



IFRS Perspectives



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In this edition ...

Uncertainty over income tax treatments: IFRIC 23 brings change

Effective in 2019, IFRIC 23 clarifies how to account for income tax when it is unclear whether the taxing authority will accept the company's tax treatment. While some requirements in IFRIC 23 are similar to US GAAP, the measurement of tax uncertainties, among other things, may differ.

See page 2 ➤

Accounting for PP&E under the IFRS component approach

Large property, plant and equipment items often comprise multiple parts with varying useful lives or consumption patterns. Unlike US GAAP, IFRS requires companies to separately depreciate those parts that are significant. While the objective is conceptually simple, implementing the component approach can be challenging.

See page 3 ➤

Foreign operations in hyperinflationary economies

The accounting applied to a foreign operation changes fundamentally when the economy in which it operates is determined to be hyperinflationary (highly inflationary). This, coupled with accounting differences

between IFRS and US GAAP, means that identifying hyperinflationary economies is an essential step in the financial reporting process of a multinational dual reporter.

See page 5 ➤

Leases survey highlights implementation issues

While companies are making progress in their IFRS 16 implementation efforts, KPMG's survey highlights the need for greater effort and a longer lead time than expected. This is especially true for dual reporters because of significant differences between IFRS 16 and ASC 842. As with all major accounting change projects, understanding the key practical issues is the first step to a successful implementation.

See page 8 ➤

IFRS and US GAAP long awaited changes to hedge accounting

IFRS 9 introduces an approach that aligns hedge accounting more closely with risk management, which many corporates view as a positive step forward. In the United States, the FASB recently issued ASU 2017-12, which provides new opportunities to use hedge accounting – some of which are similar to IFRS 9. While hedge accounting finally appears more accessible under both GAAPs, the requirements are not fully converged, creating new challenges for dual reporters.

See page 10 ➤

Uncertainty over income tax treatments: IFRIC 23 brings change

Effective in 2019, IFRIC 23¹ clarifies how to account for income tax when it is unclear whether the taxing authority will accept the company's tax treatment. While some requirements in IFRIC 23 are similar to US GAAP², the measurement of tax uncertainties, among other things, may differ.

Uncertain tax treatment

An uncertain tax treatment is any tax treatment applied by a company when it is unclear whether that treatment will be accepted by the tax authorities. Examples include tax deductibility of certain expenses, tax-exemption of certain income, and transfer pricing rules to allocate income between jurisdictions.

What's new in IFRIC 23?

Current IFRS does not explicitly address the accounting for tax uncertainties. The IFRS Interpretations Committee (IFRS IC) observed that entities applied diverse accounting methods when the application of tax laws has been uncertain.

In June 2017, IFRIC 23 was issued. IFRIC 23 applies to all aspects of income tax accounting when there is uncertainty about the income tax treatment of an item, including taxable profit or loss, the tax basis of assets and liabilities, tax losses and credits, and tax rates.

Transition

IFRIC 23 is effective for annual reporting periods beginning on or after January 1, 2019. A company applies IFRIC 23 retrospectively on adoption, and can choose whether to adjust opening equity without restating comparatives or to restate comparatives (if possible without using hindsight).

Detection risk

IFRIC 23 clarifies that, similar to US GAAP, when a company considers the uncertainty, it must assume that the taxing authorities have full knowledge of all relevant information in assessing the proposed tax treatment. Said differently, detection risk is ignored when assessing tax uncertainties.

Recognition and measurement

Under IFRIC 23, the key test is whether it is *probable* (i.e. more likely than not) that the taxing authority will accept the company's tax treatment as reported in the income tax filing. If yes, the company records the

same amount in the financial statements as submitted (or planned to be submitted) in the income tax return.

If no, the company reflects the effect of the tax uncertainty following the method that it expects will better predict the resolution of the uncertainty:

- **Most likely amount method.** The single most likely amount in a range of possible outcomes; or
- **Expected value method.** The sum of the probability-weighted amounts in a range of possible outcomes.

Under US GAAP, a company only includes the income tax effects of its tax position in the financial statements when it is more likely than not that the position will be sustained based on its technical merits if the taxpayer takes the dispute to the court of last resort. The possibility of negotiation with the taxing authority is not considered in this first step. If the more-likely-than-not threshold is not met, then no tax benefit is recognized.

In a second step, the company measures the tax effects of positions that meet the recognition threshold using the largest amount that is more than 50 percent likely of being realized upon settlement with the taxing authority (the cumulative-probability approach).

Example

ABC Corp. takes a \$100 deduction on its federal income tax return. However, ABC expects that it is not probable that the deduction will be accepted by the IRS. ABC estimates the following.

Likelihood	Tax deduction accepted by the IRS
30%	\$25
30%	\$60
40%	\$100

Under IFRS

Using the *most likely amount method*, the tax deduction used in computing the financial statement tax benefit would be \$100, because this outcome has the highest likelihood of all scenarios.

