



cutting through complexity

“ The feedback indicates that there is broad acceptance of the need for the macro hedging project. Views diverged in terms of scope but overall, most respondents seemed to support a project that addresses accounting mismatches. ”

**Chris Spall**

KPMG's global IFRS financial instruments leader



## The future of IFRS financial instruments accounting

**This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in February 2015 on its financial instruments project.**

This month, the IASB focused on responses to its April 2014 discussion paper (DP) on macro hedging. The Board discussed a summary of feedback from users of financial statements, and for a number of sections of the DP, a detailed analysis of feedback received from all respondents. The IASB staff will provide an analysis of feedback received on the remaining sections during the March meeting.

### Highlights

- Respondents broadly agreed that the DP identified the main limitations of current IFRS as it relates to dynamic risk management (DRM) activities.
- Most respondents seemed to support a project that addresses accounting mismatches.
- There were mixed views on whether the portfolio revaluation approach (PRA) would address the main limitations of current IFRS.
- Many respondents preferred a PRA scope focused on risk mitigation, rather than a scope focused on DRM.
- Most respondents supported optional application of the PRA.
- Many respondents supported incorporating behaviouralisation into the PRA, particularly for core demand deposits.
- There were mixed views on the use of PRA through other comprehensive income (OCI) as an alternative approach.

# THE IASB CONSIDERS RESPONSES TO ITS MACRO HEDGING PROJECT

## The story so far ...

### Accounting for dynamic risk management

Although current IFRS – specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* – provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some common dynamic risk management (DRM) activities; moreover, some of these models deal specifically with interest rate risk management rather than other types of risk. Without an accounting model that reflects the broader use of DRM activities, some have asserted that it can be difficult to faithfully represent these activities in financial statements.

In response to these issues, in April 2014 the IASB published its discussion paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the DP) as the first due process document for the project. As the project involves fundamental accounting questions and is not simply a modification to current hedge accounting models, the IASB did not proceed straight to issuing an exposure draft.

### Portfolio revaluation approach

The DP puts forward an outline of one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures are identified and revalued for changes in the managed risk.

- *Managed exposures*: These would be identified and remeasured for changes in the managed risk, with the gain or loss recognised in profit or loss. The remeasurement would be based on a present value technique.
- *Hedging instruments*: Risk management derivatives – i.e. hedging instruments – would continue to be measured at fair value through profit or loss (FVTPL).
- *Result of hedge accounting*: The performance of a company's DRM activities would be captured by the net effect of the above measurements in profit or loss.
- *Other risks*: Risks that are not managed would not be included in this approach – i.e. PRA is not a full fair value model.

The IASB expects the PRA to be operationally easier to apply than the current hedge accounting models for open portfolios, because it would reduce the complexities associated with one-to-one designations required under current IFRS.

### Managed exposures

A key question in applying the PRA is the extent to which DRM activities should be reflected in the accounting. The DP discusses a number of areas that would broaden the scope of the PRA as compared with current IFRS. The DP considers whether, for example, the following items should be eligible for inclusion:

- pipeline transactions – i.e. forecast volumes of draw-downs of fixed interest rate products at advertised rates;
- the equity model book – i.e. companies managing own equity to earn a minimum target return similar to interest; and
- behaviouralised expected cash flows related to core demand deposit liabilities, prepayment risk and changes in expected customer behaviour.

### Two scope alternatives

The DP presents two possible ways of applying the PRA.

- *Focus on DRM*: Under this approach, the PRA would apply to all dynamically managed exposures regardless of whether they have been hedged.
- *Focus on risk mitigation*: The PRA would apply only when companies have undertaken risk mitigation activities through hedging.

# RESPONSES TO THE MACRO HEDGING DISCUSSION PAPER

Users of financial statements broadly supported the macro hedging project and the concept of the PRA.

## What has happened since the DP was issued in April 2014?

The 180-day comment period for the DP closed on 17 October 2014, with 126 comment letters submitted to the IASB. The Board also conducted outreach meetings with interested parties including preparers, users of financial statements, regulators, accounting standard setters, accounting bodies and accounting firms. In addition, the Accounting Standards Advisory Forum discussed the topic on more than one occasion and provided members' views on the DP. A similar approach was also followed by the Global Preparers Forum.

In February, the staff provided the Board with:

- a summary of the feedback received from users of financial statements; and
- a detailed analysis of feedback received from all respondents on a number of sections of the DP.

## Feedback from users of financial statements

The IASB received four comment letters from users. In addition, there were 14 meetings between users and Board members and staff.

