchases of electricity are stable but no nature-dependent electricity is produced during the period, the entity remains unhedged for the period. In their view, such an outcome cannot be considered a good economic hedge and does not provide a faithful presentation of the underlying economic phenomenon.

IASB staff analysis

15 The IASB staff assessed that IFRS 9 already provides flexibility with regards to the designation of the hedged item, which provides entities the opportunity to designate a hedging relationship in a way that best reflects the economic offset the relationship will provide (i.e., a proportion of an entire item or a layer component). Therefore, the requirement that a forecast transaction should be documented with sufficient specificity in terms of timing and magnitude continues to apply and be relevant when designating a hedge relationship in accordance with the proposed amendments.

16 In the case of hedging relationships involving contracts referencing nature-dependent electricity, the hedged item representing the forecast purchases or sales of electricity is specified in terms of the (uncertain) variable volume of nature-dependent electricity delivered by the particular facility to the spot market and referenced in the NDE contract. In the staff's view, such a designation is consistent with the requirement that the hedged item should be documented with sufficient specificity in terms of timing.

17 However, instead of being specified in terms of magnitude, the magnitude of the hedged item is specified in terms of origin (i.e. nature-dependent electricity expected to be delivered by the particular facility to the spot market). Therefore, the hedged item can still be identified with sufficient specificity as it occurs in each period —as the referenced facility delivers nature-dependent electricity to the spot market, the occurrence of the hedged item is confirmed.

18 With regards to the concern expressed by some respondents on the 'reversed logic' of the hedge accounting (i.e., designating a hedged item with reference to the hedging instrument) the IASB staff noted that a hedging relationship is not required to be perfectly effective to qualify for hedge accounting. IFRS 9 requires documentation of the hedging relationship, the entity's risk management objective for undertaking the hedge, identification of the hedged item and hedging instrument, a description of the risk being hedged and how the entity will assess effectiveness.

19 The IASB staff acknowledged that the wording used in the ED may lead stakeholders to believe that a hedged item is defined through the hedging instrument, however it was not the intention of the IASB. However, unlike other typical hedging relationships, where the quantity can be determined as a proportion or specified volume, in these relationships, the volume of electricity expected to be delivered, cannot be defined in such a way. Therefore, reference to the hedging instrument was needed to show how the designated volume is determined.

20 The IASB staff proposed to clarify in the final version of the amendments that the amount of forecasted transactions to be designated is not based on the hedging instrument itself, but rather on the amount of highly probable electricity transaction that are aligned to the electricity expected to be delivered by the particular facility *referenced* in the NDE contract.

21 With regard to the economic relationship, if the hedged item is designated as an amount equal to the (variable) amount of the nature-dependent electricity delivered by the particular facility that is referenced in the NDE contract an economic relationship could still exist. Further, entity's risk management objective is to hedge the price risk of forecasted electricity purchases only and not the uncertainty about the variable volume of electricity to be delivered. This means that when assessing whether an economic relationship exists, the entity is assessing only value changes that relate to the hedged risk (being the price risk).

22 The IASB staff therefore recommended finalising the proposed amendments subject to clarifying that the hedged item is the amount of forecast transactions that is aligned to the (variable) amount of the nature-dependent electricity delivered by the particular facility that is referenced in the NDE contract.

Applying highly probable requirement – the purchaser perspective

Feedback to the ED proposals

23 Most of the requests for clarification of the proposed highly probable requirement were made in the context of the purchaser of electricity, specifically:

(a) how to determine whether future electricity purchases are highly probable and the level of probability that should be used when assessing whether a purchase is highly probable or not (especially considering the very long period of a contract);

(b) the granularity of the time intervals over which purchases should be estimated; and

(c) what the intended meaning of the requirement is for the variable volume designated to 'not exceed the volume of future electricity transactions that are highly probable' and over which period this should be assessed (ie discrete purchase intervals, other time periods such as a month or the whole contract duration).