However, the spread of probabilities shows three large percentage probabilities that are fairly close; this makes it difficult to conclude that a single outcome is most likely. Therefore, in this fact pattern, we believe that the expected value method better predicts the resolution of the uncertainty. Using the *expected value method*, the tax deduction used in computing the financial statement tax benefit would be \$66.^a

1. IFRIC 23, Uncertainty over Income Tax Treatments
2. ASC 740, Income Taxes

Assuming a tax rate of 35%, ABC records the following entry to adjust the current income tax expense initially recorded on the basis of the tax return.

	<i>Debit</i>	<i>Credit</i>
Income tax expense ^b	12	
Tax payable		12

Under US GAAP

It is more likely than not that some level of tax benefit will be sustained. Accordingly, ABC concludes that the recognition threshold is met, and measures the tax benefit at \$60^c using the cumulative-probability approach.

Applying the tax rate of 35%, ABC records the following entry to reflect the tax uncertainty.

	<i>Debit</i>	<i>Credit</i>
Income tax expense ^d	14	
Tax payable		14

Notes:

- a. $(\$25 \times 30\%) + (\$60 \times 30\%) + (\$100 \times 40\%) = \66 (rounded)
- b. $(\$100 - \$66) \times 35\% = \$12$ (rounded)
- c. $40\% + 30\% = 70\% > 50\%$
- d. $(\$100 - \$60) \times 35\% = \$14$

Other aspects of IFRIC 23

Under IFRIC 23, similar to US GAAP, the estimates and assumptions are reassessed if facts and circumstances change or new information emerges – e.g. a new tax rule is enacted, a tax examination is launched or the time limit for a tax audit lapses. When there is a change in estimate, the effect is accounted for on a prospective basis in the period of the change.

IFRIC 23 brings no new disclosure requirements. However, existing disclosures in IAS 1³ and IAS 12⁴ encompass judgments made in determining tax treatments or uncertain tax positions for which no liability is recognized in the financial statements. Companies also need to disclose the effects of applying IFRIC 23 before it is adopted, if material, under IAS 8.⁵

Income tax-related interest and penalties

Current IFRS is unclear about the accounting for interest and penalties related to income tax. Companies apply either IAS 12 or IAS 37⁶, leading to differences in measurement and presentation.

3. IAS 1, Presentation of Financial Statements

4. IAS 12, Income Taxes

5. IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

6. IAS 37, Provisions, Contingent Liabilities and Contingent Assets

In September 2017, the IFRS IC clarified that there is no such accounting choice going forward. A company first considers whether the particular amount payable or receivable for interest or penalties meets the definition of an income tax. This determines whether IAS 12 applies. Any scoped-out amount is dealt with under IAS 37.

Companies that have material amounts of interest or penalties related to income taxes need to reexamine their current accounting treatment to determine whether a change is required. This clarification, issued through an agenda decision, is effective immediately.

Differences could remain with US GAAP, which has guidance on accounting for and disclosing interest and penalties on unrecognized tax benefits. For example, companies can elect to classify interest and penalties as either income taxes or another expense classification.

Accounting for PP&E under the IFRS component approach

Large property, plant and equipment items often comprise multiple parts with varying useful lives or consumption patterns. Unlike US GAAP, IFRS requires companies to separately depreciate those parts that are significant. While the objective is conceptually simple, implementing the component approach can be challenging.

Complex assets, such as airplanes, ships, buildings, large manufacturing equipment and utilities infrastructure, often comprise multiple parts that need to be periodically replaced or overhauled during their useful lives.

IFRS⁷ requires significant parts of PP&E items with differing depreciation methods or lives to be depreciated separately. Further, upon replacement or overhaul of a part, the company is required to capitalize the cost and derecognize the carrying amount of the replaced part.

The objective of the component approach is to more precisely reflect the pattern in which the asset's future economic benefits are expected to be consumed by the company.

Under US GAAP, the component approach is permitted, but not required. In practice, few companies apply it. However, the option may prove useful for dual reporters that seek to avoid maintaining two fixed assets ledgers. When the component approach is not used, in our experience, PP&E items are usually depreciated by determining a useful life for the item as a whole.

7. IAS 16, Property, Plant and Equipment

Steps in the component approach

Step 1: Identify the significant components of a PP&E item

To apply the component approach, it is necessary to identify the significant parts of an asset. IAS 16 specifies two different types of components: (1) a physical component and (2) a non-physical component that represents a major inspection or overhaul.

Component accounting for inspection or overhaul costs is intended to be used only for major expenditures that occur at regular intervals over the life of an asset and last more than one period; this is referred to as 'planned major maintenance' under US GAAP. Costs associated with routine repairs and maintenance are expensed as incurred.

Step 2: Determine the cost of the components

Each component is measured at cost at initial recognition, which can create many practical issues. Assets are usually purchased for a single sum without knowing the cost of the individual components.

