4.7.1 Accounting in Financial Risk Management

Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

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Summary: Overview introducing the need for external reporting and accounting, with particular reference to reporting risk and use of financial instruments.

Keywords: reporting, regulation, accounts, financial statement, financial instrument, IAS 39, IFRS 9, IFRS 7, hedge accounting

Contents

1 Introduction 1
2 Communicating with investors 1
3 Reporting on risk 3
3.1 Risk management disclosure 3
4 Reporting the use of financial instruments 5
5 IAS 39, IFRS 9 and hedge accounting 8
5.1 IAS 39 - classification of financial instruments 8
5.2 IFRS 9 - changes to the classification of financial assets 9
5.3 IAS 39 - hedge accounting 10
5.4 IFRS 9 – hedge accounting 14

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Learning outcomes:

1. Reporting and accounting must always be considered as part of risk management.
2. Reporting and accounting maintains a flow of information to stakeholders.
3. Risk must be seen to be managed, as well as being managed.
4. Law enforces disclosure and behaviour.
5. Disclosure is quantitative and qualitative.
6. Derivatives are a large element of financial risk disclosure.
7. IAS 39 was a major leap in reporting:
   a) It talks about assets and liabilities and categorises them.
   b) It uses fair value as the guidance for accounts.
   c) All derivatives must now be on balance sheet
   d) Changes in fair value must be shown in the income statement.
8. Exceptions are allowed where hedge accounting is adopted, including: fair value hedges, cash flow hedges and net investment hedges.
9. IFRS 9 replaces IAS 39 and seeks to align hedge accounting with risk management activities

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1 Introduction

Reporting and accounting is not usually considered to be the most exciting task but as something that has to be done to keep investors and regulators happy after all of the interesting work has been finished. However, it is worth taking time to understand the underlying reasons for the need to report and therefore why it is given such weight.

The purpose of external reporting and accounting is to maintain a flow of verifiable information from the company to its stakeholders. These stakeholders are primarily shareholders and lenders although the needs of other users of accounts, such as the workforce or the general public, should not be ignored. The information must be verifiable and comply with a set of widely known and accepted rules otherwise the information cannot be relied upon. This reliability is vital if investors are to be protected from unscrupulous managers or fraudsters; financial markets – especially equity markets – cannot operate without strong controls to ensure investor protection.

External reporting – primarily the annual report and accounts – is the main avenue for communicating with investors. Inevitably it is 'after the event' but nevertheless it is a vital function for finance generally and for treasury in particular to explain to investors how the business has performed and how it has been managed.

This reading is designed only as an introduction to the topic and is not a substitute for proper advice.

2 Communicating with investors

The separation of ownership and management creates a requirement for owners (investors) to be provided with information about their investment. This information needs to be accurate, timely and relevant but above all it must enable the investor to make informed decisions about the likely risks and returns associated with continued investment. That is the base line – reporting, in an ideal world, is management telling investors what they need to know about their investment?

Of course, there is some debate as to the level and extent of information that should be disclosed, partly because too much detailed information could give away commercial secrets or risk overloading investors with information that they do not understand. On the other hand, it is important that the information provided is sufficient to prevent managers being able to hide unfavourable results or inappropriate actions which could lead to calls for their replacement if they were public knowledge.

The Chairman of the Securities and Exchange Commission (SEC), Arthur Levitt said in 1998 of the Asian financial crisis:

> 'The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial

situation in Asia … is a stark example of this new reality. These markets are learning a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news.'

There are many stories of surprise announcements by quoted companies. For example in early 2008 the UK's largest care home business, Southern Cross[1], had to ask its banks for a covenant waiver. As news of the request broke, the value of shares fell by 80% within a month. In recent years Rolls Royce has shocked the market with news releases and been criticised for its poor relationship with the City. Its shares have fallen around 50%.

This illustrates how panic can occur when bad news emerges unexpectedly. It also demonstrates the need to keep investors well informed, whether through annual reports and accounts or by interim accounts and announcements.

