SOONER OR LATER?

DECIDING WHETHER TO EARLY ADOPT THE IFRS 9 HEDGE ACCOUNTING RULES IS NOT NECESSARILY STRAIGHTFORWARD. DAN GENTZEL AND ZWI SACHO WEIGH UP THE PROS AND CONS

Companies have been able to apply hedge accounting under IAS 39, *Financial Instruments: Recognition and Measurement*, for more than 10 years. But many felt that it was difficult to apply due to some of the accounting standard's onerous provisions. Some of these include restrictions on the types of hedging relationships that can qualify for hedge accounting and the need to perform periodic quantitative effectiveness assessments that evaluate how well the hedge has performed at hedging the intended risk.

The IASB heard the criticisms of IAS 39 and drafted a new standard, IFRS 9, *Financial Instruments*, which includes provisions that are aimed at simplifying the application of hedge accounting and bringing it more in line with a company's risk management activities. The hedge accounting provisions in IFRS 9 were published in November 2013, and companies now need to begin to assess the impact on their hedging programmes, including what changes, if any, they will need to make over the coming years.

Although the standard has a mandatory effective date beginning 1 January 2018, companies currently have the choice of either early adopting IFRS 9, if permitted in their jurisdiction, or waiting until the mandatory effective date in 2018.

This article is the first in a series from Chatham that will provide practical insight to help companies evaluate the impact of adopting IFRS 9 and assist them with evaluating whether early adoption of the standard is a wise decision.

Key considerations for adopting IFRS 9

When it comes to making the decision to either early adopt IFRS 9 or continue to apply IAS 39, there are a few important issues that companies should consider.

Endorsement or regulatory approval

One of the first things a company should consider is whether or not it is permitted to early adopt IFRS 9. Even though the standard has been issued by the IASB, not every company that applies IFRS will

be able to early adopt IFRS 9. Some jurisdictions require regulatory approval before a new accounting standard can be applied. As a result, a first step in the process is to determine if your governing body permits early adoption.

Key benefits of early adopting IFRS 9

1. **The exposures permitted to be hedged are expanding.** IFRS 9 permits risk components in both financial and non-financial items to be hedged if they are both separately identifiable and reliably measureable. The impact is that the universe of risks that can be designated in hedging relationships under IFRS 9 will expand relative to those permitted under IAS 39. Companies with commodity price risk are likely to find this feature particularly beneficial.

   In addition, IFRS 9 introduces the concept of hedging aggregated exposures. This feature will allow companies to hedge exposures that consist of a derivative and an exposure, something not permitted under IAS 39.
2. **Effectiveness testing requirements are more relaxed.** IFRS 9 contains new effectiveness requirements that focus on demonstrating that an economic relationship exists between the hedging instrument and the hedged exposure. Companies will no longer be required to perform both retrospective and prospective effectiveness assessments of their hedging relationships, but rather will now be required to demonstrate prospectively that the hedging relationship satisfies the effectiveness requirements in IFRS 9.

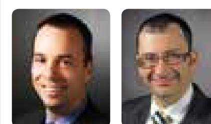
   In addition, companies may not be required to perform quantitative analysis to demonstrate effectiveness. Companies are permitted to make qualitative assessments, and quantitative assessments are only required when necessary. As we will explore in a subsequent article in this series, however, performing quantitative effectiveness assessments may be required more often than expected.
3. **Better accounting treatment is available for option products.** Under IAS 39, the time value component of option products is excluded from a hedge accounting relationship and is recognised immediately in profit or loss, making the use of options less palatable for companies seeking hedge accounting. But IFRS 9 introduces a new concept called ‘costs of hedging’, under which the time value component of an option can be separately tracked in other comprehensive income, and subsequently reclassified to profit or loss ‘on a systematic and rational basis’ as the hedged item or transaction(s) impacts profit or loss. Companies considering using options are likely to find this new feature very favourable.

Key benefits of continuing to apply IAS 39

1. **All of IFRS 9 must be adopted at the same time.** Similar to IAS 39, IFRS 9 is not only a hedge accounting standard. It includes other components related to the accounting for financial instruments, including how to classify and measure such items and how to assess them for impairment. Companies will need to evaluate how the entire standard impacts their accounting practices, which will be a larger exercise than evaluating how their hedge accounting practices are affected.
2. **Established practices are in place for applying hedge accounting.** Although there have been complaints over the years about the complexities of applying hedge accounting under IAS 39, companies and their auditors have largely come to agreement on how to apply it to their specific facts and circumstances. Over time, companies by and large have invested in establishing practices and procedures that enable them to successfully administer their hedge accounting programmes and have reached a point where their auditors are generally comfortable with their approach.

   Adopting IFRS 9 will force companies to evaluate the standard and make changes to their established practices. While these changes are inevitable (IFRS 9 will be required to be adopted eventually), each company must determine the optimal point at which it is desirable to expend the cost required to evaluate the impact of IFRS 9 on its existing practices, implement new practices and get its auditors comfortable with those changes. For companies that believe they will benefit significantly from the early adoption of IFRS 9 (see above), the benefits may outweigh the costs. Companies that do not perceive much benefit from adopting are likely to be better off deferring the cost of adoption to a later date.
3. **The outcome from adoption is unknown.** People often say “the devil is in the detail”. That is also likely to be the case when it comes to implementing IFRS 9’s hedge accounting provisions. While the IASB wrote the standard with the goal of simplifying hedge accounting for practitioners, it introduces some new concepts that have never been applied before. Here are a few:
   - Hedging aggregated exposures;
   - Rebalancing hedging relationships;
   - Deciding when quantitative effectiveness assessments are required;
   - Determining if credit risk dominates fair value changes that result from the economic relationship as part of the effectiveness assessment; and
   - Accounting for costs of hedging (time value, forward element of forward contracts and currency basis).

Companies are likely to encounter higher implementation costs for areas affected by the above items since they are new. Not only that, as auditors gain additional experience auditing those new features of IFRS 9, there is a risk that previous conclusions are challenged, which could result in the need for companies to make additional changes. Again, if companies believe they will benefit significantly from adopting the new standard, such costs are likely to be outweighed by the benefits, while the opposite is likely to be true if companies perceive there is little to be gained.



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