In our view, the cost of the individual components should be estimated either with reference to current market prices (if possible), in consultation with the seller or contractor, or using some other reasonable method of approximation (e.g. relative values).

Other complexities arise in determining the implicit cost of a major inspection or overhaul, and in allocating the total costs to the different components when the underlying asset comprises a number of physical and non-physical components (e.g. major inspection or overhaul).

Step 3: Depreciate each component separately

The components identified in Step 1 are depreciated separately over their respective useful lives in a manner consistent with their pattern of consumption. However, regardless of the components identified for an underlying asset, on the balance sheet the respective carrying amounts are all presented within the single line item, PP&E.

Step 4: Replace the components

The remaining carrying amount of a component that is replaced by a new component is derecognized. However, any amount written off is included in depreciation instead of being classified as a loss on disposal. We believe the extra depreciation is in effect a revision of the estimated useful life of the component. Costs associated with replacing items not identified as a component are expensed as incurred.

Example

ShipCo runs a merchant shipping business and has just acquired a new ship for \$400 with a useful life of 15 years.

The ship will be dry-docked every three years for the major overhaul to be carried out. At the date of acquisition, the dry-docking costs for similar ships that are three years old are approximately \$80. Therefore, the cost of the dry-docking component for accounting purposes is \$80 and this amount will be depreciated over the three years to the next dry-docking.

ShipCo's ship comprises two physical components: the ship's body of \$250 and the engines of \$150. The dry-docking will involve servicing both of these components. In practice, the ship would comprise a number of other insignificant parts that may be grouped together to be depreciated over a useful life that faithfully represents the depreciation profile of its parts; however, the example has been simplified for illustrative purposes.

ShipCo concludes that it will allocate the cost of the dry-docking component between the ship's body and the engines on the basis of their relative carrying amounts. On this basis, the allocation of the \$400 purchase price to the three components of the ship would be as follows.

Dry-docking costs		\$80
Ship's body	$250 - (250/400 \times 80) =$	\$200
Engines	$150 - (150/400 \times 80) =$	\$120

Challenges of applying the component approach

Identifying each component and the required data, such as the date purchased and the original cost, can be challenging. This will particularly be true for companies engaging in capital intensive businesses and transitioning to IFRS. The detailed recordkeeping needed to apply the component approach may not have been required under the company's current GAAP.

Companies may look to operational or tax data to retrieve sufficient information for each component. A typical challenge when looking to data outside of the accounting department is verifying the completeness and accuracy of system-generated reports or other types of schedules that are being relied on. Changes to fixed assets ledgers and CAPEX procedures may also be required.

Foreign operations in hyperinflationary economies

The accounting applied to a foreign operation changes fundamentally when the economy in which it operates is determined to be hyperinflationary (highly inflationary).⁸ This, coupled with accounting differences between IFRS and US GAAP, means that identifying hyperinflationary economies is an essential step in the financial reporting process of a multinational dual reporter.

Accounting for foreign operations is often complex. It first requires companies to establish and maintain processes and controls to ensure the consistent application of accounting policies and the correct treatment of intercompany transactions on consolidation.

International groups then have the additional task of translating the balances, results and cash flows of foreign operations into the presentation currency. This is particularly challenging when the foreign operation is in a (potentially) hyperinflationary economy, for two main reasons.

- The assessment of whether or not the economy is hyperinflationary requires significant judgment, and it is often difficult to obtain stable and reliable inflation data from stressed economies to perform the analysis.
- The accounting for operations in hyperinflationary economies is inherently complicated, as companies with operations in Venezuela (a hyperinflationary economy) can attest.

Dual reporters with foreign operations in a hyperinflationary economy face further complexity. IFRS and US GAAP have different accounting models for hyperinflationary economies that create GAAP differences in the numbers reported.

Identifying hyperinflationary economies

Both IFRS and US GAAP explicitly recognize that identifying hyperinflation requires judgment. But while the assessment methodologies are not aligned, in our experience, conclusions about hyperinflationary status generally do not diverge.

IAS 29 lists five indicators of hyperinflation to be considered, along with any other relevant factors, when analyzing the economic environment of a country. One of these indicators is a cumulative inflation rate over three years approaching or exceeding 100 percent.

8. IAS 29, Financial Reporting in Hyperinflationary Economies; ASC 830, Foreign Currency Matters. ASC 830 uses the term 'highly inflationary' whereas IFRS uses the term 'hyperinflationary'. While the concepts are not identical, equivalence is generally expected and here we use 'hyperinflationary' to refer to both IFRS and US GAAP.

However, this is not determinative and should not be considered in isolation.

IFRS indicators of hyperinflation

1. The general population prefers to keep its wealth in nonmonetary assets or in a relatively stable foreign currency. Amounts of local currency held are invested immediately to maintain purchasing power.
2. The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency.
3. Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short.
4. Interest rates, wages and prices are linked to a price index.
5. The cumulative inflation rate over three years is approaching or exceeds 100 percent.

