

# Hedge Accounting: The convergence of Accounting Standards

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## Executive Summary:

The convergence of different regional accounting standards on derivative transactions and hedging activities to a single uniform accounting standard - **International Financial Reporting Standards** (IFRS) poses a big challenge to Banking and Capital Market institutions. It has enterprise wide ramifications in terms of changing the current processes and IT system / infrastructure. Success of the effective conversion lies in enterprise wide collaboration, understanding the complex subject and walking the correct implementation path.

This paper describes the basic concepts, benefits and challenges of convergence. It depicts the importance of information technology and the advantages of a framework driven approach.

## Overview:

The 'Financial Accounting Standards Board (FASB)' issued standards for Accounting of Derivative Instruments and Hedging activities commonly known as "FAS 133" in 1998. This was aimed at greater transparency and reduction of volatility in the financial income reporting.

In a similar initiative, the 'International Accounting Standards Board' issued a directive in the form of "IAS 39" effective from 2001.

Although the standards are issued by different governing entities, conceptually they are similar. There is an ongoing drive to converge all accounting standards across the globe into a single uniform accounting standard (IFRS1) driven by the 'International Accounting Standards Board'. The exact date of conversion is not yet official, the Securities and Exchange Commission (SEC) has proposed a timeline of 2014-2016.

While there is no deadline set for complying with these accounting standards, it would be safe to say that with the increasing regulation and compliance pressure, the implementation of IFRS is no longer a case of "whether" but rather a question of "when" and "how."

The adoption envisages impact both on the financial results and organizations' operating environments.

Although the IFRS conversion begins as an accounting change, it has wide ramifications on other departments and resources of the organization, like the product structuring group, tax, human resources, information technology, treasury performance management and much more. Hence it becomes an enterprise wide initiative that demands various functional areas to be involved at the onset of the conversion to avoid surprises.

*\*International Financial Reporting Standards (IFRS) are Standards, Interpretations and the Framework adopted by the International Accounting Standards Board (IASB). Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS).*

## Business Business Benefits of the Conversion:

**Elimination of the multi-GAAP environment:** Multinational entities with significant statutory reporting may be able to save costs by harmonizing their reporting. With many countries requiring or permitting the use of IRFS or standards based on IRFS, the ability to utilize a common reporting platform across organizations is always highly beneficial.

**Cross-border transactions:** Entities that actively participate in cross-border transactions through joint-ventures or acquisitions, may find it helpful to utilize IFRS for due diligence or reporting purposes. Having one global accounting framework reduces the investment risk of misinterpretation of financial statements of foreign entities.

### Key Implementation Challenges

Though most financial services organizations will not require a complete architecture overhaul to support IFRS, a wide range of application and data issues can be anticipated due to the conversion. Hence it becomes imperative for involvement of the bank's IT unit at an early stage for identification of the changes to the system and processes for a seamless adoption of IFRS.

Critical factors that can have an impact on the outcome of the implementation

Few important factors that need special attention during implementation are mentioned below. Process and IT system should be optimally designed to minimize the impact.

