New Hedge Accounting rules arrive – finally!!.

The IASB published the long-awaited standard on hedge accounting in November. The changes have been widely accepted by preparers as an improvement. The new guidance provides relief from the 'rules-based' approach in IAS 39 and is likely to allow hedge accounting in more circumstances. It is expected that most corporates will adopt IFRS 9 to take advantage of the positive changes it introduces.

In general, IFRS 9 is good news, and its adoption will result in more qualifying hedging relationships than under IAS 39.

Scope

IFRS 9 applies to all hedge accounting, with the exception of portfolio fair value hedges of interest rate risk (commonly referred to as 'fair value macro hedges'). For these, an entity may apply the hedge accounting requirements in IAS 39. This is largely because the IASB is addressing macro hedge accounting as a separate project. Until the IASB completes its macro hedging project, entities have a choice either to apply IFRS 9 or continue to apply IAS 39 for hedge accounting. This is to allow entities not to have to change their accounting twice in the space of a few years.

Key proposals

There are a few changes to the accounting requirements, but they are not significant. The debits and credits and presentation in the financial statements will largely remain the same (e.g. the three types of hedges – fair value, cash flow and net investment hedges – continue to exist).

The main changes relate to the hedge effectiveness rules and to the eligibility of items as 'hedged items' and 'hedging instruments'. IFRS 9 aligns hedge accounting with risk management practices, which is a significant improvement. IAS 39 has been criticised for its 'disconnection' from the way entities economically manage risk.

Hedge effectiveness

The amendments remove the requirement for hedge effectiveness tests to be within the range of 80%-125%. IFRS 9 does not require quantitative hedge assessments and, under certain circumstances, a qualitative assessment may be enough (for example, when the critical terms match). Even though IFRS 9 does not completely remove the need for calculations (for example, hedge ineffectiveness still needs to be recorded in the income statement) the changes to hedge effectiveness will be welcomed by many.

Hedged items

IFRS 9 allows more items to be eligible as hedged items. Entities can now hedge risk components in non-financial items as long as those components are separately identifiable and reliably measurable.

Example

An entity that manufactures aluminum cans can hedge its exposure to the changes in prices of aluminum arising from its inventory. Under IAS 39, it is not allowed to hedge the aluminum price exposure only, because the price of the aluminum cans is not only comprises the price of aluminum but also contains other elements (for example, other raw materials and labour costs

Entities can now hedge aggregated exposures (that is, hedged items can also include derivatives).

Example

An entity issues a floating-rate debt denominated in foreign currency. At the time of issuance, the entity is concerned about its exposure to interest-rate risk but is not particularly concerned about its foreign currency risk. At that date, the entity enters into an interest rate swap to hedge its interest rate risk exposure; as a result, the entity has fixed its interest cash flows.

Now let's assume that, one year later, the entity becomes concerned about foreign currency risk and enters into a cross currency swap contract to hedge its foreign currency exposure arising from the same debt (which is now a fixed-rate debt as a result of the combination with the interest-rate swap). IAS 39 does not allow this designation because derivatives are not eligible hedged items.

Hedging instruments

The most significant change from hedge accounting under IAS 39 is that entities can defer the time value of options, the forward element in forward contracts and currency basis spreads in other comprehensive income (OCI). The effect is reclassified to profit or loss (P&L) at the same time the hedged item affects P&L. This change reduces volatility in the income statement.

In general, IFRS 9 is good news, and its adoption will result in more qualifying hedging relationships than under IAS 39.

Effective date and transition

Hedge accounting is to be applied prospectively (with some exceptions).

The mandatory date of application (which was previously 1 January 2015) has been 'temporarily' removed from IFRS 9. The IASB will publish the new mandatory effective date once all phases of IFRS 9 are completed (that is, when the accounting for impairment and some amendments to the classification and measurement are finalised). IFRS 9 (as currently published) is available for immediate application.

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

- The own credit risk requirements for financial liabilities. IFRS 9 as amended in November allows entities to early adopt the requirement to recognise in OCI the changes in fair value arising from changes in the entity's own credit risk in financial liabilities without having to adopt any other changes.
- 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 transition provisions described above are likely to change once the IASB completes all phases of IFRS 9. The IASB is expected to finalise all phases of IFRS 9 during 2014 with a mandatory effective date no earlier than 1 January 2017.

The European Union has not yet endorsed any aspect of IFRS 9.

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