US GAAP is sequenced in its approach; the assessment of a hyperinflationary economy follows a two-step methodology.

- **Step 1.** Perform a quantitative analysis of the cumulative inflation rate – any economy that has a cumulative inflation rate for the three years preceding the beginning of the reporting period in excess of 100 percent is considered to be hyperinflationary.
- **Step 2.** If Step 1 results in the cumulative rate being less than 100 percent, judgment is applied in an analysis of historical inflation rate trends and other pertinent economic factors.

When dealing with countries in economic stress, even Step 1 can require judgment because there may not be a single, reliable general inflation index available for the full three-year period.

The IPTF⁹ has developed a process to identify and monitor country inflation statistics. Our experience is that historically, US GAAP and dual reporters often use the IPTF's analysis as a significant reference point in their documentation.

9. International Practices Task Force of the Center for Audit Quality with the SEC staff

However, this does not relieve management of a responsibility to perform its own robust assessment of potentially hyperinflationary economies under both GAAPs. Companies should also have appropriate controls in place to monitor such economies. As already mentioned, there are some differences in the IFRS and US GAAP approaches. Therefore, while the underlying data on the economy should be consistently used in both assessments, a dual reporter will need to demonstrate that its assessment complies with both approaches.

What to look out for at year-end

The country that has generated much discussion recently, and which is likely to be the most significant for US companies with foreign operations, is Argentina.

We understand that most, if not all, dual reporters reached the conclusion that Argentina would not require hyperinflationary accounting for both their US GAAP and IFRS reporting for the first and second quarters of 2017. This was based on an assessment of the drivers behind the available inflation numbers and the fact that other qualitative characteristics of the economic environment do not point conclusively to the existence of hyperinflation.

However, this is a highly judgmental assessment. There is no indisputable, consistent inflation index available, and the cumulative three-year inflation rates that can be derived from the available data are sufficiently high that any change in the other qualitative characteristics of the economy in the third and fourth quarters could be enough to conclude that Argentina has become a hyperinflationary economy.

Ukraine is another country that will require significant judgment to determine whether it is hyperinflationary in 2017. Venezuela will likely remain hyperinflationary.

Accounting for foreign operations in a hyperinflationary economy

Under both GAAPs, once an economy is identified as hyperinflationary, the accounting required at the group level for foreign operations in that economy is substantially different from that applied previously. In addition, hyperinflationary accounting under US GAAP is fundamentally different from that under IFRS.

As can be seen from the summary that follows, the required methodologies for hyperinflationary accounting generate measurement differences between IFRS and US GAAP. Additionally, as a result of their transition requirements, IFRS and US GAAP result in a timing difference for the application of hyperinflation accounting.

For example, let's assume that hyperinflation is identified in Argentina in the fourth quarter of 2017 under both IFRS and US GAAP. Hyperinflationary accounting would apply for all of 2017 and comparative periods under IFRS, whereas it would only begin for US GAAP in the first quarter of 2018.

In conclusion, as well as ensuring that there is a robust, IFRS- and US GAAP-compliant assessment of hyperinflationary economies, management with foreign operations in countries like Argentina and Ukraine needs to have the processes and controls in place that will allow them to switch between the 'normal' and hyperinflationary accounting models – recognizing that the hyperinflationary model under IFRS is different from that under US GAAP in both its transition requirements and in its measurement methodology.

	IFRS	US GAAP
Methodology	Indexation to reflect purchasing power at the reporting date followed by translation to presentation currency.	The group presentation currency is adopted as the functional currency of the foreign operation (the 'new functional currency').
Application date	The beginning of the reporting period in which hyperinflation is identified.	The beginning of the reporting period (including interim reporting periods) <i>following</i> that in which hyperinflation is identified.
Transition	Retrospective, as if the currency had always been hyperinflationary – comparatives are generally restated.	Prospective – from the application date.
Assets, liabilities and equity	<p>At the application date, the opening balances of the reporting period are adjusted to reflect purchasing power at the reporting date – i.e. are adjusted for changes in a general price index.</p> <p>The closing balances of nonmonetary items are adjusted for changes in the general price index for the year or from the date of acquisition, contribution or revaluation if acquired, contributed or revalued during the period.</p> <p>The gain or loss on the net monetary position is recognized in profit or loss.</p>	<p>Nonmonetary assets and liabilities At the application date, the opening balances of nonmonetary items are established in the new functional currency based on the amounts reported in the group financial statements at the end of the immediately preceding reporting period.</p> <p>Subsequently, nonmonetary items are accounted for under the applicable literature as if they had always been assets and liabilities in the new functional currency.</p> <p>Monetary assets and liabilities At the application date, monetary items in the foreign operation are treated in the same manner as any other foreign currency monetary items.</p> <p>Subsequently, monetary items are remeasured into the new functional currency using current exchange rates.</p> <p>Differences arising from the remeasurement of monetary items are recognized in profit or loss.</p>
Income, expenses and other comprehensive income (OCI)	Subsequent to the application date, income, expenses and OCI for the period are restated for changes in the general price index from the date they were initially recognized to the reporting date.	Subsequent to the application date, income, expenses and OCI for the period are measured using the historical foreign exchange rates on the transaction dates. An average for the period may be used if not materially different from using the individual historical rates.

