Hedging headache

NEW STANDARD, NEW HEADACHE? **WILL BANKS** EXPLAINS HOW TREASURY DEPARTMENTS CAN SOFTEN THE BLOW OF ADOPTING THE IFRS 9 STANDARD.

The IAS 39 standard has been controversial since it first drew breath more than five years ago. The European Commission gave it a thumbs-down because it could "exacerbate income volatility", although Australia, New Zealand and Hong Kong have all endorsed it. The standard, which focuses on accounting for derivatives, has often caused conflict between what is an effective economic hedge and what is an effective accounting hedge.

An economic hedge is considered effective if it mitigates the risk of loss caused by price fluctuations. An accounting hedge is considered effective if it completely or partially offsets in profit and loss a change in the fair value or cashflows of a derivative. This conflict is sometimes reflected in the financial statements, making them less transparent and useful.

In general, industry has only just become comfortable with IAS 39, so there was little enthusiasm when the IASB (International Accounting Standards Board) announced that it in turn would be replaced by IFRS 9 by January 2013.

IFRS 9 aims to reduce the number of instrument classifications to two: fair value and amortised cost. Financial assets (non-tangible assets, such as bonds and equities) fall into either of these categories as determined by two tests: the business model test and the contractual cashflow characteristics test.

The business model test assesses whether the goal of the business model is to hold the financial asset to maturity and thus collect all of its contractual cashflows. The contractual cashflow characteristics test assesses the contractual terms of the financial asset by considering whether cashflow payments on specific dates are made solely based on the principal amount and that interest is based on the principal amount outstanding; a convertible bond, for example would fail the test.

Financial assets that pass both tests will be classified and measured at amortised cost. Those that fail one or both tests will be classified and measured at fair value.

The impact that IFRS 9 may have on earnings is unclear, as is the level of volatility it may generate.

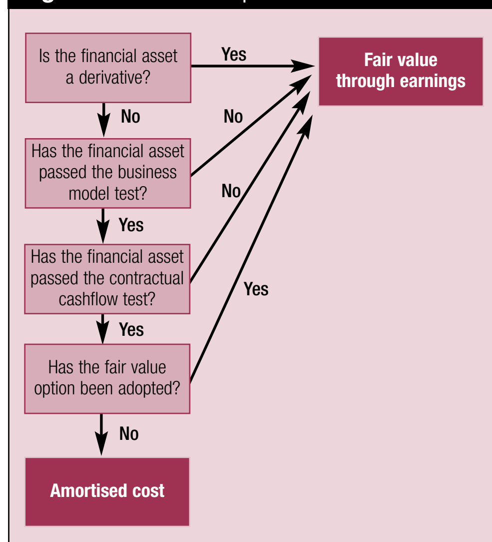
There is a change in approach towards embedded derivative packages, which may also impact earnings. IAS 39 measures derivative components at fair value with the host (principal and interest) at amortised cost. IFRS 9 does not separate embedded derivatives, so the whole package must be tested to determine if it is to be measured at amortised cost or fair value. This produces two possible outcomes:

- the removal of the embedded derivative mark-to-market from earnings; or
- the introduction of the host mark-to-market into earnings (in addition to any impact on earnings caused by the mark-to-market of the embedded derivative).

So what else does IFRS 9 have in store? Classification and measurement was released in 2009, and three further stages of the standard – impairment, hedge accounting and derecognition – are expected to be released between 2010 and 2012. The different stages of release, coupled with the different times companies adopt each stage, will make it difficult to compare various company financial statements.

While this new standard may seem daunting, its impact can be softened by planning in advance and taking preparatory measures. Recommended actions for treasury departments to take include:

Figure 1: The test process



- early adoption (including the requirement for comparatives) to understand the impact it will have on your financial statements;
- reviewing business processes and systems to ensure they comply with the new standard, such as the valuation methodology, since IFRS 9 is particularly focused on the credit element of valuations; and
- review your current hedging strategy and procedures as current policy may now be out of date and could cause you additional unwanted volatility and detrimental impact to earnings.

Whether IFRS 9 is just another headache or a welcome transformation, it is here to stay.

Will Banks is part of Sapient Global Markets.
cc_wbanks@sapient.com
www.sapient.com