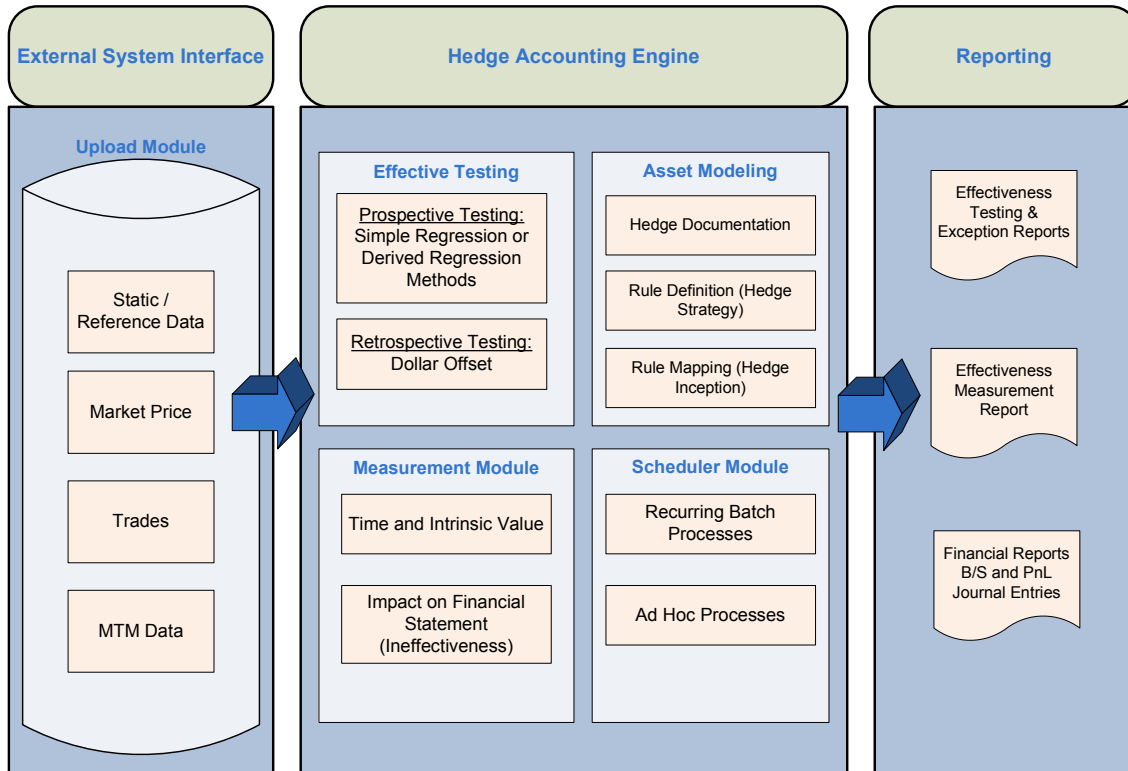
- The new system or processes designed and developed should have a strong reporting capabilities. With outdated chart of accounts design, disparate global ledgers and legacy system can complicate the conversion process and can restrict reporting capabilities.
- Conversion might not be limited only to the General Ledger and Financial Reporting platform. It might be required to enhance or modify front and middle applications. As we are well aware, trading institutions use myriad systems for various asset classes and trade management functions. In many financial institutions, the core GL serves only as a repository of accounting data whereas the actual process of generating the accounting data is handled by various back-office systems. This is usually done through an event based workflow and accounting rules based on asset class and book structure.
- Very often, a single set of accounting rules may not be sufficient for complying with local as well as global standards. Hence developing a global policy or layering on additional logic to meet the local standards may not be sufficient. A careful study of the requirements and a systematic approach impacting processes, technology and policies needs to be undertaken.