Ultimately, all business is about generating enhanced returns (i.e. returns above risk free rate) and thus creating shareholder value by taking on more risk. Therefore, investors expect management to take business risk, in order to create shareholder value, while reducing other risks to the business. This concept of 'expected to take' or 'expected to reduce' risk creates a moral contract between investors and management, which is the focus of corporate governance.

Risk policy and reporting are the core control and communication elements of the risk management framework, ensuring that the moral contract is understood and complied with.

Policies are the company's formal plans to manage risks which threaten its strategic aims – as agreed with investors. Reporting provides investors with the feedback they need in order to confirm that management are fulfilling their side of the moral 'expected to take…' contract. Reporting is thus an essential part of corporate governance. Equally, in order for management to perform their side of the moral contract, they have to receive regular information that allows them to understand the company's risk profile and how risk management action is progressing against targets.

It is therefore important that risk is not only managed but also seen to be managed externally as well as internally. Hence the Board should communicate with shareholders and other interested parties (lenders, rating agencies, analysts) on a regular basis, and the reports it uses should be closely aligned with the reports it uses internally. The following is a list of questions that interested parties should be able to answer having read through the material provided by a company:

- What is the company's philosophy towards financial risk?
- What are the company's policies with regard to the use of financial instruments (including derivatives)?
- Who formulates policies relating to financial instruments?
- What type of financial instruments can be used?
- Is there a limit system in place?

[1] Since fallen into administration.

- Is there a separation of duties between those who manage financial risk on a daily basis and those who record and report financial risk?
- Has the Board approved these policies relating to financial instruments?
- Has a risk management committee been established?
- How does the Board ensure the integrity of the Risk Management Committee?
- Is the Board regularly kept abreast of the financial exposures facing the company?

3 Reporting on risk

When reporting on risk, there is a trade-off between providing adequate information to enable an informed view and not giving too much commercially sensitive data. Understanding of risk creates a competitive advantage, so companies may want to keep their exact methodology to themselves. Similarly, the management of risk can generate competitive advantage and so again details may not be readily available. However, a minimum level of disclosure is mandatory and is specified by at least three generic bodies: by stock exchanges or other listing authorities, by accounting standards and by direct government legislation.

Clearly the most forceful of these is the direct government legislation. In the UK the various Companies Acts and in the US the Sarbanes-Oxley Act.

Until recently, accounting standard setters have been content to focus on the determination of the numbers and the certification that the numbers have been audited by a suitably qualified person or organisation. More recently, accounting standards have been issued that list specific disclosure requirements. These include IFRS 7 Financial Instruments: Disclosures.

Stock exchanges also require certain disclosures in order to fulfil their role as monitors of both an orderly market and protectors of their investors. Given that the 'equity culture' is said to be most ingrained in the Anglo-Saxon countries, it is no surprise that the US, Canada and the UK tend to have the stock exchanges and other regulators that require the most disclosure. Many countries supplement mandatory regulations with Codes of Practice – in themselves not 'required' but omission will be frowned upon.

3.1 Risk management disclosure

IFRS 7 is worth focusing on at this stage, as it substantially defines the highest level of detail in financial risk management disclosure, and is thus of core relevance to the treasurer. The standard requires full disclosure of the nature and extent of the financial risks (credit risk, liquidity risk and market risk) to which the company is exposed, together with details of how those risks are managed. It also lists detailed information to be disclosed regarding the current valuation and performance of all financial instruments[2] held by the company.

The stated objective of IFRS 7 is to enable users to evaluate:

a) The significance of financial instruments for the entity's financial position and performance; and

[2] A financial instrument is any asset or liability that is cash or a contractual right to deliver cash or deliver or exchange another financial asset or liability. It includes derivatives.

b) The nature and extent of risks arising from financial instruments and how the entity manages those risks.

In explaining how such risks are managed, each company must construct a clearly articulated financial risk management strategy that they are happy to see in their Annual Report.

The statement really forces management to tell its investors what financial risks it considers most important and what it is doing about them.

Part (b) is of the most interest to us as it focuses on the management of financial risk. It requires specific risk management disclosures, both qualitative and quantitative, that is, narrative descriptions supported by calculations.

