Showing your sensitive side

MARKET RISKS ASSOCIATED WITH FINANCIAL INSTRUMENTS ARE UNDER THE SPOTLIGHT – WITH A SIGNIFICANT KNOCK-ON IMPACT FOR TREASURERS, AS **YANN UMBRICHT** AND **STEPHANIE BRUCE** REPORT.

IFRS 7 *Financial Instruments: Disclosures* aims to give the market more information about an entity's financial assets and liabilities, and their associated risks. It requires disclosures about the significance of financial instruments for an entity's financial position and performance, and about the nature and extent of risks arising from financial instruments.

Disclosing the potential impact of market risks is one of the big changes that companies need to make under IFRS 7 – and is a key reason why treasurers are affected. In particular, they will need to perform a sensitivity analysis for each component of market risk to which an entity is exposed – namely, currency risk, interest rate risk and other price risks, such as those relating to equities or commodities. Every company has to disclose the impact on profit and loss and equity of 'reasonably possible' movements in each relevant market risk variable. Such disclosures will be new for many entities, particularly those with no listings in the US.

PROCESS CHALLENGES Achieving compliance with the sensitivity analysis requirements of IFRS 7 presents a number of challenges. First, treasurers need to consider how they will ensure they have an accurate and complete set of underlying data to base their sensitivity calculation on. All the information required may not be currently available, sufficiently accurate or auditable, so collecting it may create practical challenges. How exactly is this data to be collected and consolidated? For example, for foreign currency risk, might it be possible to apply the 80/20 rule and focus on specific areas, currency pairs, regions or operating companies believed to present the most significant risks? Such questions need to be considered at an early stage.

Thought should also be given to whether the numbers being disclosed as a result of sensitivity analysis really are meaningful. Do they correlate with the way that management sees the business and the risks that affect it? There may be a disparity because IFRS 7 deals solely with financial instruments at year-end and the sensitivity calculation only includes those financial instruments that may have an impact on profit and loss or reserves, whereas other types of (mitigating) transactions may be considered by management when assessing business risks.

Executive summary

- Under the new IFRS 7 standard, organisations must conduct sensitivity analysis on how market changes relating to financial instruments could affect performance. Treasury departments will need to take practical steps to comply properly.

SENSITIVITY ANALYSIS IN ACTION The application and implementation guidance accompanying IFRS 7 offers advice on preparing the sensitivity analysis. Consider a manufacturing company Thriving plc, with a functional and presentation currency C. Its

Table 1. Results of the sensitivity calculation

	+10bps of C interest rate (IR); +60bps of $ IR			-10bps of C IR; -60bps of $ IR	
FINANCIAL ASSETS	Carrying amount (C)	Profit (C)	Other equity movements (C)	Profit (C)	Other equity movements (C)
Cash and cash equivalents	4,135,000	9,000	-	(9,000)	-
Derivatives as cashflow hedges (interest rate swaps)	8,000	9,000	40,000	(9,000)	(40,000)
Borrowings, floating note at amortised cost	(11,935,000)	(21,000)	-	21,000	-
Impact on before tax		(3,000)	40,000	3,000	(40,000)
Tax charge of 30%		1,000	(12,000)	(1,000)	12,000
Total increase/(decrease)		(2,000)	28,000	2,000	(28,000)

financial instruments include accounts receivable, cash, trade payables, listed equity securities and borrowings. Listed equity securities include both portfolios classified as fair value through profit and loss (FVTPL) and available-for-sale (AFS).

Thriving plc also enters into derivative instruments, such as interest rate swaps and foreign exchange (FX) deals. Its borrowings are denominated in C and US dollars at floating interest rates. Based on historic movements and volatilities in these variables, and management's knowledge and experience of the financial markets, Thriving plc believes the following movements are reasonably possible over a 12-month period:

- Proportional FX rate movement of -11% (depreciation of C) and +11% (appreciation of C) against the dollar, from a $:C spot rate of 0.787;
- A parallel shift of +10bps/-10bps in C market interest rates from year-end rates of 3.85% and +60bps/-60bps of dollar market interest rates from year-end rates of 5.37%;
- Proportional other price risk movement of equity securities listed on the Dax and Dow Jones equity index of 5%.

Based on these movements, the results of the sensitivity calculation have been summarised for interest rates in *Table 1*. A number of assumptions need to be made but should be consistent with those used internally by management for budgeting and planning purposes and the development of its financial risk management strategy.

MULTINATIONALS Most multinational groups will need to provide sensitivity calculations relating to FX exposure in entities with different functional currencies. Take as an example a group that consists of a parent and two subsidiaries, which uses the euro as a presentational currency. The parent is based in the euro zone and has a euro functional currency. A UK subsidiary has a sterling functional

Table 2. FX exposure on the net monetary position of each group entity

Year-end 31/12/2006	€/$	€/£	£/$
Parent	432,000	269,000	0,000
UK company	0	430,000	38,000
US company	510,000	0	(60,000)
Total	942,000	699,000	(22,000)

Table 3. Rate movement effect on profit and loss

Year-end 31/12/2006	€/$	€/£	£/$
Consolidated financial statements total	942,000	699,000	(22,000)
Reasonable shift	7.22%	4.33%	12.1%
Total effect on profit of + movements	68,000	30,000	(3,000)
Total effect on profit of - movements	(68,000)	(30,000)	3,000

currency and a US subsidiary a dollar functional currency. These three currencies are also the main currencies to which the group entities are exposed. Each entity holds monetary items in all three currencies.

The example (see *Table 2*) shows only the impact of FX risk on the group's consolidated profit and loss. The entities in the example do not apply hedge accounting nor hold any available-for-sale financial assets, which would create an additional FX exposure and affect the group's equity, which also would need to be flexed.

It is worth noting that the exposure on translating the financial statements of subsidiaries into the presentation currency does not need to be included in the sensitivity analysis.

The first step would be to highlight all the monetary amounts in each entity that are exposed to FX movements. The monetary items denominated in Thriving plc's functional currency are not included in the analysis because they do not create any accounting FX exposures. For example, for the parent company, only monetary assets or liabilities denominated in a currency other than euros will create FX exposure, say in dollars and sterling.

These amounts are then converted into euros using the closing rate on the balance sheet date. These are the amounts that will be exposed to changes in foreign currency rates, in our example to dollars/euros and sterling/euros. Next, the exposure is translated from the functional currency to the presentation currency, using the closing rate, in order to consolidate all exposures to a specific currency pair. The same process needs to be completed for the UK and US subsidiaries.

Finally, all data is consolidated and the sensitivity calculation performed. The reasonable shifts in exchange rates are based on historic volatility: if the €/$ rates moved by +/-7.22%, €/£ rates moved by +/-4.33%, and the £/$ rate moved by +/-12.16%, then the effect on profit/loss would be as in *Table 3*.

Treasury teams need to perform detailed sensitivity analysis to make the necessary IFRS 7 disclosures on market risks arising through the use of financial instruments. But by following a structured approach, these demands can be met effectively and efficiently.

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The case study – IFRS 7: Potential Impact of Market Risks – is available via PwC's website at http://www.ifrs.co.uk