The New Hedging STANDARDS

Comparing hedge accounting under U.S. GAAP and IFRS 9

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KEY INSIGHTS:

• IFRS 9 is more compact and offers less prescriptive guidance than U.S. GAAP.
• IFRS 9 is more liberal than U.S. GAAP in allowing for component hedging in the commodity sector and in the elimination of retrospective effectiveness testing.
• The two standards differ in their treatments of forward points and option time values.

This past July, the International Accounting Standards Board (IASB) released a new accounting standard—IFRS 9. While not applicable to U.S. domiciled companies, many international companies apply the international standard in some jurisdictions and U.S. GAAP in others. This article highlights some of the more significant features of the international standard that differ from the U.S. rules.
The main difference between IFRS 9 and U.S. GAAP has to do with allowances for companies to apply hedge accounting in connection with risk components.

The big picture
Conceptually, U.S. GAAP and IFRS 9 share a common foundation:
1. Derivatives are assets or liabilities, carried on the balance sheet at their current market value.
2. Derivatives’ gains or losses generally are recognized in earnings on a current basis, but special hedge accounting can override this treatment when prerequisite conditions are satisfied.
3. Three distinct types of special hedge accounting might apply—fair value hedge accounting, cash flow hedge accounting, and hedge accounting for hedges of net investments in foreign operations.

In both jurisdictions, hedge accounting serves to allow earnings recognition from the hedging derivative coincidently with the earnings effects relating to the exposures being hedged.

Hedging differences
The main difference between IFRS 9 and U.S. GAAP has to do with allowances for companies to apply hedge accounting in connection with risk components. In the United States, the capacity to hedge risk components applies only for interest rate exposures, where, in many circumstances, U.S. reporting entities may designate “benchmark interest rate” changes as the risk being hedged.

The international standard breaks with the U.S. by allowing benchmark hedging for commodities as well as interest rates. Thus, under IFRS 9, if a commodity price is tied to a benchmark price and if the derivative also depends on this benchmark price, the hedge would be expected to perform with zero ineffectiveness.

A nuance of the IFRS 9 rules for hedging price components, however, is that this eligibility is restricted to components that represent something less than the full price risk facing the firm. This requirement would preclude component hedging in situations where the full price exposure reflects some benchmark price less an incremental difference. In this case, the hedging entity would likely opt to designate the full price risk as the risk being hedged. Note, however, that if the differential to the benchmark price is constant throughout the life of the hedge, this restriction has no real impact. That is, if the full price relating to the exposure being hedged were equal to a benchmark price minus a constant differential, the hedge of the full price effects would yield a perfect hedge outcome. In other words, the allowance to hedge a component risk in this case would be unnecessary. On the other hand, if that differential varies over time, those operating under the international standard might be forced to terminate hedge accounting if and when the variable basis conditions dominate relative to changes in benchmark prices, i.e., the same situation that U.S. reporting entities face for all of their commodity hedges.

Effectiveness testing
A prerequisite for hedge accounting for both standards is that hedges have to be expected to offset the risk being hedged—either changes in fair value for fair value hedges or changes in cash flows for cash flow hedges. Failure to achieve a sufficiently close offset would preclude the application of hedge accounting.

In the U.S. GAAP, the offset must be “highly effective,” which, in practice, is taken to mean that the ratio of the hedge results to the gains or losses on the hedged item should fall within the boundaries of 80 percent to 125 percent.

The international standard is much less prescriptive, requiring only that the hedging entity demonstrate that “an economic relationship exists” between the hedged item and the hedging derivative, whereby the two components of the hedge relationship are expected to move inversely to each other. Additionally, the international standard appears to take a somewhat more flexible approach in that it allows the assessment of effectiveness assessment to be based on the companies risk management analysis or information, i.e., the work that companies do to satisfy their internal requirements that justify that the hedge would likely meet the company’ risk management objectives.

U.S. GAAP requires prospective effectiveness tests to be repeated at least on a quarterly basis. The international standard, on the other hand, requires a prospective test at the start of the hedge relationship and on an ongoing basis;
but “ongoing” is not defined. A more substantive difference exists, however, in connection with retrospective effectiveness testing—an assessment of effectiveness pertaining to the hedge performance of the hedge relationship in question. Retrospective testing is required under U.S. GAAP, but no retrospective requirement is stipulated in IFRS 9.

The lack of a retrospective effectiveness testing requirement under IFRS 9 undoubtedly will allow for a more liberal application of hedge accounting under the international standard. In the U.S., failing a retrospective test precludes hedge accounting in that period. In contrast, under the same performance, hedge accounting would still be applied under IFRS 9, as long as the seemingly poor hedge performance in the period past is not seen to be reflective of a genuine change in the economics of the hedge, and the prospective assessment continues to be satisfied.

