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Structured finance
- accounting developments

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June 2011

Changes to hedge accounting (IAS 39)

What is the issue?

The exposure draft on hedge accounting proposes relaxing the requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting.

Adoption of hedge accounting will mean reduced volatility being reflected through the income statement and more stable returns being achieved.

Will it affect me?

Almost all entities involved in structured finance that engage in risk management activities regardless of whether they use hedge accounting today will potentially be affected by the changes.

As many of the proposed changes remove restrictions, it may be beneficial for entities to revisit risk management strategies that currently do not achieve hedge accounting to see if they will now be permitted. The impact of the new eligibility criteria may make it necessary to evaluate existing hedge accounting strategies that work today and consider whether they will continue to be eligible.

When will it be effective?

It is not yet known when the application of the final standard will be mandated and it is subject to EU endorsement. The hedging proposals are something of a moving target as the IASB continues to make decisions and while this summary reflects decisions up to early June 2011, things may change before the final standard is issued.

Key changes

The rules on hedge accounting in IAS 39 have frustrated many preparers of financial statements, as the requirements have not been well linked with common risk management practices. The detailed rules have at times made achieving hedge accounting impossible or very costly, even when the hedge has been an economically rational risk management strategy.

Hedge effectiveness tests and eligibility for hedge accounting

The exposure draft (ED) proposes relaxing the requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting. Under IAS 39 today, the hedge must both be expected to be highly effective (a prospective test) and be demonstrated to have actually been highly effective (a retrospective test) with 'highly effective' defined as a 'bright line' quantitative test of 80-125%.

The current considerations of the Board would replace this with a requirement that for the hedge to be designated there must be an economic relationship between the hedged item and the hedging instrument, and that the designated hedge ratio should reflect that economic relationship. Also, an entity shall not designate a hedging relationship such that it reflects an imbalance between the weightings of the hedged item and hedging instrument that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price).

Hedged items

A number of changes are proposed to the rules for determining what can be designated as a hedged item. The proposed changes primarily remove restrictions that today prevent some economically rational hedging strategies from qualifying for hedge accounting.

In addition, the ED would make the hedging of groups of items more flexible, although it does not cover macro hedging – this will be the subject of a separate exposure draft in 2011.

Hedging instruments

The ED proposes to relax the rules on using purchased options and non-derivative financial instruments as hedging instruments. For example, under the current hedging rules, the time value of purchased options is recognised on mark to-market basis in net income, which can create significant volatility in profit or loss.

In contrast, the ED views a purchased option as similar to an insurance contract such that the initial time value (that is, the premium generally paid) will be recognised in profit or loss – either over the period of the hedge if the hedge is time related, or when the hedged transaction affects profit or loss if the hedge is transaction related. Any changes in the option's fair value associated with time value will only be recognised in other comprehensive income (OCI). This should result in less volatility in profit or loss for these types of hedges.

Fair value measurement (IFRS 13)

What is the issue?

IFRS 13 will define how fair value is measured and this may lead to amounts held in the balance sheet being remeasured either upwards or downwards with associated impact on the income statement or reserves.

Some changes may be required (for example, bid/ask spread and inclusion of own credit risk) to those fair value measurements today. In addition there are enhanced disclosure requirements that will be required.

When will it be effective?

IFRS 13 is effective for annual periods beginning on or after 1 January 2013, with earlier application permitted subject to EU endorsement.

Key provisions of the Exposure Draft

Definition of fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The fair value of a liability therefore reflects non-performance risk (that is, own credit risk).

Principal or most advantageous market

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability.

The principal market is the market with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

Market participant assumptions

Fair value is measured using the same assumptions and taking into account the same characteristics of the asset or liability as market participants would. Fair value is a market-based, not entity-specific measurement.

Bid and ask prices

The use of bid prices for asset positions and ask prices for liability positions is permitted if those prices are most representative of fair value in the circumstances, but it is not required.

Fair value hierarchy

Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used, as follows:

- Level 1 inputs are quoted prices in active markets for items identical to the asset or liability being measured. Consistent with current IFRS, if there is a quoted price in an active market (that is, a Level 1 input), an entity uses that price without adjustment when measuring fair value;
- Level 2 inputs are other observable inputs; and
- Level 3 inputs are unobservable inputs, but that nevertheless must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability.

Each fair value measurement is categorised based on the lowest level input that is significant to it.

Disclosures

The guidance includes enhanced disclosure requirements that could result in significantly more work for reporting entities. These requirements are similar to those in IFRS 7, ‘Financial instruments: Disclosures’, but apply to all assets and liabilities measured at fair value, not just financial ones.

The required disclosures include:

- information about the hierarchy level into which fair value measurements fall;
- transfers between Levels 1 and 2;
- methods and inputs to the fair value measurements and changes in valuation techniques; and
- additional disclosures for Level 3 measurements that include a reconciliation of opening and closing balances, quantitative information about unobservable inputs and assumptions used, a description of the valuation processes in place, and qualitative discussion about the sensitivity of recurring Level 3 measurements.

Updates to IFRS 9 for financial liabilities

What is the issue?

IFRS 9 has been updated so that entities with financial liabilities designated at FVTPL recognise changes in the fair value due to changes in the liability’s credit risk directly in OCI.

This means that changes in the fair value of notes issued under a securitisation programme will no longer impact the income statement where the movement is due to changes in the credit risk related to those notes. Changes in the fair value relating to performance risk on the assets will continue to be reflected in the income statement.

When will it be effective?

IFRS 9 is mandatory for annual periods beginning on or after 1 January 2013. Entities may choose to adopt early, but it is not possible for entities to adopt the part for financial liabilities without adopting the requirements for financial assets.

Key provisions

New measurement guidance

Under the new standard, entities with financial liabilities designated at FVTPL recognise changes in the fair value due to changes in the liability’s credit risk directly in OCI. There is no subsequent recycling of the amounts in OCI to profit or loss, but accumulated gains or losses may be transferred within equity. However, if presenting the change in fair value attributable to the credit risk of the liability in OCI would create an accounting mismatch in profit or loss, all fair value movements are recognised in profit or loss.

Credit risk

The standard does not change the definition of 'credit risk' in IFRS 7, 'Financial instruments: Disclosures', but clarifies the meaning of credit risk with guidance that addresses how embedded derivatives, unit-linking features and collateral may impact the determination of a liability's credit risk.

IFRS 9 retains the flexibility that existed in IFRS 7 to determine the amount of fair value change that relates to changes in the credit risk of the liability using a default method or by an alternative method that the entity believes more faithfully represents the credit risk of the liability.

IASB and FASB leasing project

The joint IASB and FASB project on lease accounting continues and there has been substantial redeliberation resulting in reversal of tentative decisions previously taken. This has led to concern about when the standard will actually be delivered and what shape it will take.

Key issues which are currently being debated are whether there should be one model for lessee accounting or whether leases should be split into those which are financing or not for financing, the basis for the lessor accounting model and how contingent rental payments should be accounted for.

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