

# Hedge Accounting According to the International Financial Reporting Standard 9

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## Summary:

The financial crisis did not expose specific weaknesses with hedge accounting in the same way as it is claimed for classification measurement and impairment. The hedge accounting model in International Accounting Standard (IAS) 39 has been criticised as being complex, rule-based, and failing to reflect companies' activities related to risk management. Hedge accounting is a controversial topic in financial reporting and has long been an area of difficulty both for companies seeking to inform investors about what they are doing and for standard-setters in their attempt to apply the appropriate regulation. Some consider that it causes profit or loss volatility from what might be regarded as 'artificial' hedge ineffectiveness which is not representative of the entity's risk management activities. To improve financial reporting and better reflect risk management activities the International Accounting Standards Board (IASB) decided that comprehensive changes were needed. As a result, the new IFRS 9 Financial Instruments develop a model for hedge accounting that is more representative of the risk activities.

The present paper aims to present the requirements of the new hedge accounting according to the International Financial

Reporting Standards (IFRS) 9 Financial Instruments. The practical problems of risk management and hedge accounting for companies have been also considered.

**Key words:** hedge accounting, financial reporting, financial assets, financial instruments, risk management

**JEL Classification:** G11, G32, M41

The IASB is revising its accounting requirements for financial instruments. The final version of IFRS 9 Financial Instruments was published in July 2014. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments.

The new requirements seek to align hedge accounting more closely with entities' risk management activities by increasing the eligibility of both hedged items and hedging instruments and introducing a more principle-based approach to assessing hedge effectiveness.

As a result, the new requirements should serve to reduce profit or loss volatility. The increased flexibility of the new requirements are however partly offset by entities being prohibited from voluntarily discontinuing hedge accounting and also by enhanced disclosure requirements.

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## 1. Financial assets

IFRS 9 provided guidance solely on recognition, classification and measurement of financial assets. IFRS 9 also contain two primary measurement categories for financial assets: amortised cost and fair value. A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value with fair value changes generally recognised in profit or loss (IFRS 9 Financial Instruments).

The standard retains a mixed-measurement model, with some assets measured at amortised cost and others at fair value. The distinction between the two models is based on the business model of each entity and a requirement to assess whether the cashflows of the instrument are only principal and interest.

The business-model approach is fundamental to the standard, and is an attempt to align the accounting with the way in which management uses its assets in its business while also looking at the characteristics of the business.

A debt instrument generally must be measured at amortised cost if both the 'business model test' and the 'contractual cash flow characteristics test' are satisfied. The business model test is whether the objective of the entity's business model is to hold the financial asset to collect the contractual cashflows rather than have the objective to sell the instrument before its contractual maturity to realise its fair value changes.

The contractual cashflow characteristics test is whether the contractual terms of the financial asset give rise, on specified dates, to cashflows that are solely payments of principal and interest on the principal amount outstanding (GrantThornton, 2014).

All recognised financial assets that are in the scope of IAS 39 will be measured at either amortised cost or fair value. The standard contains only the two primary measurement categories for financial assets, unlike IAS 39 where there were multiple measurement categories. Thus the existing IAS 39 categories of held to maturity, loans and receivables and available for sale are eliminated, as are the tainting provisions of the standard.

A debt instrument, such as a loan receivable, that is held within a business model whose objective is to collect the contractual cashflows and has contractual cashflows that are solely payments of principal and interest generally must be measured at amortised cost.

All other debt instruments must be measured at fair value through profit or loss (FVTPL). An investment in a convertible loan note would not qualify for measurement at amortised cost because of the inclusion of the conversion option, which is not deemed to represent payments of principal and interest.

This criterion will allow for the measurement of amortised cost when the cash flows on a loan are entirely fixed, such as a fixed-interest-rate loan or where interest is floating or a combination of fixed and floating interest rates.