IASB staff analysis

24 The IASB staff acknowledged the complexity related to the probability question, however highlighted the importance to not conflate the highly probable assessment and the requirement to designate the hedged item with sufficient specificity. Although they are both based on probabilities, they are based on different sets of assumptions and inputs.

25 The staff also acknowledged that determining whether forecasted purchases over a long period are highly probable is complex, however this is not a new concept and is not unique to the contracts in scope of the proposed amendments.

26 However, the staff considered that the nature of electricity is different from other commodities. This is because there is a rebuttable presumption that an entity that has been and is currently using electricity, will continue to use electricity in future. Therefore, unless there is evidence to the contrary, there is an assumption that an entity's electricity purchases will be determinable based on its past and current levels of consumption, no matter how far in the future the estimate extends.

27 With regards to the granularity of the time periods for which forecasted purchases should be assessed, the staff considered that although electricity purchases might occur on a near-continuous basis, an entity is not required to make detailed estimates of the volume of electricity expected to be purchased every minute of every day. IFRS 9 does not require the time and date of a forecasted transaction to be specified to qualify for hedge accounting.

28 In practice, transactions like electricity purchases that occur throughout a period, or on a near-continuous basis, are aggregated over a period (usually a month) and recorded or invoiced at the end of that period. In other words, the hedged cash flows on the hedged item usually occur only once during a month and that forms the basis for the designation of forecast transactions.

29 The IASB staff therefore suggested that for the purposes of estimating forecasted electricity purchases that are highly probable, the granularity or frequency of the time intervals should be consistent with the frequency with which the hedged cash flows occur.

30 With regards to finalising the proposed amendments, the IASB staff recommended clarifying that for the purpose of the highly probable assessment:

(a) there is an assumption that an entity's forecasted electricity purchases will be determinable based on its past and current levels of consumption; and

(b) an entity is not required to make detailed estimates of forecasted purchases for every minute of every day, but that the time intervals over which estimates are made are consistent with the frequency with which the hedged cash flows occur.

Note: <u>The proposals presented above were not retained by the IASB in its tentative decisions</u>

Applying highly probable requirement – the seller perspective

Feedback to the ED proposals

31 Most respondents did not disagree with the proposed requirement of the ED that stated that forecasted sales are not required to be highly probable if the hedging instrument relates to a proportion of the total future renewable electricity sales from the production facility. However, a few respondents said that this requirement is not needed for an entity that is the generator of nature-dependent electricity and for which every spot sale transaction of electricity produced by the specified production facility is subject to an NDE contract because if all spot sales of a specified production facility are subject to an NDE contract, each MWh of nature-dependent electricity sold will be highly probable to occur for the purposes of a cash flow hedging relationship.

32 On the other hand, a few other respondents noted that proposals of the Exposure Draft do not require the seller of nature-dependent electricity to also be the generator of that electricity. They noted that, in the absence of such an explicit requirement, they are concerned about the proposed amendments being applied inappropriately and risk having unintended consequences.

33 A few other respondents did not agree with the proposed relief from the highly probable requirement only applying to sales transactions. In their view, similar relief should be available for purchasers in a physical PPA. This is because without the physical PPA, the entity has exposure to price variability with regards to future electricity purchases; in other words, the physical PPA is both the contract under which the electricity is purchased and the contract that fixes the price. They therefore consider the purchaser in such a contract to be in the same position as the seller to which this proposed relief would apply.

IASB staff analysis

34 The IASB staff reconfirmed the intention to keep the highly probable requirement as currently included in the IFRS 9 and noted that it is important that an exception is applied only when such a forecast transaction is highly probable to occur. The same probability requirements apply equally to forecasted sales and purchases. However, when cash flows under the NDE contract can arise only when there is a hedged sale or purchase, such forecast transactions could be considered to be highly probable by nature. Therefore, if an entity is a producer of nature-dependent electricity and the NDE contract only requires net settlement when the generated electricity is sold, every spot sale the entity makes, would be covered by the NDE contract.

