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Must know

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Hedge accounting: Contrasting IFRS and US GAAP

Hedge accounting represents one of the more complex and nuanced topical areas within both US GAAP and IFRS. Both frameworks have updated guidance that attempts to simplify some of the requirements, ease administrative burdens, and allow for more strategies to qualify for hedge accounting. However, complexity still remains. Further, while the objectives of the IASB and FASB were originally similar, each Board ultimately chose a distinct approach. Consequently, significant differences exist between IFRS and US GAAP.

The following is a high level comparison of the IFRS 9 hedging model and the amended ASC 815 hedging model and the. It summarizes the differences between IFRS and US GAAP that we generally consider to be the most significant or pervasive, and should be read in combination with the authoritative literature and a thorough analysis of the relevant facts and circumstances.

Hedge effectiveness criterion

Both IFRS and US GAAP permit application of hedge accounting to only certain eligible hedging instruments and hedged items. Also both require formal designation and documentation of a hedging relationship at the beginning of the relationship and an assessment of effectiveness.

However, the detailed requirements for hedge effectiveness vary between the two frameworks. Unlike US GAAP, there is no 'high effectiveness' criterion to qualify for hedge accounting under IFRS. Instead, IFRS 9 requires an economic relationship between the hedged item and the hedging instrument, which is a less restrictive test.

- *Nature and timing of effectiveness assessments* - Both IFRS and US GAAP require initial and ongoing assessments of effectiveness. However, the nature and timing of these effectiveness assessments vary between the two frameworks.
- *Recognition of ineffectiveness* - IFRS requires measurement and recognition of ineffectiveness in a hedging relationship even though the hedge meets the effectiveness criteria. US GAAP no longer has a concept of ineffectiveness that is separately measured and disclosed, although there may still be an income statement impact for certain hedges. Both IFRS and US GAAP permit an entity to exclude certain components from the assessment of effectiveness and separately account for them, which may improve hedge effectiveness.

- *Amounts permitted to be excluded from the assessment of effectiveness* - Both IFRS and US GAAP permit an entity to exclude certain components of the change in the fair value of a hedging instrument from the assessment of effectiveness. However, the standards diverge in certain respects on what is permitted to be excluded.
- *Accounting for amounts excluded from the assessment of effectiveness* - IFRS and US GAAP diverge regarding how to account for a component excluded from the assessment of effectiveness.

Eligible hedged items

Several differences exist between the two framework as it relates to the eligibility of the hedged item.

- *Components of nonfinancial items* - Under both IFRS and US GAAP, an entity is permitted to hedge a component of a nonfinancial item. However, IFRS 9 permits more nonfinancial components to qualify as hedged items.
- *Hedges of groups of items* - Both IFRS and US GAAP permit an entity to hedge groups of items, but IFRS permits more groups of items to qualify as the hedged item. In particular, IFRS 9 permits hedging groups of offsetting exposures, while US GAAP specifically prohibits it.
- *Hedging pools of prepayable financial assets* - Both US GAAP and IFRS permit an entity to hedge layers of items, provided that certain criteria are met. However, IFRS and US GAAP differ in the application of the guidance to interest rate fair value hedges of layers of prepayable financial assets not expected to be prepaid during the hedge period.
- *Aggregated exposures* - IFRS permits an entity to combine a derivative and nonderivative exposure together and to designate them together as the hedged item in a hedging relationship. This is not permitted under US GAAP.
- *Partial term hedging* - Both IFRS and US GAAP permit partial-term hedging of a financial instrument. However, US GAAP is more prescriptive about the timing of the assumed beginning and maturity of the hedged item.
- *Variable-rate financial assets and liabilities* - Both IFRS and US GAAP permit designation of the contractually specified interest rate as the hedged risk in a cash flow hedge of interest rate risk of a variable-rate financial instrument. Under IFRS 9, the interest rate does not need to be contractually specified; it only needs to be separately identifiable and reliably measurable. However, IFRS 9 does not permit the designated interest rate component to exceed the contractual cash flows.
- *Fixed-rate financial assets and liabilities* - Both IFRS and US GAAP permit the designation of the entire contractual cash flows or a component of the contractual cash flows in a fair value hedge of interest rate risk of a fixed-rate financial instrument. US GAAP also permits a hedge of the benchmark component for fair value hedges of other risks, regardless of whether the coupon or yield is more or less than the benchmark rate.
- *Hedging more than one risk* - IFRS provides greater flexibility than US GAAP with respect to utilizing a single hedging instrument to hedge more than one risk in two or more hedged items. This allows entities to adopt new and sometimes more complex strategies to achieve hedge accounting while managing certain risks under IFRS.
- *Business combinations* - IFRS permits hedging foreign currency risk in a business combination, but US GAAP does not.