The users broadly supported the project and the concept of the PRA. They considered it to be a step towards better alignment of financial reporting and DRM, based on the assertion that current IFRS does not provide sufficient information for DRM activities. There were mixed views on the scope of the PRA.

Some users noted that they are interested in seeing both hedged and unhedged risks in order to form a complete picture of DRM activities. This is based on the view that both hedged and unhedged open positions are important drivers of banks' net interest income, which is a critical element of profit or loss for banks.

Therefore, management's decision not to hedge is also an important factor from the user's perspective. However, there was no common view among the users on:

- *where* the information should be shown – i.e. profit or loss, OCI or disclosures in the notes to the financial statements; or
- *how* the information should be shown – i.e. would disclosures be adequate without recognition and measurement of the PRA to represent DRM activities?

Some noted that disclosures alone would be adequate, given that revaluation of future cash flows – including behaviouralisation – is dependent on entity-specific judgements.

Other concerns expressed by users included the following.

- Reduced comparability if PRA application is optional.
- The possibility of earnings management.
- Concerns over the accuracy of the revaluation for interest rate risk only, given its correlation with other risks.

## Detailed analysis of feedback from respondents

The Board also discussed a detailed analysis of feedback from all respondents to the DP, including the users mentioned above. The main messages from the following sections of the DP were discussed in the meeting.

Sections of the DP	Section numbers
<b>Background and introduction to the PRA, and overview</b>	1 and 2
<b>Scope of the PRA</b>	3
<b>The managed portfolio (managed exposures)</b>	5
<b>Alternative approach – PRA through OCI</b>	9

Aside from the topics above, there was also a brief discussion on applying the PRA to other risks (section 8). The remaining sections will be discussed at the March meeting.

### Background and introduction to the PRA, and overview

Issue	Summary of feedback
<b>Identifying current problems and the necessity of the project</b>	<p>Respondents broadly agreed that the DP identified the main issues with current IFRS when risk management is dynamic, and broadly agreed that the DP captured the critical elements of DRM and its characteristics.</p> <p>Therefore, many respondents felt that the project was necessary although several of them acknowledged that achieving alignment between financial reporting and DRM activities would be challenging.</p> <p>The clear preference of those respondents who supported the project was for a scope focused on risk mitigation.</p> <p>Some European respondents suggested that the project should address the EU carve-out.<sup>1</sup></p>
<b>The purpose of the project</b>	<p>Many respondents felt that the DP was not clear about whether the purpose of the project is:</p> <ul style="list-style-type: none"> <li>to represent DRM in the accounting; or</li> <li>to address 'accounting mismatches',<sup>2</sup> which have been difficult to address under current IFRS when risk management is dynamic.</li> </ul> <p>Respondents seemed to support the project's aim of addressing accounting mismatches, which is consistent with a scope focused on risk mitigation. The main reasons given in support of this purpose were as follows.</p> <ul style="list-style-type: none"> <li>It is extremely challenging to develop a single accounting approach to represent DRM, taking account of the diversity of DRM activities and techniques among companies.</li> </ul>

**Respondents broadly agreed that the DP identified the main limitations of current IFRS as it relates to DRM activities.**

**Most respondents seemed to support a project that addresses accounting mismatches.**

1. The EU endorsed a carve-out version of IAS 39 in 2004, which deleted certain paragraphs relating to hedge accounting. The carve-out version of IAS 39 relaxes certain elements for the application of fair value hedge accounting of interest rate risk.
2. These arise, for example, from a difference between assets or liabilities accounted for at amortised cost and derivatives accounted for at FVTPL.

**There were mixed views on whether the PRA would address the main limitations of current IFRS.**

Issue	Summary of feedback
<p><b>The purpose of the project (continued)</b></p>	<ul style="list-style-type: none"> <li>• Under IFRS 9, many of the banking book assets and liabilities – e.g. loans and deposits – that are managed dynamically may be measured at amortised cost based on IFRS 9’s business model assessment. However, if the purpose of the project were to represent DRM, it would require the remeasurement of all these assets and liabilities, which would in effect override IFRS 9’s business model assessment.</li> <li>• Representing DRM may involve disclosing commercially sensitive information.</li> </ul>
<p><b>Applying the PRA</b></p>	<p>There were mixed views on whether the PRA would address the issues identified in current IFRS.</p> <p>The views in support of the PRA were as follows.</p> <ul style="list-style-type: none"> <li>• Users believe that better alignment between financial reporting and DRM activities would provide more useful information.</li> <li>• As one-to-one hedge designations are required under current IFRS, the PRA would reduce complexity.</li> </ul> <p>However, concerns were raised as follows.</p> <ul style="list-style-type: none"> <li>• Reliability of measurement is critical. The PRA is a valuation-based model which would require remeasurement of the managed exposures, and may therefore: <ul style="list-style-type: none"> <li>– involve significant judgement that might take behaviouralisation into consideration, given the nature of the managed exposures; and</li> <li>– be inconsistent with a bank’s objective of interest rate risk management, if the bank’s aim is to protect net interest income from the risk of variability of future cash flows, rather than from the risk of the fair value changes on interest rate risk exposures.</li> </ul> </li> <li>• The interaction between the PRA and cash flow hedge accounting under current IFRS is not clear.</li> <li>• The distinction between open portfolios and closed portfolios – i.e. between dynamic and static risk management – is not clear.</li> <li>• The PRA is not necessarily operationally easier than current IFRS.</li> </ul>