IFRS 9 contains an option to classify financial assets that meet the amortised cost criteria as at FVTPL if doing so eliminates or reduces an accounting mismatch. An example of this may be where an entity holds a fixed-rate loan receivable that it hedges with an interest rate swap that changes the fixed rates for floating rates.

Measuring the loan asset at amortised cost would create a measurement mismatch, as the interest rate swap would be held at FVTPL. In this case, the loan receivable could be

designated at FVTPL under the fair value option to reduce the accounting mismatch that arises from measuring the loan at amortised cost.

An economic relationship exists between the hedged item and the hedging instrument meaning that the hedging instrument and the hedged item must be expected to have offsetting changes in fair value.

The effect of credit risk does not dominate the fair value changes, that is, the changes in the fair value due to credit risk should not be a significant driver of the fair value changes of either the hedging instrument or the hedged item.

The hedge ratio is required to be designated based on actual quantities of the hedged item and hedging instrument (unless doing so would create deliberate hedge ineffectiveness) – i.e. the hedge ratio applied for hedge accounting purposes should be the same as the hedge ratio used for risk management purposes hedging instrument (unless doing so would create deliberate hedge ineffectiveness) – i.e. the hedge ratio applied for hedge accounting purposes should be the same as the hedge ratio used for risk management purposes.

## 2. Gains and losses

All equity investments within the scope of IFRS 9 are to be measured in the statement of financial position at fair value with the default recognition of gains and losses in profit or loss. Only if the equity investment is not held for trading can an irrevocable election be made at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss. The amounts recognised in other comprehensive income (OCI) are not recycled to profit or loss on disposal of the investment although they may be reclassified in equity.

The standard eliminates the exemption allowing some unquoted equity instruments and related derivative assets to be measured at cost. However it includes guidance on the

rare circumstances where the cost of such an instrument may be appropriate estimate of fair value.

The classification of an instrument is determined on initial recognition and reclassifications are only permitted on the change of an entity's business model and are expected to occur only infrequently. An example of where reclassification from amortised cost to fair value might be required would be when an entity decides to close its mortgage business, no longer accepting new business, and is actively marketing its mortgage portfolio for sale. When a reclassification is required it is applied from first day of the first reporting period following the change in business model (Deloitte, IFRS 9 Financial Instruments – Overview of the new requirements, 2014).

All derivatives within the scope of IFRS 9 are required to be measured at fair value. IFRS 9 does not retain IAS 39's approach to accounting for embedded derivatives. Consequently, embedded derivatives that would have been separately accounted for at FVTPL under IAS 39 because they were not closely related to the financial asset host will no longer be separated. Instead, the contractual cash flows of the financial asset are assessed as a whole and are measured at FVTPL if any of its cashflows do not represent payments of principal and interest.

A frequent question is whether IFRS 9 will result in more financial assets being measured at fair value. It will depend on the circumstances of each entity in terms of the way it manages the instruments it holds, the nature of those instruments and the classification elections it makes. One of the most significant changes will be the ability to measure some debt instruments, such as investments in government and corporate bonds, at amortised cost. Many available-for-sale debt instruments measured at fair value will qualify for amortised cost accounting.

Many loans and receivables and held

to maturity investments will continue to be measured at amortised cost but some will have to be measured at FVTPL.

IFRS 9 applies one classification approach for all types of financial assets, including those that contain embedded derivative features. Financial assets are therefore classified in their entirety rather than being subject to complex bifurcation requirements.

Two criteria are used to determine how financial assets should be classified and measured:

- (a) the entity's business model for managing the financial assets; and
- (b) the contractual cash flow characteristics of the financial asset.

By allowing aggregated exposures to qualify as eligible hedged items, the new model enables entities to achieve hedge accounting more easily when they manage multiple risks separately as part of their risk management strategy. This permits entities to better reflect their risk management activities in the financial statements.