Qualitative disclosures
For each type of risk, IFRS 7 requires:

- a narrative description of the exposure to risk and how it arises
- the objectives, policies and processes for managing the risk, including methods used to measure the risk
- any changes from the prior period.

Quantitative disclosures
Quantitative disclosures provide the figures to support the narrative descriptions above. They aim to help the users understand the extent of the exposures involved and also give more insight into the nature of those exposures by providing information on values, timings and the level of uncertainty involved in these figures.

The information disclosed should be based on the information provided internally within the company to key management personnel – for example the Board of directors or chief executive officer ('through the eyes of management' principle). This could be a treasury report or the relevant parts of the management accounts that cover financial instruments.

Companies are required to provide minimum quantitative disclosures to the extent not provided in the summarised management information above. These disclosures include:

- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk, and market risk and how each of these risks are managed as described below
- concentrations of risk

- Credit risk[3]
    - calculation of the maximum exposure
    - details of the age and credit quality of the assets
    - information about collateral or other credit enhancements obtained or called

[3] Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation – IFRS 7.

- Liquidity risk[4]
  - maturity analysis for remaining contractual positions
  - method used to manage these risks

- Market risk (that is, exchange rate, interest rate and other price risk)
  - sensitivity analysis (answering the question 'what if rates move') showing how profit or loss and equity would have been affected by 'reasonably possible' changes in market price
  - method used to prepare the sensitivity analysis

A good example of risk management disclosure can be seen in the Annual Report of the Potash Corporation of Saskatchewan ('PotashCorp'), Canada at www.potashcorp.com. PotashCorp reports under Canadian GAAP, but the disclosure of financial risks in the notes to the accounts is similar to (but more extensive than) required by IFRS 7. In addition, PotashCorp includes extensive disclosure and discussion of the non-financial risks to its business and their management, and clearly aims to give readers of its accounts as informative and balanced assessment of the overall risks to the business as it can.

In December 2011, the IASB amended the disclosure requirements in IFRS 7 to require information about all recognised financial instruments that are set off or netted in accordance with IAS 32 (paragraph 42). The new offsetting disclosure requirements are effective for annual periods that began on or after 1 January 2013.

Additional disclosures were added in November 2013 when the IASB issued IFRS 9 *Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)* resulting from the introduction of the hedge accounting chapter in IFRS 9.

As part of the IASB's Annual Improvements to IFRS's 2012-2014 cycle minor amendments to IFRS 7 were made clarifying that the offsetting disclosures do not apply to condensed interim financial statements.

4 Reporting the use of financial instruments

The problem at the core of the issue when reporting on the use of financial instruments is whether an instrument is being used to create risk or reduce risk.

Over the last twenty years there has been tremendous growth in the use of derivatives by both banks and corporates. Corporates have moved from using only straightforward financial instruments, such as cash, trade accounts, receivables and payables and long-term debt to the adoption of sophisticated risk management strategies using 'vanilla' derivatives such as forward foreign exchange and interest rate swaps, and more complex 'exotic' financial instruments such as options.

[4] Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities – IFRS 7.

However, a series of large corporate collapses in the early years of this century in which risk management instruments featured (e.g. Enron), has increased the need for communicating the use of derivatives so that now a minimum level of disclosure is mandatory. The issue which increased disclosure attempts to address, on behalf of investors and companies, is that the advent of financial engineering has created a problem in that the same instruments can be used both to manage risk by hedging and to create or increase risk for the company.

Hedging: is the process of trying to neutralise or smooth the impact of fluctuations in financial market variables on the company's cash flows.[5]

A foreign exchange forward contract, for instance, can be used as a hedging instrument to fix a future exchange rate and therefore reduce exchange rate risk. This is true providing that the company has a future requirement to buy or sell foreign currency that can be fulfilled by the forward contract. If not, then the forward contract is a purely speculative instrument.

Example 1: Uses of a financial instrument

Scenario 1

If we are a UK company and need to make a US dollar (USD) supplier payment in 3 months' time, we could fix the rate by entering into a forward foreign exchange transaction, to buy the amount of USD required to make the payment and sell GBP in 3 months. If the GBP/USD rate moved between now and then, the cost to us of the USD would not change – we would be 'hedged'.