35 The IASB staff acknowledged that the current wording included in the ED may be subject to interpretation and recommended clarifying that the proposed requirement in paragraph 6.10.5 of the Exposure Draft applies to hedging relationships to which the proposed amendments are applied and for which cash flows of the hedging instrument are contractually linked to the hedged item such that the cash flows only arise when the forecasted transaction occurs.

Measuring the hedged item

Feedback to the ED proposals

36 Many respondents asked for clarification of the proposed requirement to measure the hedged item using the same volume assumptions as those used for measuring the hedging instrument. A few respondents were concerned that this could result in the measurement of the hedging item to simply mirror the measurement of the hedging instrument (with no resulting ineffectiveness arising), which would be a fundamental departure from the current hedge accounting requirements.

37 The main areas for classification included:

(a) whether measurement of the hedged item should reflect trading intervals for spot purchases (ie hourly intervals) or the intervals on which the hedging instrument is traded (for example 15 min);

(b) the level of granularity with which the hedged item needs to be modelled as there are concerns about the availability of relevant pricing information (such as spot prices and forward curves) on a very granular basis;

(c) how to reflect differences in the demand profile compared to the delivery profile of electricity between the hedged item and the hedging instrument when assessing the economic relationship or measuring ineffectiveness;

(d) how the operation of the 'lower of' test could work when forecast assumptions manifest (and likely to be different than the estimate) through actual settlement at different prices; and

(e) how other potential sources of ineffectiveness could be reflected in the comparison between the hedged item and the hedging instrument, for example when more electricity was delivered in a calculation period as estimated, or when there is basis risk between the hedged item and hedging instrument.

IASB staff analysis

38 The IASB staff acknowledged the concern raised by respondents about the hedged item simply mirroring the hedging instrument if the same volume assumptions are used for measurement, however the staff noted that this should not be the case since the hedged item is defined independently from the hedging instrument (as outlined in paragraphs 20-22 above).

39 Further the staff clarified that:

(a) the hedged item is the forecasted spot electricity sales or purchases of the entity and not the amount of electricity to which net settlement is required under the NDE contract;

(b) the extent to which highly probable forecasted electricity transactions are designated is aligned to the variable amount of the nature-dependent electricity delivered by the particular facility that is referenced in the NDE contract; and

(c) detailed estimates of forecasted transactions are not required to be made for every minute of every day, but for time intervals that are consistent with the frequency with which the actual cash flows occur (for example monthly).

40 In terms of granularity of time intervals over which the hedged cash flows are measured, the staff estimates that the question is not unique to the nature-dependent electricity contracts but is relevant to all forecasted transactions which are expected to occur throughout a period, rather than in a point in time. Therefore, in terms of a *methodology* to measure the hedged cash flows, an entity could use a similar methodology to how it is measuring other hedged items or hedging instruments for which transactions occur throughout the period.

41 The staff is of the view that the intention in the proposals with regards to using the same volume assumptions was to determine the variable volume of forecast transactions to be designated. As the variable volume of forecast transactions is aligned to the variable volume to which the NDE contract relates, it therefore follows that the entity uses the same assumptions to determine the variable volume for measurement. This does not mean that cash flows of the hedged item and hedging instrument would be the same. Differences in pricing of the hedged item and the hedging instrument must be incorporated as well.

42 Respondents identified additional challenges in determining the reclassification adjustment when the hedged item is designated at an amount equal to the variable amount of nature-dependent electricity delivered to the spot market by the facility referenced in

the NDE contract and the hedging relationship is discontinued. Discontinuation could occur for many reasons, but the two main reasons include:

(a) a lack of sufficient highly probable forecast transactions but some of the hedged cash flows are still expected to occur;

(b) the NDE contract is closed out and derecognised.

43 The staff is of the opinion that in these situations, sufficient guidance in IFRS 9 already exists. An entity is expected to apply paragraph 6.5.11 of IFRS 9 in these situations consistently across all its hedging relationships.