### 3. Business model for managing financial assets

A business model refers to how an entity manages its financial assets in order to generate cash flows—by collecting contractual cash flows, selling financial assets or both. The business model should be determined on a level that reflects how financial assets are managed to achieve a particular business objective. However, the determination is not dependent on management's intentions for an individual instrument, and should be made on a higher level of aggregation.

A business model can typically be observed through the activities that an entity undertakes to achieve its business objective. As such, a business model is a matter of fact rather than an assertion. Objective information, such as business plans, how

managers of the business are compensated and the amount and frequency of sales activity should be considered. Judgement needs to be used when assessing a business model and that assessment should consider all relevant available evidence.

IFRS 9 specifies that the mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists. As a result, entities should always perform a qualitative analysis of the nature of the economic relationship between the hedged item and the hedging instrument.

### 4. What business model qualifies for amortised cost?

Financial assets at amortised cost are held in a business model whose objective is to hold assets in order to collect contractual cash flows. The objective of this business model is unchanged in the July 2014 version of IFRS 9. To assist in application, additional guidance has however been provided. Sales information in isolation doesn't determine the business model; however, it does provide evidence about how the business objective is achieved and how cash flows are realised. When determining whether this business model is applicable, an entity should consider past sales information and expectations about future sales activity. Having some sales activity is not necessarily inconsistent with this business model. For example, sales that are infrequent or insignificant in value may be consistent with this business model, as are sales that occur as a result of an increase in credit risk. However, if more than an infrequent number of sales occur and those sales are more than insignificant in value, an entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

### 5. What business model qualifies for fair value through other comprehensive income (FVOCI)?

Financial assets classified and measured at fair value through other comprehensive income are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and volume of sales. Various objectives may be consistent with this business model, for example to manage liquidity, maintain a particular interest yield profile or to match the duration of financial liabilities to the duration of the assets they are funding. This business model was added in the July 2014 version of IFRS 9. This measurement category results in amortised cost information being provided in profit or loss and fair value information in the balance sheet (ERNST&YOUNG, Hedge accounting under IFRS 9, 2014).

### 6. Other business models

Any financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss. As such, fair value through profit or loss represents a 'residual' category. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

### 7. Hedge accounting

The new hedge accounting model will allow entities to better reflect their risk management activities in their financial statements. Management may wish to consider the new requirements carefully as there may be benefits from early adoption.

Financial institutions such as banks often use a macro-hedging strategy to manage their interest rate risk exposure of a portfolio

of financial assets and liabilities e.g. hedging the net position of fixed rate financial assets and fixed rate financial liabilities.

Under a macro-hedging model, the amounts of both the hedging instrument and the hedged item change constantly (on a daily, hourly or a more frequent basis).

As a result, the IASB has broadened the application of hedge accounting to include many more risk management activities in IFRS 9. As a result of this, there is the potential for entities significantly to reduce reported profit or loss volatility through economic hedging activities and the application of hedge accounting. Companies will need to evaluate how the entire standard impacts their accounting practices, which will be a larger exercise than evaluating how their hedge accounting practices are affected.

### 8. Reclassification

IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes. This is a significant event and thus is expected to be uncommon. This ensures that users of financial statements are always provided with information reflecting how the cash flows on financial assets are expected to be realised. When reclassification is required, IFRS 7 Financial Instruments: Disclosures requires disclosures about such reclassifications (including the amount of financial assets moved out of and into different measurement categories and a detailed explanation of the change in business model and its effect) to ensure that users of financial statements can see clearly what has occurred.

### 9. Contractual cash flow characteristics

One of the criteria for determining the classification of a financial asset is whether the contractual cash flows are solely payments of principal and interest

(SPPI). Only financial assets with such cash flows are eligible for amortised cost or fair value through other comprehensive income measurement dependent on the business model in which the asset is held. Often it will be readily apparent whether contractual cash flows meet the SPPI criteria but sometimes closer analysis is required. IFRS 9 now provides more extensive guidance on SPPI. Importantly, it has been clarified that interest can comprise a return not only for the time value of money and credit risk but also for other components such as a return for liquidity risk, amounts to cover expenses and a profit margin. For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, so for example, if the contractual cash flows include a return for equity price risk then that would not be consistent with SPPI.