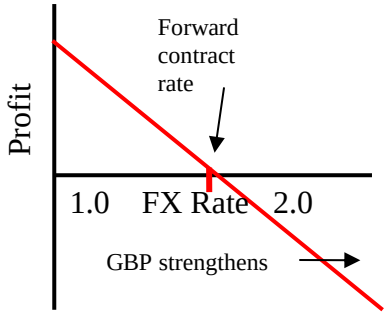
Scenario 2

Alternatively, we could be a foreign exchange speculator. We could enter into a similar foreign exchange transaction, to buy USD and sell GBP in 3 months. We would intend to make a profit from the transaction by selling the USD back to the market at a later date, at a lower rate than that at which we had bought them. This would enable us to make a GBP profit. Of course if rates increased, we would make a loss; but that is the nature of speculation.

The profit/loss on the forward contract in Scenario 2 under various GBP/USD rates at maturity is shown below. It shows a loss when GBP strengthens against the USD above the forward contract rate and shows a profit if GBP weakens.

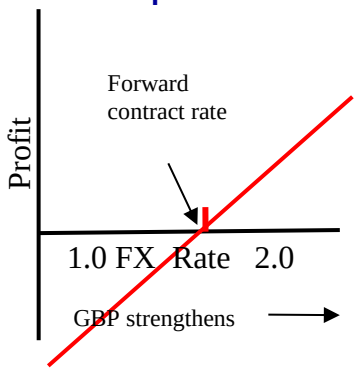
[5] Hedging strategies can also be focussed on protecting the balance sheet values such as the net investment in a subsidiary in which case the cash flow effect is long term or indirect

The Speculative - forward contract

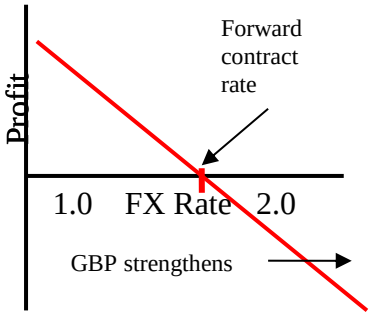


In Scenario 1, the USD supplier payment has the opposite profit/loss profile to the forward contract and this is shown as 'The Exposure' below. When a forward contract is used to hedge the full amount of the exposure, the profit/loss profiles of both 'The Exposure' and 'The Hedge – forward contract' cancel out and the company is no longer exposed to changes in the GBP/USD exchange rate as shown under 'Net hedged exposure' below.

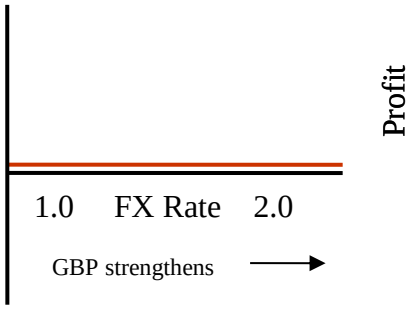
The Exposure



The Hedge – forward contract



Net hedged exposure



So the risk profile of the forward contract (the derivative contract) is the same in either case - it is the use to which it is put that determines the effect of the instrument on the risk profile of the company.

Financial reporting rules provide a standardised framework for distinguishing the use to which instruments are put. This gives rise to the need to designate instruments as 'hedges' where appropriate and also the need for rules to govern the designation process. These two needs are met by the technique of 'hedge accounting'.

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5 IAS 39, IFRS 9 and hedge accounting

Historically, before the advent of 'fair value[6] accounting' (IFRS and the US equivalent), derivatives were largely accounted for off balance sheet as they were accounted for in cash flow terms i.e. as cash flows occurred rather than in value terms. The corporate collapses of the 1990's and early 2000's highlighted the flaw in this methodology in that management were taking bets on the financial markets using financial instruments that could be held off-balance sheet, invisible from the investor. The increased disclosure requirements during the late 1990s failed to solve the problem.