### Hedge Accounting Framework

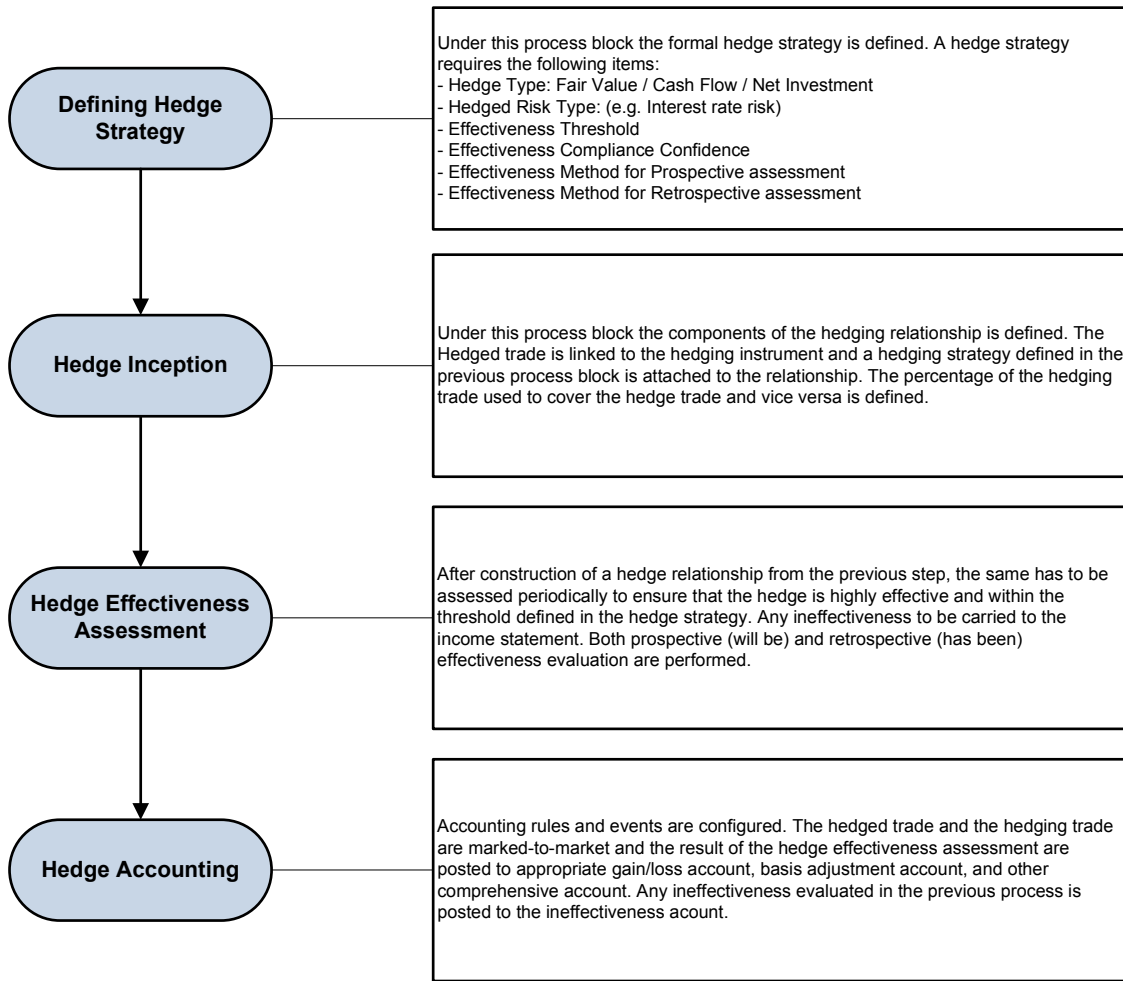
Although there are differences between FAS 133 and IAS 39, the overall concept and objectives remain similar.

In the transformation process, the existing framework needs to be studied and assessed as most of the features can be reused with minor modifications or enhancements.

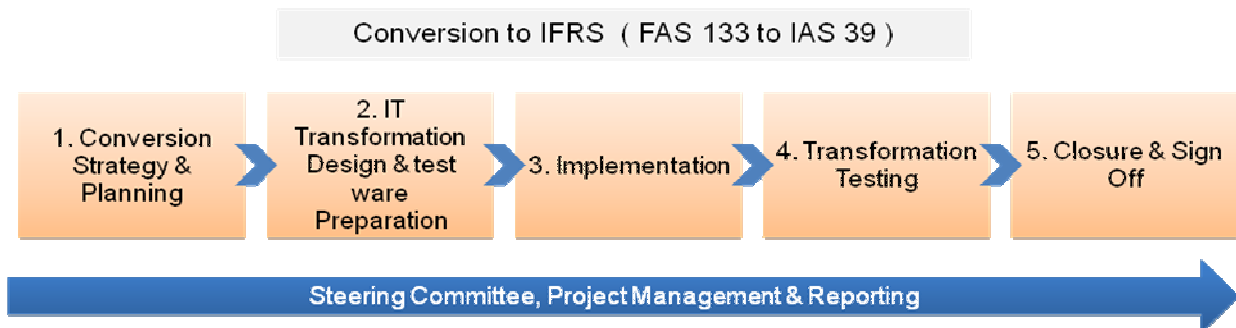
#### General framework used for hedge accounting:



**Hedge Accounting Process Blocks:**



A high level framework / methodology describing the transformation needs from a technology prospective is mentioned below.



## 1. Conversion Strategy and Planning:

- Senior management buy in
- Formation of core transformation group
- Discussion and conducting joint workshop with Accounting, Treasury, Tax, IT department, Product Maintenance group
- Identification of the systems and processes affected ( accounting diagnostic & impact assessment)
- Identification of risks, assumptions, issues & dependencies
- Define and review of strategy for IT transformation
- Sign off IT transformation and Plan.