Many respondents preferred a PRA scope focused on risk mitigation, rather than a scope focused on DRM.

Most respondents supported optional application of the PRA.

## Scope of the PRA

Issue	Summary of feedback
<p><b>Focus on DRM or risk mitigation?</b></p>	<p>Many respondents preferred a scope focused on risk mitigation, rather than DRM. This is largely because a scope focused on DRM would lead to more volatility in profit or loss as a result of revaluing unhedged risk exposures. The main messages from respondents included the following.</p> <ul style="list-style-type: none"> <li>• The purpose of the project should be to address accounting mismatches. Revaluing all dynamically managed exposures would be inconsistent with this purpose.</li> <li>• Even if a scope focused on DRM would provide a complete picture of its effects, information is only ‘point-in-time’ and may not be useful. To represent a complete picture of DRM, enhanced disclosures would be a better solution.</li> <li>• If a scope focused on DRM were applied, it may be counterintuitive if the volatility of profit or loss for a bank that dynamically manages interest rate risk turns out to be greater than the volatility of profit or loss for a bank that does not manage interest rate risk.</li> <li>• Applying a scope focused on DRM would require a robust definition of DRM, which would be difficult to achieve given the diversity of DRM activities that exist in practice.</li> <li>• A scope focused on risk mitigation would be consistent with current IFRS.</li> </ul> <p>Some respondents supported a scope focused on DRM for the following reasons.</p> <ul style="list-style-type: none"> <li>• Appropriately reflecting DRM activities in the primary financial statements would help to enhance the usefulness and comparability of information.</li> <li>• The PRA with a scope focused on DRM would be operationally easier to apply than a scope focused on risk mitigation.</li> <li>• The PRA with a scope focused on risk mitigation could be applied arbitrarily to achieve a favourable outcome in profit or loss.</li> </ul>
<p><b>Mandatory or optional application of the PRA?</b></p>	<p>Most respondents supported optional application of the PRA, regardless of their preferred scope alternatives. This is because:</p> <ul style="list-style-type: none"> <li>• it would be consistent with the optional application of the existing hedge accounting requirements; and</li> <li>• the PRA would be one mechanism (along with fair value and cash flow hedge accounting, and the fair value option) that provides entities with the flexibility to best reflect business and risk management activities.</li> </ul>

Many respondents supported incorporating behaviouralisation into the PRA, particularly for core demand deposits.

## The managed portfolio (managed exposures)

Issue	Summary of feedback
<b>Behaviouralisation</b>	<p>Many respondents supported incorporating behaviouralisation into the PRA. This is because:</p> <ul style="list-style-type: none"> <li>• DRM is generally based on behaviouralised cash flows rather than contractual cash flows;</li> <li>• current IFRS already has some requirements that are based on expected cash flows, such as fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs AG114–AG132 of IAS 39); and</li> <li>• concerns about behaviouralisation may be mitigated if a single net line item approach<sup>3</sup> were used for the presentation of the statement of financial position, because the effects of the PRA would be presented separately.</li> </ul> <p>In particular, there was strong support for incorporating the behaviouralisation of core demand deposits into the PRA, for the following reasons.</p> <ul style="list-style-type: none"> <li>• Behaviouralisation of core demand deposits is widely used and is an integral part of DRM in many banks.</li> <li>• The inability to show the effects of DRM through behaviouralisation would require the use of alternative hedge accounting designations such as cash flow hedging. This would provide less transparent information.</li> </ul> <p>However, some wide-ranging concerns were raised, including the following.</p> <ul style="list-style-type: none"> <li>• Behaviouralisation could be accepted only if relevant safeguards (such as appropriate documentation) were in place, along with sufficient disclosures for the modelling and assumptions used. This would avoid problems such as a lack of comparability and earnings management.</li> <li>• A behaviouralisation approach would introduce significant judgement and subjectivity.</li> <li>• It is difficult to distinguish whether changes in behaviouralised cash flows arise due to changes in behaviour or flaws in previous assumptions.</li> </ul>
<b>Pipeline transactions and the equity model book</b>	<p>There were mixed views over including pipeline transactions and the equity model book in the PRA. Respondents who currently include these items in their DRM supported their inclusion in the accounting because it would enable them to provide more faithful information.</p> <p>However, many respondents expressed concerns over the inclusion, as it contradicts the <i>Conceptual Framework for Financial Reporting</i>.<sup>4</sup></p>