#### 10. Time value of money

Time value of money is the element of interest that provides consideration for only the passage of time. Usually there is a link between the period of time for which this interest element is set and the rate that is used (for example, 3 month LIBOR is used for a 3 month period). However, in some cases this element may be modified (ie imperfect), for example if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate. In these cases, an entity will assess the asset's contractual cash flow characteristics by assessing the modification, qualitatively or quantitatively, to determine whether the contractual cash flows represent SPPI. The objective of this assessment is to determine whether the contractual cash flows could be significantly different to those that would arise if the time value of money element was not modified.

#### 11. Contractual terms that change the timing or amount of cash flows

A financial asset may contain contractual terms that could change the timing or amount of contractual cash flows. An entity must assess whether the contractual cash flows that could arise both including and excluding the effect of those contractual terms are consistent with SPPI. For example, for a prepayable financial asset to have contractual cash flows that are SPPI, the cash flows if prepayment occurs and the cash flows if prepayment does not occur must both be consistent with SPPI. In order for the financial asset to have contractual cash flows that are SPPI, the cash flows resulting from the change in contractual terms should be consistent with a basic lending arrangement.

#### 12. Financial liabilities and own credit

During the development of IFRS 9 the IASB received feedback that the accounting requirements for financial liabilities in IAS 39 had worked well. Most respondents did not think that a fundamental change was needed to the accounting for financial liabilities. Hence, IAS 39's treatment of financial liabilities is carried forward to IFRS 9 essentially unchanged. This means that most financial liabilities will continue to be measured at amortised cost. IFRS 9 includes the same option as IAS 39 that permits entities to elect to measure financial liabilities at fair value through profit or loss if particular criteria are met. For example, an entity can choose to measure a structured financial liability at fair value in its entirety rather than being required to account for its component parts. This is referred to as the fair value option (FVO).

The only issue that the IASB was told needed urgent attention was the volatility in profit or loss caused by changes in the credit risk of financial liabilities that an entity has elected to measure at fair value. The fair value of an entity's own debt is affected by changes

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in the entity's own credit risk (own credit). This means, somewhat counterintuitively, 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 recognised in profit or loss (and vice versa). Many investors and others found this result counterintuitive and confusing.

IFRS 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 FVO. To address the so-called own credit issue, IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in other comprehensive income rather than in profit or loss. Such liabilities would continue to be measured in the balance sheet at fair value, which provides information that was confirmed to be useful by users of financial statements.

In some circumstances it will be relatively easy to determine if cash flows are solely payments of principal and interest. For example a bond that pays interest at 10% less an adjustment equal to twice the rate on a benchmark such as LIBOR, clearly contains leverage and will therefore fail the test. In more complex scenarios, however, it may be necessary for the holder of the asset to 'look through' to the particular underlying assets or cash flows to determine whether the contractual cash flows of the asset being classified are payments of principal and interest on the principal amount outstanding.

Examples of such situations could include non-recourse loans or asset backed loan notes that are sub-ordinated to more senior tranches. For the purpose of applying this test, 'principal' is the fair value of the financial asset at initial recognition.

'Interest' consists of consideration for:

- the time value of money
- the credit risk associated with the principal amount outstanding during a particular period of time

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- other basic lending risks and costs
- a profit margin.

Contractual cash flows that are SPPI are consistent with a basic lending arrangement.

If the effects of changes in credit risk significantly outweigh the effect of changes in commodity prices on the fair value of the hedging instrument, the credit risk could be viewed to dominate the economic relationship.

In some jurisdictions, the government or a regulatory authority sets interest rates. As a result, in some cases the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite IFRS 9's normal requirements, the Standard guides that for the purpose of applying the 'solely payments of principal and interest' test, a regulated interest rate shall be considered a proxy for the time value of money element, if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement (see fig.1).