Under IAS 39 and many jurisdictions' local GAAP (e.g. FAS 133 in US), all financial instruments must now be accounted for on the balance sheet at fair value. As rates change, the values of the instruments change so we need to be able to deal with the gains or losses arising due to the changes in balance sheet values. This is achieved by creating categories to which all financial instruments must be assigned. Financial instruments are classified into various categories depending upon the type of instrument, which then determines the subsequent measurement of the instrument (typically amortised cost or fair value). Special rules apply to embedded derivatives and hedging instruments.

IAS 39 *Financial Instruments: Recognition and Measurement* outlines the requirements for the recognition and measurement of financial assets, financial liabilities, and some contracts to buy or sell non-financial items. IAS 39 was reissued in December 2003, applies to annual periods beginning on or after 1 January 2005, and will be largely replaced by IFRS 9 *Financial Instruments*. The IASB issued IFRS 9 (2014) as a complete standard in July 2014 and is effective for reporting periods beginning on or after 1 January 2018.

5.1 IAS 39 - classification of financial instruments

IAS 39 requires financial instruments to be classified under one of the following categories:

- Assets and liabilities at fair value through profit or loss (FVTPL[7]). This includes both assets held for trading as well as any financial asset that is designated at initial recognition as one to be measured at fair value through the income statement, other than those which are differently classified by election. All derivatives fall within this category.
- Available-for-sale assets (AFS) are those non-derivative financial assets which are not HTM or LR (see below) and that are designated as available-for-sale. Fair value revaluation gains and losses are directly posted to equity until disposal at which time they must be recycled to the income statement. Note that even for AFS assets foreign currency gains and losses as well as interest income are posted to profit or loss.
- Held to maturity instruments (HTM), are financial instruments with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those which are differently classified by election.

[6] *Fair value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction – IAS 39.
[7] Sometimes seen as FVPL.

- Loans and receivables (LR) are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those which an entity intends to sell in the short term or which are differently classified by election.

The classification determines how instruments are to be shown in the financial statements and how gains and losses will be treated. Gains and losses are either taken to the Income Statement directly, held in reserves (part of equity) or amortised over the life of the instrument. Clearly if the instrument is held as a means to trade on the financial markets then a gain (or loss) should be taken to the Income Statement because a gain on the trade generates a profit while a loss on the trade generates a loss.

The general rule is that financial instruments in the first two categories are measured at fair value, while those in the last two categories are measured at amortised cost, that is, with the income or expense (including fees) spread over the life of the instrument on effective interest rate basis.

But if there is an offsetting underlying exposure (in other words if the instrument is being used as a hedge) then, assuming the hedge is effective, any gain or loss on the instrument should be treated in the same way as the equal (assuming the hedge is matched to its underlying perfectly) and opposite loss or gain on the underlying exposure. In either case therefore (trading or hedging), in principle, the accounting should match the economics.

How to calculate the fair value of a financial instrument

The general rule is that, where quoted prices or rates exist in an active market for the instrument, they must be used to determine the fair value.

Quoting from IAS 39:

> 'Fair value is the amount for which the financial asset could be exchanged or the financial liability settled, between knowledgeable, willing parties in an arm's length transaction.'

That is, the fair value is the price at which an instrument can be unwound or closed out. That is:

- The bid price should be used for an instrument that was originally bought.
- The ask/offer price should be used for an instrument that was originally sold.

However, *mid rates* may be used if there are offsetting assets and liabilities, i.e. offsetting risk positions.

Where market rates are not available, another suitable pricing model may be used, e.g. option pricing models such as the Black Scholes model is commonly used to value option contracts.

5.2 IFRS 9 - changes to the classification of financial assets

IFRS 9 *Financial Instruments* (covering classification and measurement of financial assets only) was issued in November 2009 in the first step in its project to replace IAS 39 in its entirety. In February 2014 the IASB announced that the effective date for IFRS 9 will be 1 January 2018. (The original effective date was 1 January 2013 and later amended to 1 January

2015). Although early adoption is allowed, it has not yet been endorsed by the European Commission for use by companies based in Europe and so such companies are not currently able to adopt the standard[8]. However non-EU countries such as Switzerland, Australia and South Africa are able to adopt early and for all companies it is important to be aware of the implications of changes that will soon be in force.