3. The DP describes three alternative approaches for presenting the revaluation adjustments in the statement of financial position: (a) line-by-line gross-up; (b) aggregate adjustment; and (c) single net line item. The single net line item approach would require that the net revaluation adjustment for the entire revalued portfolio be presented in a single line item in the statement of financial position.
4. Remeasuring the managed exposures for those items would involve remeasuring items that do not meet the definitions of an asset or a liability under the IASB's Conceptual Framework – i.e. revaluing a pipeline transaction would require the recognition of an asset or a liability before the company becomes a party to the transaction, and revaluing the equity model book would recognise the remeasurement of equity.

**There were mixed views on the use of PRA through OCI as an alternative approach.**

### Alternative approach – PRA through OCI

Issue	Summary of feedback
<b>PRA through OCI</b>	<p>There were mixed views on the alternative approach incorporating the use of OCI.</p> <p>The main arguments against this approach mention conceptual and practical difficulties with the use of OCI which include:</p> <ul style="list-style-type: none"> <li>• potential conflict with the <i>Conceptual Framework for Financial Reporting</i> – the IASB’s current Conceptual Framework project includes a discussion of the purpose of OCI;</li> <li>• the contradiction with a key assumption in the DP that the PRA would not change the accounting for derivatives – i.e. derivatives are measured at FVTPL;</li> <li>• the treatment of internal derivatives – i.e. if PRA through OCI were applied, then the effects of internal derivatives would no longer be eliminated in consolidated profit or loss;</li> <li>• the fact that reclassification from OCI to profit or loss would not occur even if managed exposures were sold;</li> <li>• the fact that recognising hedge ineffectiveness in OCI would contradict a key principle in existing hedge accounting that requires it to be recognised in profit or loss; and</li> <li>• a potential increase in the volatility of equity caused by the PRA through OCI approach.</li> </ul> <p>Other respondents presented the following views in support of PRA through OCI.</p> <ul style="list-style-type: none"> <li>• It would address concerns that the PRA with a scope focused on DRM would increase volatility in profit or loss.</li> <li>• It could address the issue of accounting mismatches that could arise in insurance companies (see ‘Applying the PRA to other risks’).</li> </ul>



## Applying the PRA to other risks

Issue	Summary of feedback
<b>Non-financial industries</b>	<p>There were limited comments from non-financial industries, which included the following.</p> <ul style="list-style-type: none"><li>• The treatment of forecast transactions that do not arise from recognised assets or liabilities would be a key element and a hurdle if the PRA were to be extended to other risks. This is because revaluing the forecast transaction would not be consistent with the Conceptual Framework.</li><li>• Some recommended that the IASB should further analyse DRM for non-interest rate risks in non-financial industries.</li><li>• The application of the PRA should be kept narrow and be limited to dynamic interest rate risk management in banks only, because applying the PRA to other types of risks or other industries would involve many challenges.</li></ul>
<b>Insurance companies</b>	<p>Insurance companies expressed their interest in the project because they too apply DRM to financial assets and insurance liabilities in practice. However, it is uncertain how the approach in the DP could apply to them because the DP focuses on the dynamic interest rate risk management approach used in banks.</p> <p>Insurance companies noted that the DP does not address the accounting mismatches that could arise from the final standard still to be issued as part of the IASB's insurance contracts project, and that these mismatches would be different from the accounting mismatches for banks.</p>

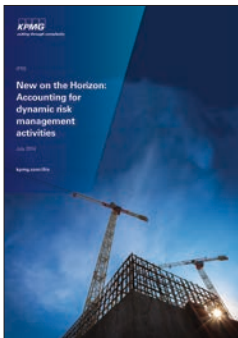
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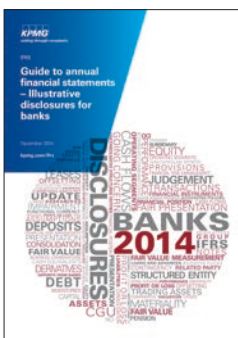
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June and October 2014

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