

# *Straight away*

## IFRS bulletin from PwC

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### *IASB issues final standard on hedge accounting and amendments to IFRS 9*

#### *What's the issue?*

The IASB has published IFRS 9 Hedge Accounting, the third phase of its replacement of IAS 39. The new requirements align hedge accounting more closely with risk management, and so should result in more 'decision-useful' information to users of financial statements. The revised standard also establishes a more principles-based approach to hedge accounting and addresses inconsistencies and weaknesses in the current model in IAS 39.

#### *What are the key changes?*

##### *Hedge effectiveness tests and eligibility for hedge accounting*

IFRS 9 relaxes the requirements for hedge effectiveness and, consequently to apply hedge accounting. Under IAS 39, a hedge must be highly effective, both going forward and in the past (that is, a prospective and retrospective test, with results in the range of 80%-125%). IFRS 9 replaces this bright line with a requirement for an economic relationship between the hedged item and hedging instrument, and for the 'hedged ratio' to be the same as the one that the entity actually uses for risk management purposes. Hedge ineffectiveness will continue to be reported in profit or loss (P&L). An entity is still required to prepare contemporaneous documentation; however, the information to be documented under IFRS 9 will differ.

#### *Hedged items*

The new requirements change what qualifies as a hedged item, primarily removing restrictions that currently prevent some economically rational hedging strategies from qualifying for hedge accounting. For example:

- Risk components of non-financial items can be designated as hedged items, provided they are separately identifiable and reliably measurable. This is good news for entities that hedge for only a component of the overall price of non-financial items (such as the oil price component of jet fuel price exposure), because it is likely that more hedges will now qualify for hedge accounting.
- Aggregated exposures (that is, exposures that include derivatives) can be hedged items.
- IFRS 9 makes the hedging of groups of items more flexible, although it does not cover macro hedging (this will be the subject of a separate discussion paper in the future). Treasurers commonly group similar risk exposures and hedge only the net position (for example, the net of forecast purchases and sales in a foreign currency). Under IAS 39, such a net position cannot be designated as the hedged item; but IFRS 9 permits this if it is consistent with an entity's risk management strategy. However, if the hedged net position consists of forecast transactions, hedge accounting on a net basis is only available for foreign currency hedges.
- IFRS 9 allows hedge accounting for equity instruments measured at fair value through other comprehensive income (OCI), even though there will be no impact on P&L from these investments.

### *Hedging instruments*

IFRS 9 relaxes the rules on the use of some hedging instruments as follows:

- Under IAS 39, the time value of purchased options is recognised on a fair value basis in P&L, which can create significant volatility. IFRS 9 views a purchased option as similar to an insurance contract, such that the initial time value (that is, the premium generally paid for an at- or out-of-the-money option) must be recognised in P&L, either over the period of the hedge (if the hedge item is time related, such as a fair value hedge of inventory for six months), or when the hedged transaction affects P&L (if the hedge item is transaction related, such as a hedge of a forecast purchase transaction). Any changes in the option's fair value associated with time value will be recognised in OCI.
- A similar accounting treatment to options can also be applied to the forward element of forward contracts and to foreign currency basis spreads of financial instruments. This should result in less volatility in P&L.
- Non-derivative financial items can be used as hedging instruments, provided they are accounted for at fair value through P&L, unless they are hedging foreign currency (FX) risk. Under IAS 39, non-derivative financial items were only allowed for hedges of FX risk.

### *Accounting, presentation and disclosure*

The accounting and presentation requirements for hedge accounting in IAS 39 remain largely unchanged in IFRS 9. However, entities will now be required to reclassify the gains and losses accumulated in equity on a cash flow hedge to the carrying amount of a non-financial hedged item when it is initially recognised. This was permitted under IAS 39, but entities could also choose to accumulate gains and losses in equity. Additional disclosures are required under the new standard.

### *Own credit risk in financial liabilities*

Although not related to hedge accounting, the IASB has also amended IFRS 9 to allow entities to early adopt the requirement to recognise in OCI the changes in fair value attributable to changes in an entity's own credit risk (from financial liabilities that are designated under the fair value option). This can be applied without having to adopt the remainder of IFRS 9.

### *Am I affected?*

All entities that engage in risk management activities, regardless of whether they currently use hedge accounting, could potentially benefit from the changes to hedge accounting. However, entities should note that the European Union has not yet endorsed any aspect of IFRS 9.

Amendments to IFRS 9 have removed the previous mandatory effective date of 1 January 2015, but the standard is available for immediate application. The standard provides an accounting policy choice for an entity to continue to apply hedge accounting (and hedge accounting only) under IAS 39 instead of IFRS 9 until the IASB completes its separate macro hedging project.

Entities can elect to apply IFRS 9 for any of the following:

- The own credit risk requirements for financial liabilities.
- Classification and measurement (C&M) requirements for financial assets.
- C&M requirements for financial assets and financial liabilities.
- The full current version of IFRS 9 (that is, C&M requirements for financial assets and financial liabilities and hedge accounting).

The transitional provisions described above are likely to change once the IASB completes all phases of IFRS 9.

IFRS 9 applies retrospectively; however, hedge accounting is to be applied prospectively (with some exceptions).

### *What do I need to do?*

It will be beneficial for entities to revisit their risk management strategies to assess whether more relationships might qualify for hedge accounting under IFRS 9. Entities should also carefully assess the IFRS 9 transitional provisions (described above) and decide whether to apply IFRS 9 or IAS 39 for hedge accounting. Each alternative could bring opportunities and challenges, for example:

- Retaining IAS 39 hedge accounting might be beneficial for financial institutions that currently have macro hedges and do not want to change their hedge accounting practices in advance of the Board's proposals in this area, but it will not have the benefits introduced by IFRS 9.
- On the other hand, IFRS 9 might be beneficial for non-financial entities that currently hedge risk components.

If you have questions or require further information, please speak to your regular PwC contact.