IFRS 9 replaces the multiple classification and measurement models in IAS 39 with a single model for financial assets that only has two classification categories:

- amortised cost
- fair value

A financial asset will be measured at amortised cost if both of the following two criteria are met:

- The objective of the business model is to hold the financial asset for the collection of the contractual cash flows (rather than to sell the instrument prior to maturity and realise its fair value changes).
- The contractual cash flows under the instrument solely represent payment of principal and interest.

If one or other of the two criteria is not met, the financial asset will be shown at fair value.

All fair value changes must be recognised in the income statement. The ability to carry non-equity financial assets at fair value through equity is therefore removed.

Equity investments can be designated at inception as at fair value through equity. Dividend income on such investments (e.g. an ordinary share in Nestle) is recorded in profit or loss and all other changes in fair value are recorded in the shareholders' equity. These gains or losses are not recycled when the shares are sold.

As for IAS 39, there are exceptions to the general rule for a financial asset that is allocated to a recognised hedging relationship.

5.3 IAS 39 - hedge accounting

IAS 39 *Financial Instruments: Recognition and Measurement* has been in existence for over a decade. Since November 2010 the IASB together with the US Financial Accounting Standard Board (FASB) have been reviewing hedge accounting with the aim of establishing a more objective based application to hedge accounting and also to more closely align it with an entity's risk management policies and practices. This culminated in the publishing of IFRS 9 *Financial Instruments (hedge accounting)* – refer section 0.

Two key principles underlie hedge accounting. Firstly, the hedged transaction or risk must have the potential to affect profit or loss. Secondly, although many risks within the financial

[8] This is expected in the second half of 2016

items may be designated as hedged, they must be separately identifiable and reliably measurable.

Three forms of hedge accounting are recognised by IAS 39:

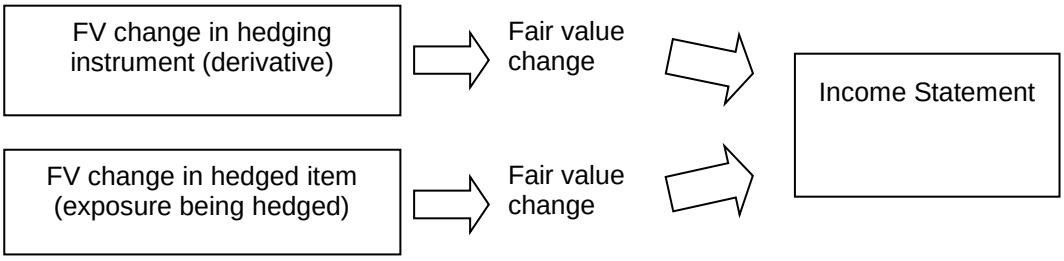
- fair value hedge
- cash flow hedge
- net investment hedge

A *fair value hedge* is a hedge of the exposure to changes in fair value of a recognised asset or liability, or an unrecognised firm (i.e. binding) commitment. Examples: protecting the market value of an investment or of debt.

Any change in the fair value of the hedged item due to changes in the hedged risk (e.g. interest rate risk) are matched to changes in the fair value of the hedging instrument, which should be directionally opposite, and posted to the Income Statement in the same period.

Exhibit 1: Accounting for a fair value hedge

(Any ineffectiveness automatically recognised in the income statement)



A cash flow hedge is a hedge of the exposure to variability in future cash flows – arising from a recognised asset or liability or a highly probable forecast transaction – that could affect profit or loss.

Examples:

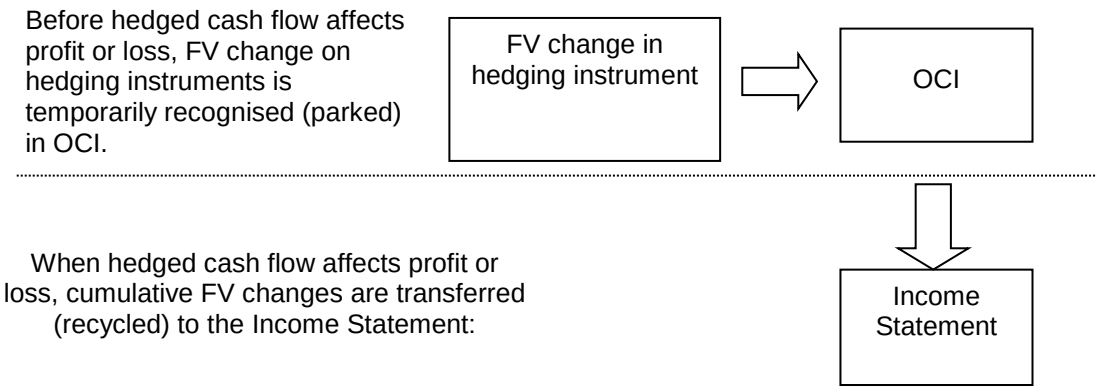
- fixing the interest rate on floating rate debt
- fixing the exchange rate for a forecast future export sales receipt denominated in foreign currency

Changes in the market value of the hedging instrument are initially recognised (or ‘parked’) in a ‘hedging reserve’ in equity called Other Comprehensive Income (OCI). They are transferred (recycled) to the Income Statement when the hedged transaction affects the income statement.

Any ineffective portion of the gains and losses is recognised in the Income Statement immediately.

Exhibit 2: Accounting for a cash flow hedge

(To the extent that the hedge is effective)



A net investment hedge is a hedge is of the net investment in a foreign operation.

Accounting for a net investment hedge (consolidated financial statements only)

Where a foreign currency loan has been used to hedge the net investment in a foreign operation, the transaction should be accounted for in a similar way to a cash flow hedge.
That is, to the extent that the hedge is effective, changes in the fair value of the hedging instrument are initially recognised in 'other comprehensive income' in equity. They are transferred (recycled) to the income statement on disposal of the foreign operation. Gains and losses in relation to each hedged foreign net investment and the related hedged should therefore be tracked meticulously.

Rules for qualifying for hedge accounting

In order to prevent management from trying to use hedge accounting to benefit from gains but hide losses away in equity and to prevent undercover speculation strict criteria must be met before hedge accounting may be used.

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met:

- At the inception of the hedge there is formal designation and documentation in place both of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge;
- The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, and this is consistent with the originally documented risk management strategy for that particular hedging relationship;
- Any forecast transactions that are the subject of a cash flow hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect net profit or loss;
- The effectiveness of the hedge can be reliably measured; and
- The hedge is assessed on an ongoing basis and it is shown to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Effectiveness testing

We can see from the qualifying rules that a hedge needs to be tested for effectiveness both at the start (prospective testing) and on a continuing basis throughout its life (retrospective testing).

As a minimum retrospective tests must be performed at each external financial reporting date, including that of any interim financial statements.

A tolerance range is specified for use with retrospective testing.

For the "dollar-offset" method (a simple ratio calculation), one of the more popular effectiveness testing methods, for each reporting period or cumulatively (the company can choose which basis to adopt in their risk management procedures):

$$\frac{\text{Change in fair value of the hedged item}}{\text{Change in fair value of the hedging instrument}} \text{ should be within the range 80-125\%}$$

This is sometimes referred to as 80:125 test.

Example 2: Dollar-offset method

Company Z is hedging the risk of a change in the fair value of debt (the hedged item) using an interest rate swap (the hedging instrument).

The change in fair value of the debt during the period is £100 but the change in the fair value of the interest rate swap is £110.

Effectiveness test – the relative change in fair values is within the 80-125% range.

Ineffectiveness amount – 10%.

Since changes in fair value of the hedging item and the hedged instrument are recognised in profit or loss so as to offset changes in the fair value, all hedged ineffectiveness is automatically recognised in profit or loss in the relevant period.

Splitting a hedging instrument in order to improve hedge effectiveness

Normally, a financial instrument can only be designated as a hedging instrument in its entirety because it can be difficult to value partial instruments.

There are two exceptions where hedging instruments can be split into component parts and just one part used in a hedge relationship in order to improve hedge effectiveness. These are listed below and will be examined in more detail elsewhere:

- Option contract: the intrinsic value (that is, the difference between the strike price and the current market price) can be separated from the time value; only the intrinsic element is then designated as the hedging instrument.