**Accounting for cash-flow hedges**

Under U.S. GAAP, effective cash-flow hedge results are posted to AOCI and reclassified to earnings coincidently with the earnings recognition for the associated hedged item; and the process of closing out AOCI to earnings is called reclassification. It works somewhat differently for IFRS 9. First, IFRS 9 has a unique treatment of forward points and time value effects. Beyond that, under IFRS 9, the deferred effective gains or losses (excluding forward point or time value effects) are posted to a cash-flow hedge reserve account—analogous to AOCI in U.S. GAAP.

The timing of when the hedge reserve account is closed out under IFRS 9 may differ from the AOCI reclassification date under the U.S. standard, and the geography may also be different. Specifically, for an IFRS 9 cash flow hedge, if the hedge item is a purchase or sale of some good or commodity, the offset to the closing out the hedge reserve account is to the line item pertaining to the hedged item, per se. In such a case, IFRS 9 explicitly states that this close-out is not to be considered a reclassification. (The standard is silent as to what it should be called.) In contrast, for an interest rate hedge, closing out the cash flow hedge reserve would be a reclassification to an earnings account (e.g., interest income or interest expense)—identically to the U.S. treatment.

**Accounting for forward points and option time values**

Under both standards, hedgers have the flexibility to choose whether to exclude forward points and/or option time values from their assessment of hedge effectiveness. If excluded, though, the U.S. standard requires gains or losses of those excluded components of hedge results to be recognized in earnings on a current basis. This requirement has no earnings impact for fair value hedges, as those effects are recorded in earnings, anyway. In cash flow hedges, however, the rules serve to preclude time value or forward point effects from being deferred.

Under U.S. GAAP, hedging entities that would prefer to defer all or most of these components of the derivatives’ results would opt not to exclude forward points or time values. In these instances, effectiveness is generally measured by comparing actual derivative result to those of a hypothetical derivative, allowing for the possibility of the full derivative gain or loss being deferred through AOCI if the actual and hypothetical forwards or options are identical to their respective hypothetical counterparts. Excess gain or loss of the actual derivative relative to its associated hypothetical, however, would be recognized in earnings as ineffectiveness. Any amounts initially recorded in AOCI amounts would subsequently be reclassified to earnings coincidently with the date of the earnings impact of the hedged item.

The accounting process for forward points and option time values is somewhat different under IFRS 9. Under this standard, a separate AOCI account is created for results associated with forward points and option time values (as distinct from the cash flow hedge reserve account), and gains and losses of those components are posted to that separate account. The hedging entity is required to apply a “rational” amortizing methodology for reversing those amounts out of that account and into earnings, but no specific method is prescribed. The accumulated amount in this account is ultimately closed out at some point. Depending on the nature of the hedged item, the offset to the journal entry to close this account would either be (a) an adjustment to the cost basis of the hedged item at the time of the transaction—not necessarily an earnings recognition date, (b) an amortization during the term of the hedge horizon, or (c) an adjustment to earnings in the case of an interest rate hedge, during the horizon where the hedged item affects earnings.

This separate equity account (distinct from the cash flow hedging reserve) is also used in connection with the hedges that employ forward contracts, in connection with the associated forward points. Treatment for forward points follows analogously to that of option time value changes.
Discontinuing hedge accounting

Under U.S. GAAP, hedge accounting is an elective that can be instituted at will—assuming all prerequisites are satisfied—and it can be discontinued at will, as well. IFRS 9 seemingly restricts this option to terminate hedge accounting prior to the hedge naturally terminating when the derivative expires or when the exposure no longer exists. It appears, however, that the international standard provides somewhat of a loophole.

The international standard takes pains to distinguish strategies from objectives. Strategies reflect how the entity manages its risk. Objectives, on the other hand, reflect the anticipated outcome that the company would hope to achieve from hedging. In the context of this discussion, early termination of hedge accounting may be able to be achieved by stipulating additional qualifying criteria in the hedge documentation within the discussion of the hedge strategy and objectives that, if not satisfied, would necessarily preclude application of hedge accounting.

IFRS 9 is more compact and offers less prescriptive guidance than U.S. GAAP. However, IFRS 9 bears close resemblance to its U.S. precursor, and it can be categorized as more liberal in allowing for component hedging in the commodity sector and in a total elimination of retrospective effectiveness testing.

The most important differences deal with risk components and time values and forward points. IFRS 9 requires the use of a special equity account for current market changes in these components of hedge results. Amounts in this special account subsequently get closed out of this account on some amortized schedule, subject to some discretion on the part of the reporting entity. This feature of the international standard alters the timing of earnings recognition associated with forward points and time values in a way that likely resulting in a smoother earnings presentation than that which would occur under the U.S. standard.

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