### **Examples of instruments meeting the SPPI test:**

- ✓ an instrument with a stated maturity date where the cash flows are entirely fixed, or where interest is at a variable rate or a rate which is a combination of fixed and floating;
- ✓ a bond with a stated maturity date where principal and interest are linked (on a non-leveraged basis) to an inflation index of the currency in which the instrument is issued;
- ✓ a variable rate instrument with a stated maturity date that permits the borrower;
- ✓ to choose the market interest rate on an ongoing basis;
- ✓ a bond with a stated maturity date which pays a variable market interest rate;
- ✓ subject to a cap;
- ✓ a full recourse loan secured by collateral.

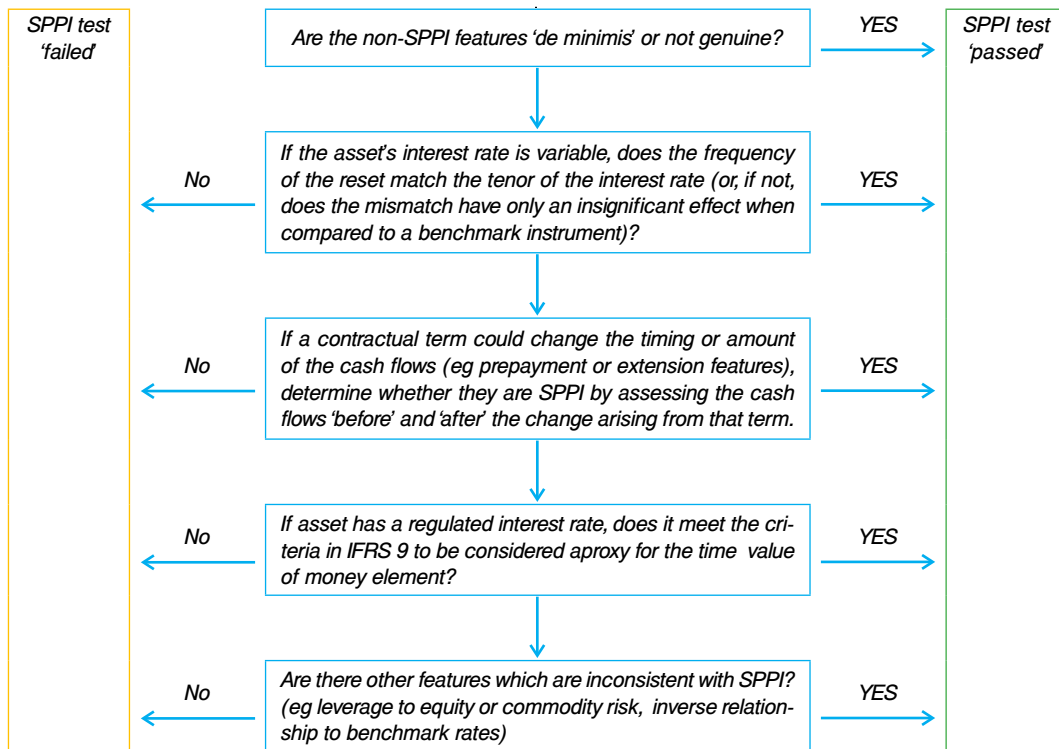


Fig. 1. SPPI model

Source: Author's figure based on: ERNST&YOUNG, 2014, Hedge accounting under IFRS 9

Examples of instruments that do not meet the SPPI test:

- ✓ derivatives;
- ✓ investments in equity instruments;
- ✓ a convertible bond;
- ✓ a loan that pays an inverse floating interest rate;
- ✓ an instrument whose cash flows are based on asset prices or an index.