Leases survey highlights implementation issues

While companies are making progress in their IFRS 16 implementation efforts, KPMG’s survey highlights the need for greater effort and a longer lead time than expected. This is especially true for dual reporters because of significant differences between IFRS 16 and ASC 842.¹⁰ As with all major accounting change projects, understanding the key practical issues is the first step to a successful implementation.

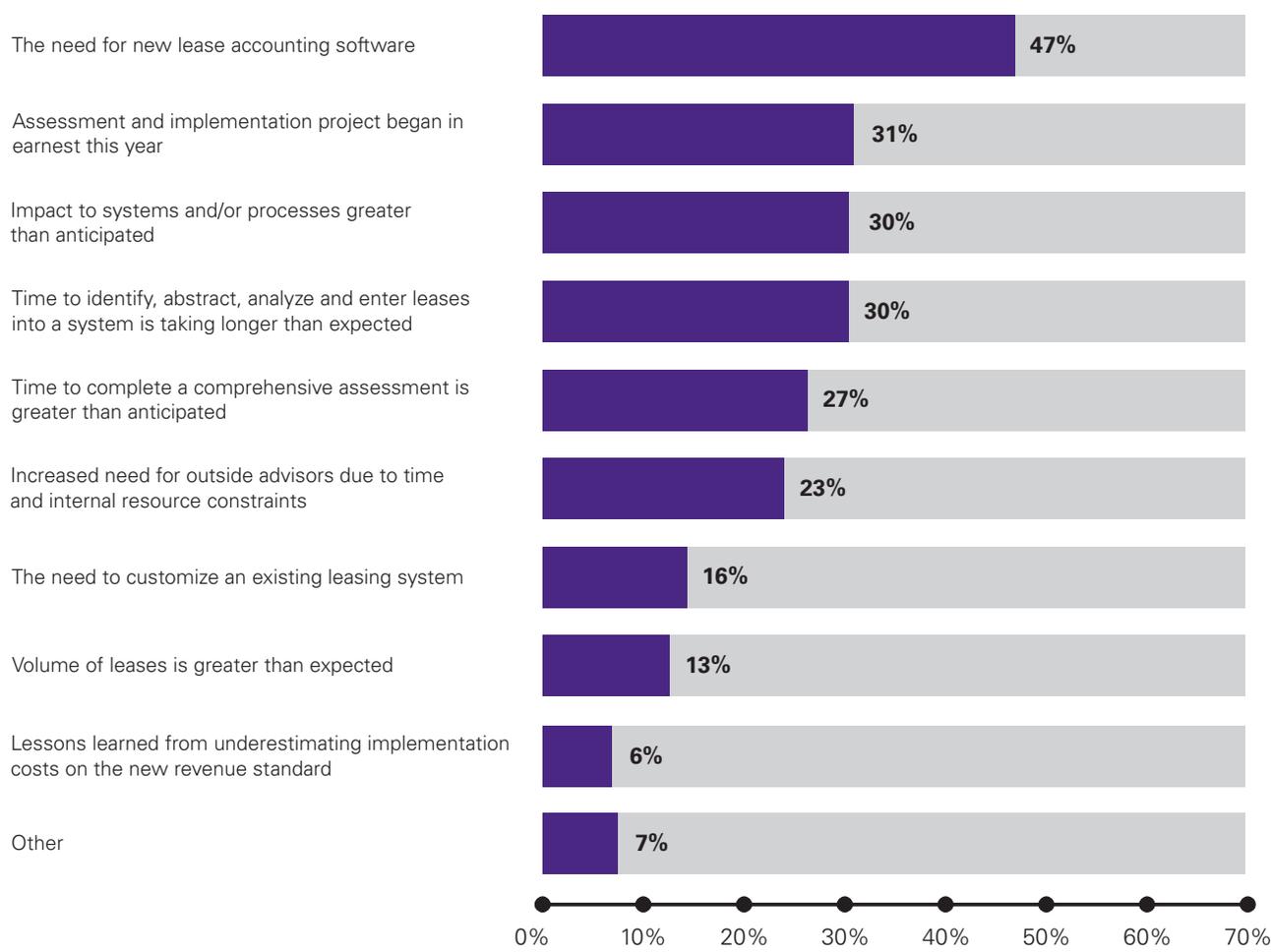
KPMG recently released the results of our [2017 Accounting Change Survey](#), which includes companies’ feedback on their implementation of the new leases standard. Although focused on US GAAP, we believe that the results are equally informative about likely implementation experience under IFRS.

