

IFRS 9: INTRODUCING FLEXIBILITY INTO RISK MANAGEMENT

The flexibility that comes with IFRS 9 will allow companies to manage risk more efficiently and effectively, write **Derarca Dennis** and **Emer Keaveny**.



The unprecedented volatility in financial markets that has been witnessed in recent times has adversely impacted on many entities which have not been able to manage their risk exposures effectively. This has been exacerbated in some cases by the fact that hedge accounting under IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) was at times difficult to achieve in practice, resulting in income statement volatility.

IAS 39 has often been criticised as being complex and rules-based, thus ultimately not reflecting an entity's risk management activities. With the introduction of the new financial instruments accounting standard, IFRS 9 *Financial Instruments* (IFRS 9), which will replace IAS 39 in its entirety, we now have what is viewed as a more risk management-friendly standard. IFRS 9 has

also replaced some of the arbitrary rules in IAS 39 through more principle-based requirements and allows for more hedging instruments and hedged items to qualify for hedge accounting.

The high-level aim of the new standard with regard to the hedging model is to provide useful information about risk management activities that use financial instruments, with the effect being that financial reporting will reflect more accurately how entities manage their risks and the extent to which any hedging undertaken mitigates those risks. Ultimately, the goal is to ensure that there is a clearer link between an entity's risk management strategy, the rationale for hedging and the impact of that hedging on the financial statements.

In the past, the use of certain hedging instruments gave rise to potentially adverse

accounting (i.e. volatility in the financial statements). The misalignment between optimum economic risk management and the associated accounting has had very real impacts on earnings due to the requirements that had to be met in order to achieve hedge accounting treatment under IAS 39. IFRS 9 eases many of the accounting obstacles, giving corporate treasurers an opportunity to deploy the hedging instruments that best meet their risk management needs and that will achieve hedge accounting treatment.

IFRS 9 has a mandatory adoption date of 1 January 2018 with early adoption permitted for financial years beginning on or after 1 January 2017. With the EU endorsement process expected to conclude in Q4 2016, early adoption should be strongly considered by finance and corporate treasury functions as it presents a

real opportunity to access the considerable benefits IFRS 9 offers by allowing them to manage their risks in the most efficient and effective manner.

The benefits that may be realised through the adoption of the new hedge accounting model include:

- Increased transparency for shareholders as a result of better linkages between financial statements and the risk management strategies employed by management;
- Reduced volatility in the income statement due to an increased ability to achieve hedge accounting treatment;
- Removal of 'bright-line' rules relating to retrospective hedge effectiveness testing;
- More flexibility in risk management strategies being applied due to eligibility of components, rebalancing and net positions for hedge accounting;
- Potential to reduce ineffectiveness and costs of hedging as a result of being able to enter into derivatives that manage correlated and net positions more efficiently; and
- More favourable treatment of unavoidable 'costs of hedging' such as time value of options.

QUALIFYING CRITERIA AND EFFECTIVENESS TESTING

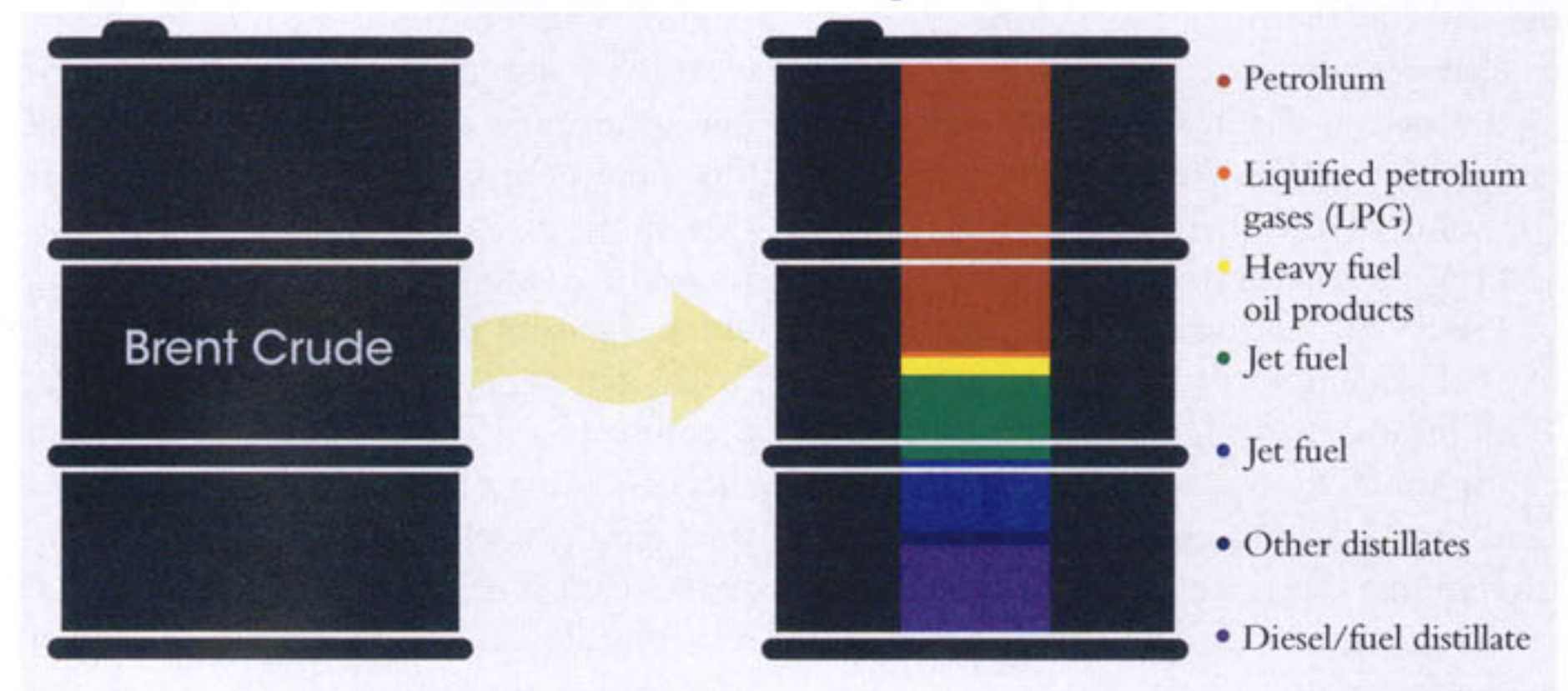
One of the biggest changes with the introduction of IFRS 9 has been the removal of the retrospective effectiveness assessment requirement and the 80-125% rule that many have found a frustration in the past. To qualify for hedge accounting under IFRS 9, the following effectiveness requirements must be met:

- There must be an 'economic relationship' between the hedged item and the hedging instrument;
- The effect of credit risk must not 'dominate the value changes' that result from that economic relationship; and
- There must be a balance in the ratio between the quantity of the item being hedged and the quantity of the hedging instrument being used.

As noted above, IFRS 9 introduces the concept of an economic relationship between a hedged item and a hedging instrument in order for hedge accounting to be applied. The approach adopted by

Figure 1:

Predominant drivers of volatility



companies to assess effectiveness may, in certain circumstances, be qualitative only. The critical term 'matching concept' can be applied to prove that there is an economic relationship between the hedged item and instrument. In practice, this can sometimes be difficult to achieve due to basis risks and timings. Correlation can also be proven through regression analysis and this has already been used by some companies implementing IFRS 9 in demonstrating the economic relationship concept using a quantitative approach. The key point is that there are a number of ways to prove that an economic relationship exists, many of which would already be considered by risk managers before entering into any derivative instrument to hedge an exposure that may result in an increased ability to meet hedge accounting criteria.

HEDGING COMPONENTS OF NON-FINANCIAL ITEMS

A further change from the world of IAS 39 hedge accounting is the ability to hedge a component of a non-financial item under IFRS 9. Previously, many companies with exposures to commodity price risk struggled with accounting mismatches as a result of basis risk (i.e. a difference in how the hedged item and hedging instrument are priced) being included in the assessment of hedge effectiveness.

IFRS 9 now shifts how a risk manager views their exposure. In the past, where risk managers tried to hedge a variable that they had determined to be the predominant driver of price variability in a non-financial item, IAS 39 required them to hedge all the variables in the non-financial item and this sometimes resulted in unfavourable accounting arising from a good risk management decision.

IFRS 9 has addressed this by recognising that there are multiple variable price elements (risk components) that

risk managers may look at in isolation. A risk component can be hedged once it is separately identifiable and reliably measurable. This creates an opportunity to remove any price basis risks that may have caused ineffectiveness and consequently, profit or loss volatility under IAS 39.

By making risk component hedging available under IFRS 9, commodity-based hedging will become more flexible. This change will be welcomed by many sectors and in particular, the transport sector where refined products used for fuel are often priced on more than one variable, such as the biodiesel and diesel fuel oil components making up the fuel price for certain fuel types or jet fuel being made up of various price components. Under IFRS 9, a company can isolate the predominant drivers of volatility, such as the diesel fuel oil in Figure 1, and hedge this in isolation, making for a more effective hedge relationship and strategy.

By hedging specific components, companies now have the option of entering into one derivative that sufficiently hedges the dominant component within an identified exposure or designating derivatives as a hedge of each component separately. Both options now give the risk manager more flexibility in how they approach risk management than was previously permitted in an IAS 39 world.

REBALANCING

Treasury functions managing a company's risk understand that the conditions on which they based historic decisions can sometimes change and, as a result, the ratio or amounts hedged may need to change in response. Under IAS 39, where a hedge ratio is revised, companies have to discontinue the hedge accounting relationship in its entirety and restart a new hedging relationship, which can lead to ineffectiveness. This was common for

companies that hedged transaction risk for either price or foreign exchange where the dates of the transactions were subject to change. This has caused ineffectiveness in the past as the re-designated hedging instrument would likely have a non-zero fair value at the inception of the hedge accounting relationship.