The following diagramme (fig. 2) summarises the three main categories and how the business model and cash flow characteristics determine the applicable category:

In practice, accounting has become a key driver in how treasurers manage risk, instead of reflecting how management decides to manage financial risks. The companies may:

- ✓ Review your treasury policies to ensure they allow new hedging strategies and instruments;
- ✓ Review the hedging strategies to ensure they are best fit for the company and the risk being managed;
- ✓ Assess which non-financial items you potentially want to hedge;
- ✓ Review contracts to ensure risk components are separately identifiable and measurable;
- ✓ Determine appropriate hedging strategies to address the risks;
- ✓ Determine the optimal hedging ratios for existing hedging strategies;
- ✓ Consider whether your tools are appropriate to measure the hedge ratio during the existence of the hedge relationship.



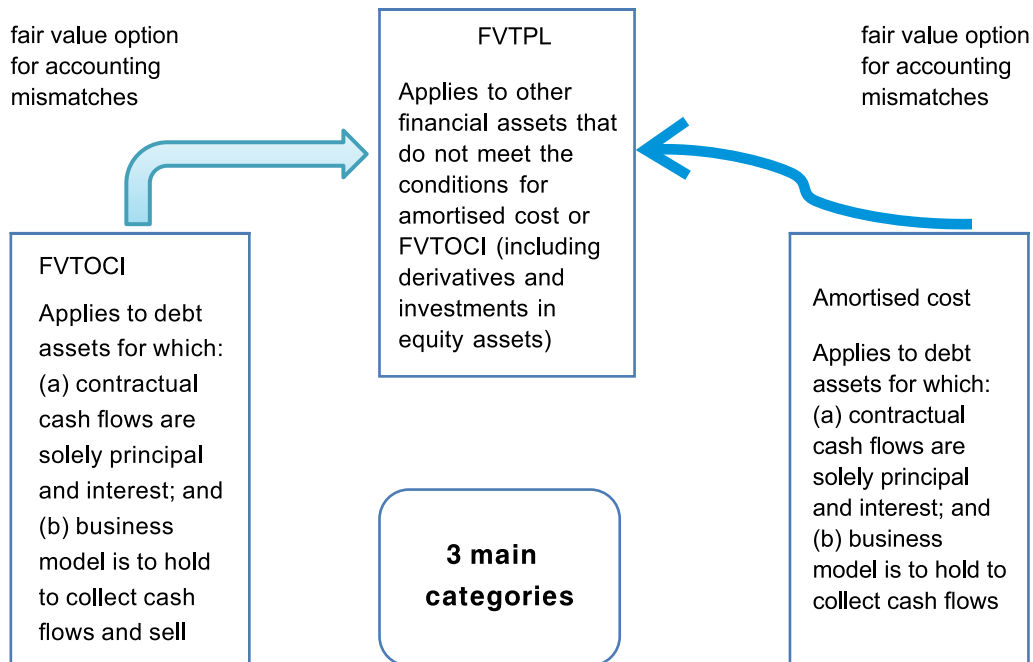


Fig. 2. Applying models

Source: GrantThornton, Sept. 2014, IFRS News, Special Edition, <http://www.grant-thornton.co.uk>

### 13. Practical insight – more than one business model?

An entity may have more than one business model for managing its financial instruments. For example, where an entity holds a portfolio of investments that it manages to collect contractual cash flows and another portfolio that it manages by trading to realise fair value changes. The Standard also notes that in some circumstances, a portfolio of assets might need to be split into sub-portfolios to reflect how an entity manages them. For example, if an entity holds a portfolio of mortgage loans and manages some of the loans to collect contractual cash flows while having an objective of selling other loans within the portfolio in the near term.

Analysts and risk managers often hedge net risk positions (i.e. allowing the risks within the group to naturally offset each other) in order to reduce the number of

hedging instruments entered which lowers transaction and administrative costs. Entities may also take out a number of loans, some at fixed rates and others at floating rates, which have differing maturity dates with interest rate swaps then being taken out and 'layered' to manage the overall mixture of fixed and floating rates to a risk management policy of, for example, 50% fixed rate and 50% floating rate. The new hedge accounting model accommodates this type of risk management by permitting aggregated exposures of non-derivatives and derivatives, and net positions, to be designated as the hedged item.