The survey shows that most companies have now started implementation efforts, although projects are still being hindered by competing priorities with the new revenue standard implementation efforts.

Noteworthy is that 60 percent of companies indicated that they have been surprised by some of the challenges they are running up against, including identifying leases and selecting and deploying an adequate lease tool. And nearly 40 percent of companies reported more intensive implementation efforts than planned – the top reason being the need for new lease accounting software.

Because the IFRS and US GAAP versions of the new leases standard are different, US companies that report under both GAAPs face an even bigger challenge. With that in mind, we summarize here the key practical issues that dual reporters should consider in the early stage of their lease implementation project.

Circumstances leading to increased cost of leasing implementation since prior year (select all that apply)



10. IFRS 16, Leases and ASC 842, Leases. See our article, [Leases: Top differences between IFRS 16 and ASC 842](#) published in IFRS Perspectives – August 2017.

What is the population of leases?

A critical issue is to identify a company's complete population of leases. Some companies may have good repositories of lease agreements in place. But it may not be readily apparent that many arrangements not explicitly called 'lease agreements' may include embedded lease components that need to be included in that population as well.

This step is equally important for implementing both the US GAAP and IFRS leases standards because the definition of a lease is converged, and the need to identify embedded leases is pivotal to both US GAAP and IFRS. However, the number of leases accounted for on-balance sheet under IFRS may be smaller because of the 'low-value items' practical expedient in IFRS 16¹¹, which is an exemption a company can take on a lease-by-lease basis. Because there is no equivalent of this practical expedient in ASC 842, some dual reporters may decide not to take this exemption under IFRS to decrease the number of differences between US GAAP and IFRS reporting.

What will be your approach to implementation?

As with any accounting standard implementation, even before identifying the lease population, a company needs to decide how to approach the project: using a centralized, decentralized or hybrid approach.

The answer mainly depends on the company's organizational structure and corporate culture, as well as the number of locations and complexity of potential lease transactions.

- **A centralized approach** may help achieve greater efficiency in terms of knowledge and consistency, but may place a greater burden on the centralized team and may require longer implementation time.
- **A decentralized approach** allows the implementation work to be allocated among multiple teams having local business knowledge and local language abilities in multiple locations, but requires greater effort to develop a standardized implementation process and instructions to minimize inconsistencies.
- **A hybrid approach** combines elements of the above two approaches, spreading the work effort but allowing key parts of the analysis to be done by a centralized team.

What technology will you deploy?

Another challenge is to find the right technology solution that will address both operational and accounting concerns. Historically, many companies

may have had a lease administration tool for real estate leases, but non-real estate leases may not be in any coordinated accounting-based solution. Depending on how (or whether) relevant data are currently captured and stored, a company may need to determine whether the technology can be used to recognize and capture key lease terms, and handle accounting and reporting under both US GAAP and IFRS.

The answers will affect how the project implementation is conducted and staffed. For dual reporters, finding the right technology solution will be an important consideration because there are significant differences on day two lessee accounting for operating leases¹² that will require separate tracking for leases that have a different classification under US GAAP versus IFRS.

Have you started education and communication?

Because of the challenges involved in the implementation process, it is very important to start education and communication with key stakeholders early. Timely education and communication will be the critical step in decision-making about the right technology solutions, respective budget approvals and allocating the right resources to the implementation project, which will have a direct effect on the success of the project.

What KPMG resources are available?

Resource	Description
10 key questions to help you prepare	KPMG's 10 quick questions to get a feel for the scale of the IFRS 16 implementation challenge ahead.
Leases – First Impressions	KPMG's overall insight and analysis on the impact of IFRS 16.
Transition to the new leases standard	KPMG's in-depth guide to help determine the best option for transitioning to the new standard.
Lease definition	KPMG's in-depth guide to assess whether a transaction is, or contains, a lease and to understand differences to current practice.
Leases: Discount rates – What's the correct rate?	KPMG's in-depth guide focused on the appropriate discount rate (lessee and lessor) and how this will affect a company's financial statements.

11. Lessees may elect to apply the recognition exemption for leases of 'low-value items' – i.e. underlying assets with a value ≤ \$5,000 when new, even if they are material in aggregate.

12. IFRS 16 uses a single lessee accounting model that treats all leases as financing arrangements, whereas ASC 842 applies a dual classification model for lessees (finance leases and operating leases).

IFRS and US GAAP long awaited changes to hedge accounting

IFRS 9¹³ introduces an approach that aligns hedge accounting more closely with risk management, which many corporates view as a positive step forward. In the United States, the FASB recently issued ASU 2017-12¹⁴, which provides new opportunities to use hedge accounting – some of which are similar to IFRS 9. While hedge accounting finally appears more accessible under both GAAPs, the requirements are not fully converged, creating new challenges for dual reporters.

