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IFRS Developments

The IASB issues IFRS 9 (2013) – hedge accounting is now complete

What you need to know

The IASB has issued a new version of IFRS 9 *Financial Instruments*.

- This version of IFRS 9 includes the new hedge accounting requirements.
- The standard does not have a mandatory effective date, but it is available for application now; a new mandatory effective date will be set when the IASB completes the impairment phase of its project on the accounting for financial instruments.
- Entities may elect to apply only the accounting for gains and losses from own credit risk without applying the other requirements of IFRS 9 at the same time.
- Entities may make an accounting policy choice to continue to apply the hedge accounting requirements of IAS 39 for all of their hedging relationships. They may later change that policy and apply the hedge accounting requirements in IFRS 9 before they eventually become mandatory. This choice is intended to be removed when the IASB completes its project on accounting for macro hedging.

IFRS 9 (2013) has the new hedge accounting requirements. The IASB will set the mandatory effective date later.

Highlights

On 19 November 2013 the IASB[1] issued a new version of IFRS 9 *Financial Instruments* (*Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39*) (IFRS 9 (2013)), which includes the new hedge accounting requirements and some related amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. IFRS 9 (2013) also replicates the amendments in IAS 39 in respect of novations.[2]

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[1] The International Accounting Standards Board.

[2] See *IFRS Developments* Issue 62 http://www.ey.com/Publication/vwLUAssets/IFRS_Developments_Issue_62:_Amendments_to_IAS_39:_continuing_hedge_accounting_after_novation/$FILE/Devel62_FI_Hedging_June2013.pdf

Building a better working world

In addition, IFRS 9 (2013) includes two changes that result from other phases of the IASB's financial instruments project[3]:

- A 'fast-track' to applying the requirements of IFRS 9 for the presentation of own credit risk-related fair value gains and losses arising on financial liabilities designated at fair value through profit or loss under the fair value option. This 'fast track' is an option for entities to apply the accounting for own credit risk in isolation (i.e., without applying the other IFRS 9 requirements at the same time).
- IFRS 9 (2013) does not have a mandatory effective date. This unusual circumstance is the result of the ongoing project phase on the impairment of financial instruments. The IASB decided to remove the mandatory effective date from IFRS 9 until the impairment phase of the project is completed, at which time, the appropriate lead-time for implementing the new impairment model will be known so that a new mandatory effective date can be set.

Terminology

IFRS 9 (2013) refers to the standard being available for application. This is equivalent to a standard being available for early application but reflects that, because of the removal of the mandatory effective date, there is no reference date compared to which application could be described as 'early'. As a consequence, IFRS 9 (2013) may be applied before the IASB completes the limited amendments to classification and measurement and to the impairment phase of the project.

The new landscape of accounting for financial instruments

IFRS 9 (2013) marks an important milestone in the IASB's project on the reform of the accounting for financial instruments. The project started as an attempt to simplify the accounting for financial instruments. It started with the 2008 Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, which discussed, as one possible solution, the elimination of hedge accounting altogether. Since then, the project has evolved and the focus for hedge accounting shifted towards providing useful information about risk management activities that use financial instruments.

The completion of the hedge accounting phase means that non-financial entities may now consider applying IFRS 9. For many of them, hedge accounting will be the most significant effect of the reform of the accounting for financial instruments. In particular, non-financial entities will have an incentive to apply IFRS 9 (2013) before the IASB completes the phase on impairment because it then intends to create a consolidated version of IFRS 9 that will reduce the early application choices for different parts of the requirements. Applying IFRS 9 (2013) before it is superseded by a consolidated version would enable hedge accounting to be applied whilst deferring the application of the requirements for impairment until the mandatory effective date. Based on previous IASB discussions, once the new consolidated version of IFRS 9 has replaced IFRS 9 (2013), entities may be left with no choice but to early apply the hedge accounting and impairment requirements (and the revised classification and measurement requirements) all at the same time.

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[3] See *IFRS Developments* Issue 65
http://www.ey.com/Publication/vwLUAssets/IFRS_Developments,_Issue_65:_IASB_to_defer_effective_date_of_IFRS_9_and_accelerate_own_credit_requirements/$FILE/Devel_65_FIRM_July2013.pdf

How we see it

The addition of the new hedge accounting requirements mean that, for the first time, the application of IFRS 9 will be a serious consideration for non-financial entities. Those entities will need to consider their hedging activities and existing hedge accounting, or why hedge accounting has not been achieved in the past, to gauge the benefits of the new requirements. This assessment encompasses operational aspects (such as the hedge effectiveness test) as well as the eligibility of items (such as risk components of non-financial items) that can be designated in hedging relationships.

For financial entities, the situation is more complex: the ongoing development of the limited amendments to the classification and measurement of financial instruments, as well as the projects on accounting for macro hedging and insurance contracts, create more uncertainty about the eventual picture and how the different projects will interact.

How we see it

For financial entities, the 'fast track' for applying the accounting for gains and losses from own credit risk will be attractive, especially now that it becomes available without having to apply the other requirements in IFRS 9.

The new hedge accounting requirements

In September 2012, the IASB published a draft of the new hedge accounting requirements of IFRS 9 on its website. At its January and April meetings in 2013, the IASB made the last decisions of the project's hedge accounting phase. Please see previous issues of EY's *IFRS Developments* which covered those developments.[4]

Below is a brief outline of the most significant areas of change for hedge accounting:

- **Hedge effectiveness testing**: this is prospective only and can be qualitative, depending on the complexity of the hedge. The 80-125% range is replaced by an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship.
- **Risk component**: this may be designated as the hedged item, not only for financial items, but also for non-financial items, provided the risk component is separately identifiable and reliably measureable.
- **Costs of hedging**: the time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging. This means that, instead of the fair value changes of these elements affecting profit or loss like a trading instrument, these amounts get allocated to profit or loss similar to transaction costs (which can include basis adjustments), while fair value changes are temporarily recognised in other comprehensive income (OCI).
- **Groups of items**: more designations of groups of items as the hedged item are possible, including layer designations and some net positions.
- **Disclosures**: these are more extensive and require the provision of more meaningful information and insights.

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[4] Issue 40
http://www.ey.com/Publication/vwLUAssets/Devel40_Hedging_Sept12/$FILE/Devel40_Hedging_Sept12.pdf
Issue 50
http://www.ey.com/Publication/vwLUAssets/Devel50_Hedging_Jan2013/$FILE/Devel50_Hedging_Jan2013.pdf
Issue 57
http://www.ey.com/Publication/vwLUAssets/IFRS_Developments_IASB_concludes_its_re-deliberations_on_the_hedge_accounting_project/$FILE/IFRS_Developments_IASB_concludes_its_re-deliberations_on_the_hedge_accounting_project.pdf

Outlook

The IASB is currently re-deliberating the proposals for the first phase (classification and measurement) and the second phase (impairment) of the financial instruments project. The substantive discussions are expected to be completed by the end of 2013 and a complete version of IFRS 9 comprising all phases is expected to be issued in the first half of 2014.

Even though the IASB and the FASB[5] are still trying to achieve some convergence between their separate financial instruments projects, the future standards will be different. The FASB will consider the feedback it received on its hedge accounting proposals and the IASB's Exposure Draft that the FASB had issued as a Discussion Paper. The FASB will then decide on the best way to proceed with their re-deliberations on hedge accounting.

[5] The US Financial Accounting Standards Board.