IFRS 9 introduces the concept of 'rebalancing' a hedge relationship. This means that the hedge relationship continues if the quantity of the hedged item or hedging instrument changes in response to a change in conditions, reducing in turn this source of potential ineffectiveness.

IFRS 9 allows for changes to the documentation and hedge ratio for accounting purposes to align with the hedge ratio for risk management purposes on a prospective basis, with all previous deferred gains and losses remaining in equity. IFRS 9 will therefore afford risk managers and finance functions more flexibility in managing their exposures through rebalancing. A consequence of linking discontinuation of a hedge to a change in the risk management objective is that voluntary discontinuation, where there is no change in the risk management objective, is not permitted.

NET POSITIONS

IFRS 9 expands the range of eligible hedged items by including synthetic exposures (i.e. a combination of a derivative and non-derivative) and aggregated exposures (i.e. net positions). Under IAS 39, where a company wanted to manage price exposure on a non-financial item such as jet fuel, they would use a hedging instrument priced in US dollars which leaves the company with a US dollar foreign exchange exposure to hedge. Another derivative and hedge relationship would then be entered into to hedge that risk. The concept of a derivative hedging a position that contained another derivative was not allowable under IAS 39. This meant that an entity had to maintain hedge relationships and documentation separately for each hedging relationship, unless both were designated in a combined hedge relationship which was sometimes not practical.

IFRS 9 now allows companies to use a derivative to hedge an exposure that is made up of a derivative and non-derivative instrument and still avail of hedge accounting. This will be a significant benefit to many companies as they can manage their overall risk to

both the commodity price and foreign exchange risk on fuel prices, with more flexibility by looking at the total exposure.

IFRS 9 also addresses the eligibility of net positions as hedged items. Under IAS 39, some companies have managed their exposures on a one-to-one basis. This means that more derivatives were being entered into in order to manage risk.

By looking at exposures on a net basis, a company can now see where they are short and long on certain risks and address this appropriately. Instead of designating gross exposures into IAS 39 hedge relationships and entering into a higher number of derivatives, these companies may now be able to manage exposures on a net basis. This will result in increased efficiency while managing risk effectively.

COSTS OF HEDGING

Currently under IAS 39, entities can designate the intrinsic value of an option or the spot element of a forward contract. When doing so, the changes in fair value of the time value of the option or the forward points of the forward contract are accounted for in profit or loss, resulting in potentially significant profit or loss volatility.

In response to these concerns, IFRS 9 introduces a new accounting treatment for changes in the fair value of the time value of an option where only the intrinsic value is designated in the hedge relationship. The cost of hedging, being the time value of the option, is treated separately depending on its relationship to the hedged item. Where the hedge relates to a transaction-based item, such as a hedge of a future purchase of property, plant and equipment in a foreign currency, the costs of hedging would be included within the initially-recognised cost of the property plant and equipment purchased as a basis adjustment.

If the hedged item is expected to impact profit and loss over a period of time, such as a floating rate bond, then the costs of hedging should be treated in a systematic manner, being amortised in line with when the hedged risk occurs in profit and loss.

IFRS 9 also includes an optional accounting treatment for the forward element of a forward contract. This applies when only the spot element of the forward contract is designated as the hedging instrument. Where this treatment is chosen, the change of fair value of the forward element is recognised in other comprehensive income and the forward

element is amortised to profit and loss on a rational basis. A similar treatment is also available for the foreign currency basis spread of a financial instrument if it is excluded from the designation as the hedging instrument.

This treatment means that these 'costs of hedging' can be recognised in profit or loss at the same time as the hedged transaction, rather than these elements affecting profit or loss like a trading instrument. This will result in the accounting treatment being more aligned with how a risk manager would view these costs.

CONCLUSION

The potential conflict between optimum risk management decisions and the associated accounting under IAS 39 has had, at times, an adverse impact on both working capital and earnings. There is now a real opportunity to access the considerable benefits that IFRS 9 offers to those looking to manage their risks in a more efficient and effective manner. Risk managers should therefore consider reviewing current practice to identify opportunities to capitalise on the standard's changes and fully realise all available benefits – be that a reduction in cost, volatility, risk or complexity. In some companies, risk management has been conducted within the boundaries of what could be achieved from the end accounting result. IFRS 9 now removes many of those barriers and allows risks to be managed more effectively. Instead of looking at risks in isolation, IFRS 9 brings a more flexible and integrated approach to risk management.

To gauge the benefits of the new requirements, companies should consider the overall risks they are exposed to; hedging activities to mitigate those risks; existing hedge accounting; and the reasons why hedge accounting may not have been achieved in the past. By identifying the many risk components that a company is exposed to, and managing those risks in a more integrated way, IFRS 9 has introduced the flexibility required to enable companies to manage risk more efficiently and effectively.



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