When the IASB and FASB began discussing hedge accounting, both were seeking to ease current rules, often considered by preparers to be rigid and burdensome. In addition, both Boards aimed to align hedge accounting more closely with risk management and to provide useful information about the purpose and effect of hedging instruments. Both delivered on that promise, but in different ways.

The IASB took a comprehensive approach in revising its hedge accounting guidance. Effective for most companies in 2018, IFRS 9 brings many welcomed changes.

For example, it provides new flexibility compared to the current model¹⁵ by:

- allowing the fair value option for certain credit exposures and own-use contracts;¹⁶
- allowing further use of cash instruments as hedging instruments;
- allowing certain excluded components of hedging instruments to be treated as deferred costs of hedging;
- extending the availability of hedge accounting to additional risk exposures; and
- easing hedge effectiveness requirements.

However, IFRS 9 also brings certain new requirements and prohibitions, such as the:

- requirement to rebalance hedge relationships;
- prohibition of voluntary termination of hedge relationships; and
- accounting for the excluded components of hedging instruments.

In contrast, the FASB has introduced targeted improvements to address specific practice issues. Although some of the changes made by IFRS 9 and ASU 2017-12 are similar, hedge accounting under IFRS and US GAAP will not be completely converged going forward.

We have highlighted below some of the changes introduced by IFRS 9 and how they compare to the ASU; these differences require consideration as you rethink your hedge accounting and hedging strategies. Contact your KPMG team to further understand how these differences could apply to your circumstances.

IFRS 9 introduces new flexibility

New fair value options

IFRS 9 creates a new fair value option for certain credit exposures. This may allow companies a better accounting treatment for their credit risk management activities without having to apply hedge accounting. Companies can designate a credit exposure (or a proportion of it) as measured at fair value through profit or loss (FVTPL) if a credit derivative is used to manage that credit exposure.

IFRS 9 also creates a fair value option for contracts that meet the own-use scope exception if certain conditions are met. This addresses the accounting mismatch that occurs when a derivative is used as an economic hedge of a commodity contract that is not accounted for as a derivative.

The ASU does not include these fair value options.

Cash hedging instruments

Generally under IFRS 9, a nonderivative asset or a nonderivative liability (except in certain situations) that is measured entirely at FVTPL may be a hedging instrument for any risk, not just foreign currency risk. However, for hedges of risks other than foreign currency risk, the nonderivative instrument must be designated in its entirety or proportionately.

The ASU does not permit this expanded opportunity to use nonderivative instruments for hedge accounting.

Excluded components

IFRS 9 allows a company to exclude from hedge relationships certain components of various hedging instruments. Changes in fair value of those excluded components are recorded in either profit or loss (P&L) or other comprehensive income (OCI).

13. IFRS 9, Financial Instruments; effective for annual periods beginning on or after January 1, 2018

14. ASU 2017-12, Targeted Improvements to Hedge Accounting; effective for public business entities for fiscal years beginning after December 15, 2018, and one year later for all other entities

15. IAS 39, Financial Instruments: Recognition and Measurement

16. Contracts to buy or sell nonfinancial items that can be net settled that were entered into and continue to be held for the purpose of the receipt or delivery of a nonfinancial item in accordance with the company's expected purchase, sale or usage requirements

Hedging instrument	Excluded component	Change in fair value of the excluded component recorded in:
Purchased option	Time value	OCI
Forward contract	Forward element	P&L or OCI – as elected
Financial instrument	Foreign currency basis spread	P&L or OCI – as elected

Amounts recorded in accumulated OCI will eventually be reclassified to P&L. Timing may vary depending on whether the hedged item is transaction- or time period-based, which may create some new complexity.

The ASU continues to allow a company to exclude time value and forward element components from hedge accounting, and also permits excluding foreign currency basis spreads. In addition, the ASU allows a company to elect to recognize the fair value changes of the excluded components in P&L (like current US GAAP), or to amortize the initial value of the excluded component in P&L over the term of the hedge.

Additional exposures may be hedged items

IFRS 9 expands the number of qualifying hedging strategies by allowing additional exposures to qualify as hedged items.

Example 1, Risk components. A specified risk component of a financial or nonfinancial item may be a hedged item if it is separately identifiable and reliably measurable. For example, it may be possible for the crude oil component of jet fuel to be an eligible hedged item.

Example 2, Net positions. A net position of a portfolio of financial instruments may be a hedged item if:

- each individual item comprising the group is an eligible hedged item;
- the individual items comprising the group are managed together for risk management purposes; and
- in the case of a cash flow hedge of items with offsetting risk positions, the risk being hedged is foreign currency risk and the designation specifies certain details about the forecast transactions.