Eligible hedging instruments

Several differences exist between the two framework as it relates to the eligibility of the hedging instruments.

- *Eligible hedging instruments – Nonderivatives* – Both IFRS and US GAAP permit nonderivatives to be designated as hedging instruments in certain cases. IFRS generally permits nonderivatives to be designated as hedging instruments in more instances than US GAAP. Nonderivative financial instruments are most commonly used as hedges in hedge relationships involving foreign currency risk. In this way, US GAAP and IFRS are similar. As a result, there is not a substantive difference in practice in most cases.
- *Location of hedging instrument* - IFRS permits a parent company to hedge exposures of an indirect subsidiary regardless of the functional currency of intervening entities within the organizational structure. The rules under US GAAP for hedges of foreign exchange risk for forecasted transactions (cash flow hedges) or net investments in foreign operations are prescriptive regarding the functional currency and structure of the entities involved.

Cash flow hedging and basis adjustments

For hedges of a forecasted purchase of a nonfinancial item, IFRS and US GAAP differ with regards to the accounting (at the time of acquisition of the nonfinancial item) for the fair value changes of the hedging instrument that were deferred in OCI. This results in different amounts in OCI and different carrying amounts of the nonfinancial items between IFRS and US GAAP. However, the ultimate effect on earnings is the same.

Presentation of hedging instrument gains or losses

US GAAP is more prescriptive regarding the presentation of gains and losses from hedges than IFRS.

Voluntary dedesignation of a hedging relationship

Under both IFRS and US GAAP, an entity is required to discontinue a hedging relationship if the respective qualifying criteria are no longer met. However, voluntary dedesignation is not allowed under IFRS 9. In practice, this may have a limited impact because IFRS requires discontinuance of the hedging relationship when the risk management objective is no longer met. This likely includes most instances when an entity might choose to voluntarily dedesignate a hedging relationship.

Novations, rollovers, and replacements

Both IFRS and US GAAP permit continuance of a designated hedging relationship when a contract is modified in certain circumstances. However, the circumstances under which the hedge relationship can continue after a modification differ under the two frameworks.

For a more detailed comparison, please refer to our 'In depth: Hedge accounting: Contrasting US GAAP and IFRS'.

For the full guidance in understanding the differences between IFRS and US GAAP, refer to our 'IFRS and US GAAP: similarities and differences' publication.

For more detailed guidance on IFRS 9's hedging provisions, see PwC's In depth: Achieving hedge accounting in practice under IFRS 9. For more detailed guidance on ASC 815, see PwC's Derivatives and hedging guide.

Cryptographic assets and related transactions: accounting considerations under IFRS

Cryptographic assets, including cryptocurrencies such as Bitcoin, have generated a significant amount of interest recently, given their rapid increases in value and volatility. As activity in cryptographic assets has increased, it has attracted regulatory scrutiny across multiple jurisdictions.

At issue is how to recognise, measure and disclose activities associated with the issuances of, and the investment in, the various types of cryptographic assets.

Since there are no accounting standards that specifically address cryptographic assets, one must look at the existing IFRS and apply a principles-based approach.

In our 'In depth - Cryptographic assets and related transactions: accounting considerations under IFRS', we highlight some of the accounting questions that are currently being debated and share our views on how IFRSs could be applied. The issues that arise are diverse and highly dependent on specific facts and circumstances.

While the examples and considerations illustrate generic principles, cryptographic asset transactions are rapidly evolving. As guidance and practices in this area evolve, this publication might be updated from time to time and expanded to capture further areas of interest (such as crypto mining).

Cannon Street press

The September 2018 IASB update has been published and the work plan updated.

The topics, in order of discussion, were:

- Dynamic Risk Management
- Implementation—Costs Considered in Assessing Whether a Contract is Onerous
- Extractive Activities
- Research Programme
- Primary Financial Statements
- Classification of Liabilities
- Disclosure Initiative: Targeted Standards-level Review of Disclosures

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