The new model will enable more entities, particularly non-financial institutions, to apply hedge accounting to reflect their actual risk management activities. This, combined with enhanced disclosures, will assist users of financial statements in understanding entities' risk management activities. This model requires entities to

perform a hedge effectiveness assessment only prospectively, thereby removing the burden of performing retrospective hedge effectiveness assessment.

The application of the new rules requires careful consideration and due care is needed on first time application. This is a challenging task for both corporate treasurers as well as directors requiring significant investment of time, appropriate planning and training and streamlining of information generating channels or systems.

The application of the new hedge accounting model required to established practices for applying hedge accounting. Although there have been complaints over the years about the complexities of applying hedge accounting under IAS 39, companies and their auditors have largely come to agreement on how to apply it to their specific facts and circumstances. Over time, companies by and large have invested in establishing practices and procedures that enable them to successfully administer their hedge accounting programmes and have reached a point where their auditors are generally comfortable with their approach.

Originally, the requirement to rebalance was seen as onerous, but it might actually be a pragmatic solution that avoids discontinuing hedging relationships that would have failed the effectiveness test in the past. In practice, entities will not need to rebalance very often if they have a good risk management strategy in place and the economic relationship is stable. There is always some volatility in any hedging relationship but, if the initial hedge ratio is appropriate and in line with the risk management strategy, rebalancing should only be necessary if the 'ideal' hedge ratio changes significantly. Entities should document their tolerance to such variations.

IFRS 9 requires an entity to assess risk components (that are separately identifiable

and reliably measurable) within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. However, there are no criteria specified to be used in the analysis of the market structure, nor are there any definitions of the market to be analysed.

#### **14. Conclusions**

The new Standard makes significant changes to the criteria for hedge accounting qualification, relaxing the current requirements with the objective of making it easier for entities to reflect their underlying risk management objectives.

To qualify for hedge accounting under IAS 39, a hedge had to be highly effective on both a prospective and a retrospective basis. 'Highly effective' refers to the degree of offset between the changes in fair value or cash flows of the hedging instrument and the hedged item, and is defined in terms of a 'bright line' quantitative range of 80-125%. The IASB has responded to these criticisms by eliminating the 80-125% threshold and introducing more principles-based qualifying criteria.

The designation of the hedging relationship must not however reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. In practice, risk management strategies often must be expressed with broad parameters, for example, that an entity should maintain interest rate risk within a certain range. Overall, the requirements in the IFRS 9 are not clear and run a very real risk of bright-line rulemaking or significant inconsistencies in application.

In many cases, companies do not have any way to predictably forecast the timing

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of the payments during the specified time period and therefore have no reliable way to define the appropriate hypothetical derivative, for example, when hundreds or even thousands of cash payments are made on capital projects. There could also be considerable ineffectiveness for companies who use shorter-dated derivatives due to credit or market constraints to hedge longer-dated exposures.

The Standard requires that in order to apply hedge accounting from the date of initial application for existing hedging relationships, the hedge accounting requirements of the new Standard must be met at that date. Existing hedge relationships that qualify under the requirements of the new Standard (after taking into account any rebalancing on transition) are regarded as continuing.

Adopting IFRS 9 will force companies to evaluate the standard and make changes to their established practices. While these changes are inevitable (IFRS 9 will be required to be adopted eventually), each company must determine the optimal point at which it is desirable to expend the cost required to evaluate the impact of IFRS 9 on its existing practices, implement new practices and get its auditors comfortable with those changes. For companies that believe they will benefit significantly from the early adoption of IFRS 9, the benefits may outweigh the costs. Companies that do not perceive much benefit from adopting are likely to be better off deferring the cost of adoption to a later date.

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