Example 3, Layer components. A layer component may be a hedged item (e.g. the last \$20 million principal payment of a \$100 million debt instrument) if the effect of the prepayment option is included in the effectiveness assessment.

Example 4, Aggregated exposures. The combination of a derivative and a nonderivative exposure that is managed together for risk management purposes may be designated as the hedged item in a hedge relationship.

The ASU allows risk components of nonfinancial items to be designated as a hedged item if they are contractually specified. Unlike the ASU, IFRS does not require the component to be contractually specified; instead, it requires that the risk component be separately identifiable and reliably measurable.

The ASU also allows a ‘last of layer’ approach for fair value hedges. However, this approach differs from the layer component approach in IFRS 9. In addition, the ASU does not allow hedge accounting for net positions or aggregate exposures.

Hedge effectiveness assessment

IFRS 9 replaces the bright-line 80–125 percent effectiveness test with a forward-looking assessment that can be performed qualitatively if certain conditions are met. It generally requires that:

- an economic relationship must exist between the hedging instrument and the hedged item;
- the effect of credit risk does not dominate the value changes that result from that economic relationship; and
- the hedge ratio designated is the one actually used for risk management.

The ASU retains the ‘highly effective’ threshold to qualify for hedge accounting; however, it eases the current subsequent quantitative effectiveness assessment requirements, and the application of the shortcut method and the critical terms match method. As a consequence, differences between US GAAP and IFRS may arise in practice in these areas.

Other requirements and prohibitions of IFRS 9

Rebalancing hedge relationships

Companies may be required to rebalance a hedge relationship that is not behaving as expected by adjusting the quantity of the hedged item or hedging instrument. This allows hedge accounting to continue without needing to stop and restart a hedge relationship.

Prohibition on voluntary termination of hedge relationships

Companies are prohibited from voluntarily terminating a hedge relationship that continues to meet its risk management objective and other qualifying criteria – which could affect the use of certain dynamic hedging strategies.

However, if the risk management objective for a hedge relationship has changed, the hedge relationship would be discontinued. Companies could designate a new hedge relationship involving the hedging instrument or hedged item from the discontinued hedge relationship.

US GAAP will continue to allow voluntary termination of a hedge relationship after adoption of the ASU.

Other issues for dual reporters

There will be some other noteworthy differences between IFRS and US GAAP once ASU 2017-12 becomes effective. In particular, the ASU eliminates the separate measure and reporting of ineffectiveness. The change in the hedging instrument's fair value will be reported as follows.

- For **fair value hedges**, in the same income statement line item that captures the change in the hedged item's fair value attributable to the hedged risk.
- For **cash flow hedges**, entirely in OCI (no splitting between OCI and earnings). When the amounts from OCI are reclassified to P&L, they will be reported in the same income statement line item where the hedged item's gains/losses are presented.

More to come on macro-hedging

While IFRS 9 solves many concerns for corporates, some financial institutions and insurers are expecting more. The IASB continues to work on an alternative macro-hedging model. This model attempts to reflect how financial institutions manage the dynamic net interest margin resulting from typical banking book assets and liabilities. The IASB staff is scheduled to present the Board with the objectives and outline of this proposed model for a potential Discussion Paper targeted for the second half of 2018.

To learn more about the differences between IFRS and US GAAP, see KPMG's publication, [IFRS compared to US GAAP](#).

For more information please contact:



Kevin Bogle
Principal, Accounting Advisory Services,
IFRS Institute Advisory Leader
T: +1 212-872-5766
E: kevinbogle@kpmg.com



Valerie Boissou
Partner, Department of
Professional Practice
T: +1 212-954-1723
E: vlesageboissou@kpmg.com



Holger Erchinger
Partner in Charge
US Germany Corridor
T: +1 212-909-5529
E: herchinger1@kpmg.com



PK Kalavacherla
Partner in Charge
International Accounting Group
Department of Professional Practice
T: +1 415-963-8657
E: pkalavacherla@kpmg.com

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East region

Erik Lange
Partner, Accounting Advisory Services
T: +1 212-872-6654
E: elange@kpmg.com

Reza van Roosmalen
Principal, Accounting Advisory Services
T: +1 212-954-6996
E: rezavanroosmalen@kpmg.com

Ingo Zielhoff
Managing Director, Accounting Advisory Services
T: +1 212-872-4423
E: ingozielhoff@kpmg.com

West region

Jason Anglin
Principal, Accounting Advisory Services
T: +1 415-963-7606
E: janglin@kpmg.com

South region

Michael Nesta
Partner, Accounting Advisory Services
T: +1 214-840-2730
E: mnesta@kpmg.com

Southeast region

Jack Ingram
Partner, Accounting Advisory Services
T: +1 404-221-2398
E: jtingram@kpmg.com

Midwest region

Marybeth Shamrock
Partner, Accounting Advisory Services
T: +1 216-875-8158
E: mshamrock@kpmg.com