Rule changes, anyone?

THE EFFECTIVE DATE FOR IFRS 9 MAY BE SOME WAY OFF, BUT WITH WIDE-RANGING IMPACT, TREASURERS WOULD DO WELL TO LOOK CLOSELY AT ITS IMPLICATIONS, DEE KOTHARI ARGUES

SHUTTERSTOCK

IFRS 9 – a conversation killer if ever there was one. But while the international financial accounting standard has gone through a long period of stop, start, review and consultation, it is finally time to take a closer look at its impact.

The standard is effective for annual periods beginning on or after 1 January 2018 and the new hedge accounting requirements are more principles based, less complex and provide better links to your company's risk management activities than IAS 39. IFRS 9 also allows companies to apply hedge accounting more broadly to manage profit or loss mismatches and improve what might be regarded as ineffective hedging under IAS 39.

Key changes introduced by IFRS 9

- The removal of the 80-125% highly effective threshold. Moreover, when there is a change in the economic relationship between the hedged item and the hedging instrument, an adjustment to the economic hedge ratio, known as rebalancing, can be introduced (see below).
- Generally, more items qualify for hedge accounting, for example, pricing components within a non-financial item and net FX cash positions.
- Companies can now hedge account exposures that give rise to two risk positions (for example, interest-rate risk and FX risk, or commodity risk and FX risk) that were previously managed by separate derivatives over different time periods.
- We can expect less profit-and-loss volatility using options, FX forwards and FX foreign currency swaps. For example, a time value/interest differential component can now be deferred under other comprehensive income (OCI) and can either be amortised to profit or loss, or capitalised into the hedged item, depending on the nature of the hedged item.
- New alternatives are available for economic hedges of 'own use' contracts that have the potential to reduce profit-and-loss volatility.
- Fair-value hedging at group consolidated level with offsetting hedge item positions is possible, for example, asset-side bonds at fixed-rate offset with liability-side fixed-rate bonds using an interest-rate swap.
- Cash-flow hedging at group-consolidated level with offsetting or net positions (for example, acquisition of a non-financial asset offset with non-financial liabilities) is permitted, providing critical terms are met.
- Equity investments at fair value through other comprehensive income (FVTOCI), where ineffectiveness can be recorded in OCI.
- Cash instruments measured at fair value through profit and loss (FVTPL) are eligible as hedging instruments, too.

Who benefits?

Organisations engaging in economic hedging activities (irrespective of applying

hedge accounting under IAS 39) have the greatest likelihood of benefiting from the changes. Corporates in mining and natural resources, airlines, agriculture and other industry sectors that use commodities are among those likely to benefit. The same goes for entities with significant foreign currency transactions or foreign funding sources that use derivatives to manage risk in their treasury and/or business activities.

How to use IFRS 9 hedge accounting

There are a few scenarios that highlight the main differences between IAS 39 and IFRS 9 in terms of its practical application:

Non-compliance with the company's risk management strategy: Under IAS 39, as long as the hedge is documented and effectiveness testing is met, hedge accounting is permitted. However, IFRS 9 states there is a requirement to comply with the risk management policy of the company to achieve hedge accounting. For example, rolling FX swaps or FX options to hedge three years out would not be permitted if the risk policy states up to two years only. Another example could be where the risk policy states that interest-rate risk can only be hedged when borrowings or funding is drawn or received. This policy would prevent treasury entering into a forward-rate agreement or forward-start interest-rate swap.

Conditions to achieve successful hedge accounting remain largely unchanged from the former standard, but IFRS 9 stipulates additional qualifying conditions on top of IAS 39. Importantly, an economic relationship must exist between the hedged item and hedging instrument; and credit risk must not dominate value changes from that economic relationship. For instance, physical purchase of jet fuel that will be priced off Platts' price benchmark with the reference derivative to a London Metal Exchange (LME) precious metal price (gold) would be disallowed, even though correlation is highly effective.

Rebalancing is prohibited under IAS 39, whereas IFRS 9 prospectively permits altering the hedge ratio without discontinuing or terminating an existing hedge-accounting relationship to improve effectiveness.

Hedge effectiveness: IAS 39 requires prospective effectiveness testing using a qualitative approach, such as 'critical terms' if met or a 'quantitative test' if critical terms are not met. Retrospective effectiveness testing requires a quantitative approach. On the other hand, IFRS 9 prospective effectiveness testing can be qualitative, using critical terms, which is acceptable still. Retrospective effectiveness testing is now no longer required.

Derivatives as hedged items: Derivatives are not allowed to be part of a hedged item under IAS 39. However, they are allowed to be part of a hedged item under IFRS 9. For example, imagine a GBP functional company issuing a 15-year, JPY-denominated fixed-rate bond. It synthetically converts it into a 15-year, fixed-rate GBP bond where critical terms are met using a cross-currency interest-rate swap. The company then decides to overlay the structure with a second GBP interest-rate swap paying floating one-month Libor and receives a fixed rate for 18 months. IFRS 9 would allow the second interest-rate swap as a hedging instrument for the first 18 months of the bond against the first cross-currency interest-rate swap, using partial-term hedging.

Commodity hedging: For hedges of non-financial items, for example, forecasted commodity sales or purchases, the hedged risk can only be the FX-rate risk or the entire cash-flow variability (which typically can include freight and insurance), and that increases the risk of hedge ineffectiveness under IAS 39. IFRS 9, on the other hand, states that we can select an observable and measurable risk component for the financial and non-financial hedged item, thus limiting variability, which would not impact hedge ineffectiveness. For example, we sold grade A zinc physical based, on the future average base zinc LME price plus freight for delivery in one month's time. The reference derivative here would be the zinc LME average price for the month.

Hedging a layer component: Cash-flow hedges under IAS 39 can be based on a proportion (percentage) or a portion (layer) of a specific item or group of items. However, a fair-value hedge is restricted to proportions of specific items, so that there is traceability to the hedged item. Under IFRS 9, however, a fair-value hedge can now be assigned as a percentage or proportion of the hedged item, for example, part of a monetary transaction volume, physical volume or nominal amount. For instance, hedge the first five million cubic metres of natural gas; the first 500 barrels of oil purchased; the first 500MWh of electricity sales; the last \$20m of a \$100m firm commitment; or \$50m of a total \$150m of floating-rate debt.

Net profit margin hedging for FX risk is not permitted under IAS 39. Surprisingly, and to the benefit of highly astute CFOs and treasurers, IFRS 9 allows the fair value of the derivative to be shown below the sales and cost of goods sold (COGS) line, as a 'hedging result' under a cash-flow hedge, as the accounting result of the derivative cannot be grossed up to affect both the sales and COGS line.

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What now?

While there is some time to go before mandatory adoption is upon us, there are some benefits to adopting IFRS 9 early. As a first step, setting up an IFRS 9 project team with treasury and finance colleagues in the driving seat and IT as business partners to set out your road map for IFRS 9 adoption is a task that should be undertaken sooner rather than later. As with all new international accounting standards, the impact will affect systems, people and processes time and time again.

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