EFRAG Secretariat assessment

44 The EFRAG Secretariat is overall supportive of the IASB's tentative decisions related to the hedge accounting requirements. We note that the IASB's tentative decisions address some of the comments raised in question 3 of EFRAG's Comment letter – for example:

(a) EFRAG's suggestion to include a comprehensive example of how the hedge accounting is to be applied. The IASB tentatively decided to add qualitative examples to illustrate the application of the proposed amendments;

(b) EFRAG's observation that the seller of an NDE contract may not be the producer of electricity leading to unintended consequences. This comment was considered and the IASB staff proposed to clarify that the requirement in paragraph 6.10.5 of the Exposure Draft applies to hedging relationships to which the proposed amendments are applied and for which cash flows of the hedging instrument are contractually linked to the hedged item such that the cash flows only arise when the forecasted transaction occurs.

45 However, EFRAG's comment letter and other respondents to the IASB's ED, as outlined in paragraph 23, asked to clarify:

(a) how to determine whether future electricity purchases are highly probable and the level of probability that should be used when assessing whether a purchase is highly probable or not (especially considering very long period of a contract);

(b) the granularity of the time intervals over which purchases should be estimated.

46 Despite the IASB's staff recommendation to provide additional clarification and application guidance to respond to the stakeholders' concerns, the IASB tentatively decided not to add any additional guidance for the purpose of the 'highly probable' assessment. In reaching this decision, the IASB considered that providing additional guidance with regard to the

'highly probable' criterion could lead to unintended consequences as this criterion is not specific to the contracts in scope of the proposed amendments and is a fundamental concept underpinning IFRS 9.

47 As such, EFRAG Secretariat considers that both questions raised in the Comment letter (i.e., the assessment of the highly probable criterion and the granularity of the time intervals) remain an area of concern to the stakeholders.

48 Further, since the IASB's staff response to the questions raised about the measurement of ineffectiveness is based on the clarification related to the granularity of the time intervals (not retained by the IASB), the application questions raised by the respondents in relation to the measurement of hedge ineffectiveness remain without response.

49 With regard to the illustrative example provided in the IASB's staff agenda paper, the EFRAG Secretariat:

(a) notes that there is an ambiguity in paragraph 5A, A6 and A7 on what is the hedged item. Paragraph A5 states "The entity wants to hedge the cash flow variability of <u>future electricity purchases</u> arising from changes in the market price of electricity in the market" (our emphasis) not being specific of which future electricity purchases representing the hedged transactions. Paragraph A6 states "The hedged item is the entity's forecast electricity purchases in the market over the hedged term (being 25 years)." again making no reference to identify the intended subset of future electricity purchases being the hedged item. Paragraph A7 finally identifies the hedged item as "a variable nominal amount of the entity's highly probable monthly electricity purchases that is aligned to the variable nominal amount of electricity delivered by Wind Farm X."

(b) notes that the wording in paragraph A7 "aligned to the variable nominal amount of electricity delivered by Wind Farm X." in practice should be linked to the definition of the underlying volume in the NDE contract for difference being the hedging instrument as this volume may not be the same as (or aligned with) the variable nominal amount of electricity delivered by Wind Farm X. (The NDE contract would represent X% of this volume subject to possible caps and or floors where 0<X.)

(c) notes that the text in paragraph A7 is better located as the second sentence in paragraph A6 as it is premature to determine the hedged item to be highly probable before the hedged item is defined.

(d) notes the conflict between the requirements in B6.3.1 and B6.3.8 of the hedged item being identifiable and the assessment of the hedged item being highly probable in paragraph A7.

(e) notes that "the expected consumption profile of the entity for that period" in paragraph A10 should be read as a reference to "the expected profile of the hedged purchases of the entity for that period."

(f) notes that the baseload price referenced to in paragraph A10 and A11 is an average of prices with similar weighting and thus the use of "volume-weighted" connected to the term baseload may be misdirecting readers.

(g) notes that paragraph A13 may not be easily understood by the stakeholders and suggests that "The hedged item" may be replaced with "A hypothetical derivative".

(h) understands that paragraphs A14 and A15 would only apply when there is ineffectiveness.