IFRS 9 Hedging – Was it Worth the Wait?

by Clarette du Plooy, Director, Corporate Treasury Solutions and Kees-Jan de Vries, Director, Capital Markets and Accounting Advisory Services, PwC

In November 2013, the IASB issued the long-awaited IFRS 9, 'Financial instruments', which replaces hedge accounting under IAS 39. The new standard responds to a number of needs:

- to improve the previous accounting standards for financial instruments, particularly given the increased use and sophistication of hedge accounting; and
- to address a number of accounting issues that emerged as a result of the financial crisis in 2008, especially with respect to the IAS 39 impairment model.

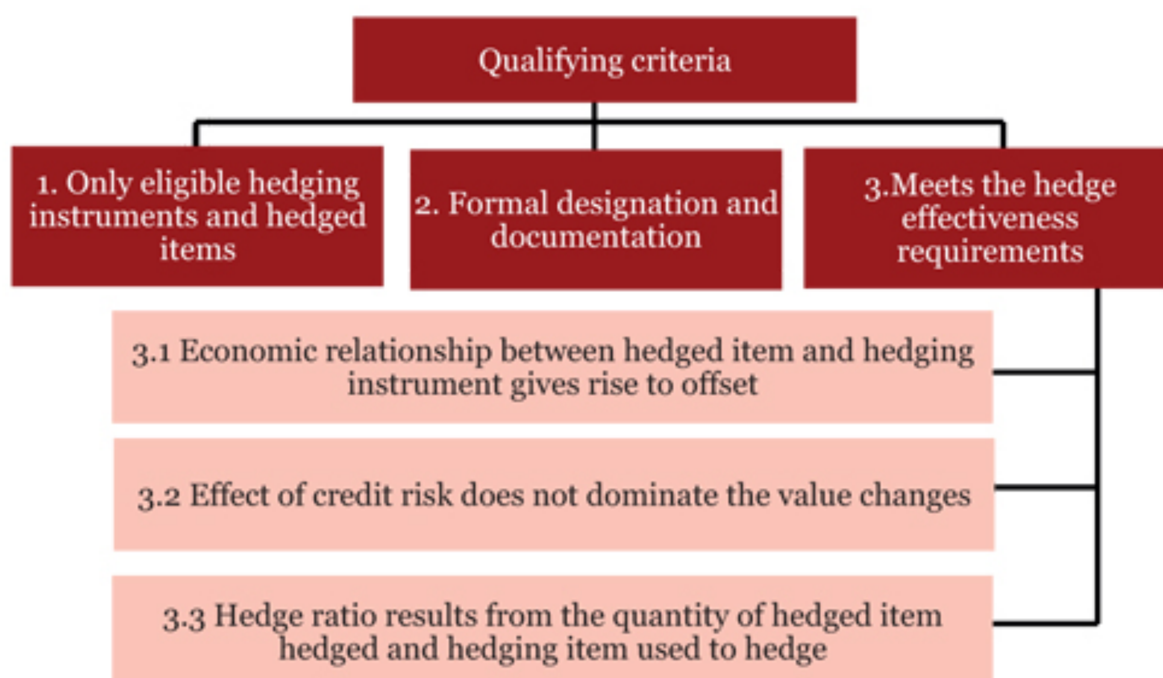
Treasurers and accountants have often complained that the hedge accounting requirements under IAS 39 were onerous, complicated and not really useful to the readers of financial statements. For example, IAS 39 comprises around 300 pages of the total 2,800 pages of IFRS, so 10%. Much of these 300 pages cover detailed hedge accounting guidance and rules. In practice, accounting has become a key driver in how treasurers manage risk, instead of reflecting how management decides to manage financial risks. This is especially true where companies are hedging commodity risks.

The good news for treasurers is that hedging under IFRS 9 will be both easier and more aligned with risk management. The bad news is that documentation is still required in order to qualify for hedge accounting. And although effectiveness testing as we know it today will no longer be required, there is a new requirement to maintain a hedge ratio and rebalance where needed. Accounting ineffectiveness will also continue to affect income statements.

Over two articles, we will dive into more detail and show the key changes to hedging under IAS 39, explain new concepts introduced by IFRS 9 and, most importantly, look at what that means for you. In next month's edition, we will also address transition and early adoption, especially interesting for readers outside the EU.

Qualifying criteria

As indicated by Figure 1, the requirements for hedge accounting remain relatively unchanged, but the meaning of effectiveness testing will be different.



Qualifying hedging instruments…

Under IFRS 9, more instruments may qualify as hedging instruments. Besides derivatives and financial instruments for currency risk, non-derivative instruments that are carried at fair value through profit or loss (FVTPL) may also be designated as hedging instruments. This, combined with the fact that IFRS 9 allows for many more instruments to be carried at FVTPL, means that more (and easier) hedge accounting can be achieved. In practice, this will not have a lot of benefit for the corporate treasurer. But it could mean, for example, that it is possible to hedge a loan given for interest rate risk with a loan that is carried at FVTPL, or that it is easier to set up certain commodity risk hedge relations.

Similarly to IAS 39, embedded derivatives have to be considered in financial liabilities or non-financial contracts; if these are deemed not to be closely related to the host contract, they are accounted for separately. Derivatives that are separately accounted for can still be designated as hedging instruments. Under IFRS 9 the concept of embedded derivatives for contracts that are financial assets has been removed. This means that certain non-derivative financial instruments (for example, a loan given with a structured interest index) will have to be carried in their total at FVTPL. Such contracts can now be designated as hedging instruments as well.

What do you have to do now?

- *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.*

…and hedged items

IFRS 9 brings a dramatic change from IAS 39 with respect to which positions and risk can be designated as items being hedged. And change will be for the better. A number of exposures that were not allowed to be designated as hedged items under IAS 39 now can be. The most important are risk components of non-financial items, aggregated exposures, net positions and combinations of derivatives and non-derivatives.