- Forward contract: the spot element can be separated from the interest element (i.e. the forward points adjustment) and only the spot element designated as the hedging instrument. Although splitting the forward contract results in forward points volatility in the income statement, this volatility is usually not material and could be a small price to pay compared to the resulting simplification of the hedge effectiveness test.

5.4 IFRS 9 – hedge accounting

In July 2014 the IASB published a complete IFRS 9 (2014) standard which includes the amendments previously issued including revisions to the general hedge accounting model. The new model is generally perceived as a good change replacing some of the arbitrary rules by more principle –based requirements. IFRS 9 also allows more hedging instruments and hedged items to qualify for hedge accounting and overall is trying to more closely align hedge accounting with the corporate's risk management strategies.

The basics of hedge accounting do not change as a result of IFRS 9. There are still three types of hedging relationships: fair value hedges; cash flow hedges; and net investment hedges. Hedge accounting still remains optional and as with IAS 39 to qualify for hedge accounting, a hedge relationship has to consist of eligible hedging instruments and eligible hedged items. Also at inception of the hedging relationship there still needs to be formal designation and documentation of the relationship.

The main changes to the IFRS 9 hedge accounting model:

Designation of non-financial risks as hedged item

IFRS 9 more closely aligns hedge accounting with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures. IAS 39 allowed components of financial items to be hedged but not components of non-financial items. For example under IAS 39 airlines are not able to hedge account the oil price component of their jet fuel price exposure, even though from an economic perspective they typically hedge this risk with derivatives. Under IFRS 9 it is possible to designate risk components of non-financial items as the hedge item provided the risk component can be separately identified and reliably measured.

Designation of derivative as hedged item

IAS 39 precludes derivatives from being designated as part of a hedged item for accounting purposes. However IFRS 9 expands the range of eligible hedged items by including aggregated exposures that are a combination of an exposure that could qualify as a hedged item and a derivative. This allows corporates to hedge more than one type of risk over a time period. For example, some commodities are based in USD which gives rise to both commodity and FX risk. The corporate can now hedge the commodity risk first and then in a later period hedge the FX risk by aggregating the original exposure with the commodity hedge.

Hedge effectiveness testing

The new model allows an entity to use information produced internally for risk management purposes as a basis for hedge accounting. Hedge effectiveness testing is prospective only and can be qualitative depending on the complexity of the hedge. The 80-125% 'bright lines' threshold for hedge effectiveness currently required under IAS 39 has been replaced by an

objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument. However a prospective effectiveness assessment is required on an ongoing basis and as a minimum at each reporting date.

Groups of items

IAS 39 was designed for a hedge relationship to consist of a single hedging instrument hedging a single item. A group of items was only eligible as a designated hedge if the individual items share the same designated risk exposure and the change in the fair value attributable to the hedge risk for each individual item in the group is approximately proportional to the overall change in the fair value attributable to the hedged risk of the group. Many hedges fail the second criteria. IFRS 9 allows hedge accounting to apply to a group of items if the group consists of items or components of items that would individually qualify for hedge accounting and for risk management purposes the items in the group are managed together as a group.

Time value of options

IFRS 9 introduces a new accounting treatment for changes in the fair value of the time value of an option, if only the intrinsic value is designated in the hedging relationship. Changes in the fair value of the time value of options are first recognised in OCI and subsequently amortised or moved to profit or loss depending on the nature of the hedged transaction i.e. transaction related hedged item or time-period related hedge item.

Own credit

IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of an entity's own debt when the entity has chosen to measure that debt at fair value under the fair value option. Changes to the fair value of an entity's own debt caused by changes in its own credit quality are recognised in OCI. This change to IFRS 9 would not typically apply to corporates as they don't tend to account for their debt at fair value.

Mandatory effective date

The previous mandatory effective date of 1 January 2015 was removed as part of the amendments made to IFRS 9 in November 2013. In February 2014 the IASB announced that the effective date for IFRS 9 will be 1 January 2018 with early adoption allowed (subject to local endorsement requirements).