## 2. IT Transformation Design & Test ware Preparation:

- Defining phase wise plan
- Detailed system and process study
- Identification of the gaps between US GAAP and IFRS
- Identification of any other regulatory requirements like SOX 404 affected
- Embedded accounting rules in front office transactional system will need to be identified, catalogued, and modified on the revised accounting framework
- Sub GL in back office needs to be studied for incorporating the new accounting rules
- Studying the Data Sets (e.g. warehouses and data marts) designed for supporting US GAAP reporting may not contain key data elements needed for IFRS
- Identification of any ad hoc work around tactical solutions in spread sheet ( care must be taken during the transformations process to minimize these in the to-be solution)
- Designing of a suitable account framework for IFRS for parallel run
- Documentation of final operating module
- Creating of checklist and test ware.

## 3. Implementation:

- Setting of development platform
- Enhancement of existing system and development of new features
- Configuration and parameterization of systems (e.g. new accounting rules and events)
- Data migration to the to-be system and framework.

## 4. Transformation Testing:

- Setting of testing platform
- Executing the test cases and recording the results
- Daily progress / Incident Management
- Plan for re-testing of fixes and deferred testing.
- Testing involves parallel run of US GAAP and IFRS and recording and the desired result.

## 5. Closure and Sign-off:

- Consolidation of test results and reconciliation
- Analysis of test result
- Test result validation from various department concerned- Accounting, Treasury, Tax, IT
- Conducting user training workshop and knowledge transfer
- Final Sign-Off.

## Conclusion:

The complexity of the subject proves to be the major difficulty for the convergence of FAS 133 into IAS 39. Compliance will impact many parts of an organization, and the key decision makers of the organization need to invest in time and resources to gain sufficient knowledge of not only the big picture, but also the details. Lack of proper understanding of compliance details, coordination between affected departments, flexibility and scalability of existing systems, coupled with the challenges of managing product and accounting data can result in time consuming and costly implementations.

Using a framework based approach and a technology solution that supports this framework, the organization benefits from:

- A shortened implementation cycle.
- Increased accuracy in the compliance and the transformed data.
- Better decision making by optimizing existing IT systems and business processes, thus driving out inefficiencies and redundancies.
- Identification of deficiencies in data flow and quality.
- Avoidance of late surprises.

## The Quinnox Value Proposition

The Capital Markets practice team within Quinnox has a unique understanding of the challenges involved in carrying out such a transformation. The strategic partnership with product vendors such as Calypso allows Quinnox to quickly translate the right accounting principles into the product configuration. By leveraging the available functionality in an optimal manner, the implementation provides the true business benefits that are needed by the client thus providing effective ROI to the project sponsors.

The team within Quinnox has developed strong methodologies for implementation and testing which result in faster “go-live” timelines. The re-usable automaton testing framework and checklists for product configuration allows for faster and more frequent testing cycles and the depth of domain expertise available provides functional validation of the accounting results as well. More details of our tools, services and customer case studies can be found on our corporate website [www.quinnox.com](http://www.quinnox.com).

## About Quinnox

Quinnox is an IT services and solutions provider headquartered in the US, with offices in UK, Japan, Germany and India. We also have four state-of-the-art development centers in India that leverage a cost-effective delivery mechanism and a wide talent pool catering to a client base consisting of Fortune 500 companies.

Quinnox offers the full spectrum of IT lifecycle solutions, right from development to support services, including packaged implementations and product development services. We are a technology-focused company, with a wide experience in select industries – Banking and Financial Services, Retail and Manufacturing.

Quinnox's strong understanding of the Investment Banking and trading landscape allows us to provide scalable technology solutions to real business challenges faced by our customers. Our clients include large Investment Banks, Asset Management companies, Bank Treasuries and Hedge funds.

## QUINNOX FACTFILE

- Headquartered in Naperville, Illinois in US
- Over 1000+ employees globally
- ISO 9001:2000 certified
- Preferred IT solutions partner for several Fortune 500 companies

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