IFRS 9 OPENS UP MAJOR HEDGE OPPORTUNITIES, BUT WITH A COST

May 2016

Many companies use hedge accounting to offset significant risks from commercial or financial exposures. The new standard on financial instrument accounting under IFRS 9 will transform how they do so.

Given the continued volatility of commodity prices, interest rates and foreign currency exchange, well calculated hedging is increasingly applied to day-to-day financial management. But the accounting for it will remain complex and not without inconvenience, an audience of treasury executives has heard.

Speaking at a Bloomberg event in April in London, titled *'Hedge accounting under IFRS 9: unlock the possibilities'*, industry experts stated there are nevertheless some clear opportunities for companies within the new standard, which will be effective for annual accounts starting from January 2018 onwards.

Less volatility from options

A number of factors in the new standard remain the same as the existing IAS 39 rules. Hedge accounting remains optional, and when it is used as a method, its effectiveness still needs to be assessed, measured and reported, just in a more qualitative manner.

Within the detail of the standard, there are some major changes that bring both new opportunities and new demands.

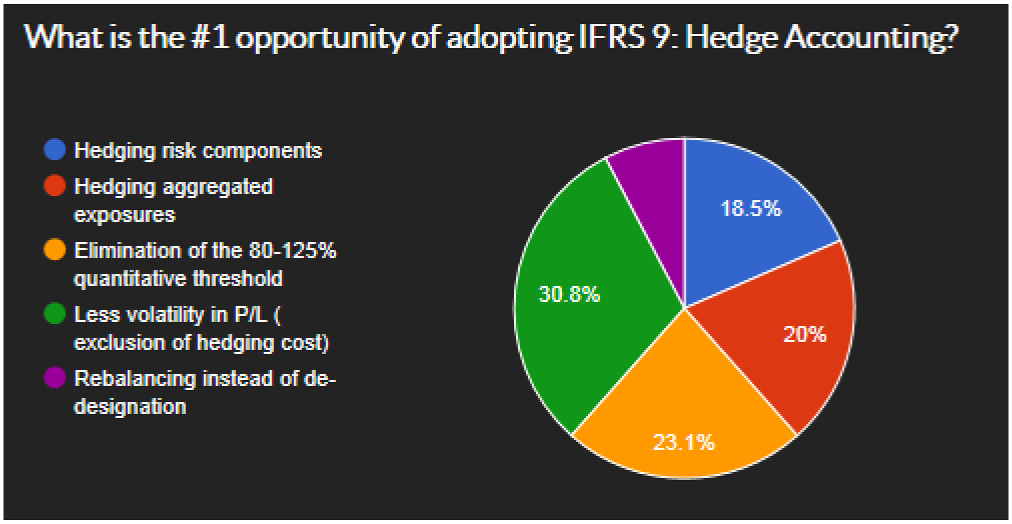
They include a fresh way to account for the change in time value of an option, when such an instrument is used as a hedge and the time value is excluded from the designation. Under the existing IAS 39 rules it was typically recognised directly within profit or loss, leading to volatility in profit or loss and even deterring some companies from hedging at all with options.

With IFRS 9, time value can be accounted for as a cost of hedging, temporarily bleeding the fair value movement through the balance sheet, and is likely to encourage more companies to hedge with such options.

Indeed in a live audience poll at the event, the cost of hedging approach was cited as the main IFRS 9 opportunity by nearly one third of delegates.

Bloomberg

Kush Patel, Partner in Deloitte's UK IFRS Centre of Excellence, said in a keynote presentation that "many have welcomed this change" because of the reduced volatility in profit or loss, but warned that with structured options "it's not always straightforward".



Effectiveness threshold

Another change is proving popular. The abandonment of a strict quantitative threshold, around the demonstrable effectiveness of hedges, was supported by over a fifth of the audience as the greatest opportunity. Aisling Kavanagh, Senior Manager of Corporate Treasury Services at Deloitte, said that among the firm's clients, "most people are excited about the removal of the 80 to 125% threshold".

In essence the rule, which had been set under IAS 39, stated that companies could apply hedge accounting if tests showed that it would offset - or had offset - 80 to 125% of the hedged risk.

IFRS 9 has moved instead towards a need to demonstrate a much closer and high quality economic relationship between an item and its hedging instrument, instead of holding businesses to a demanding figure. The opportunity here is great, as it allows more realistic linking of the two, through a qualitative demonstration. Entities will still need to measure ineffectiveness, however, if qualitative assessments indicate it has arisen.

Hedging risk components and derivatives

Patel drew strong attention to the beneficial increase in the scope of items eligible for hedge accounting, including separating risk components of non-financial items. Such items can be included as long as they are separately identifiable and reliably measurable. Under IFRS 9, companies can hedge account against those specific components, improving the reporting of risk management.

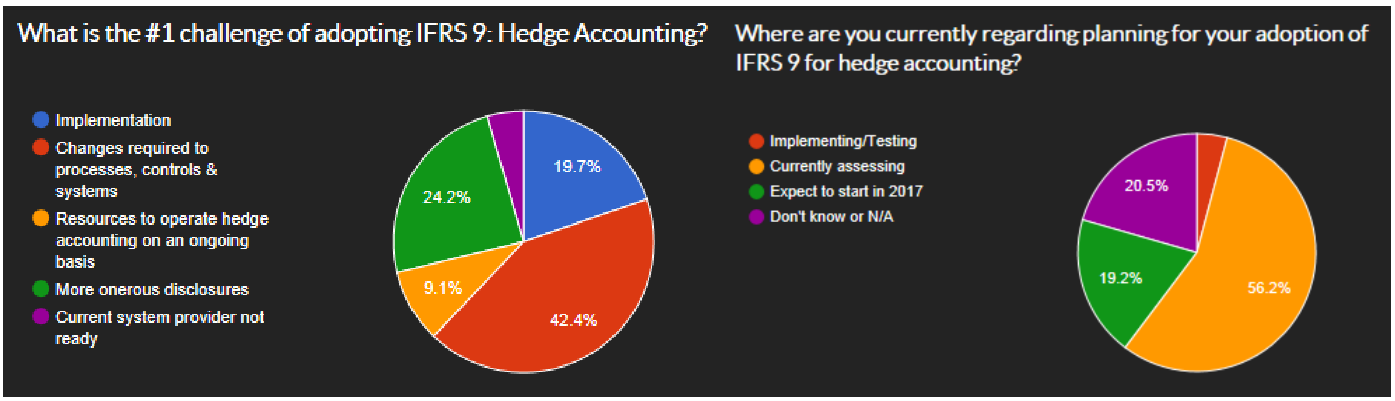
Equally, the move to allow hedging of aggregated exposures, so that derivatives can be hedged alongside traditionally hedged items in one package, was described as further reducing volatility in profit or loss and better reflecting risk management realities.

Nevertheless, delegates were advised to pay close attention to the specific rules, with Patel adding that the "devil was in the detail" of its text.

Where businesses are at

The live polling of treasury managers at the event revealed some interesting facts about their planned adoption of IFRS 9. Nearly six in 10 are currently assessing the requirements, with 19% planning to start work next year. Many were unsure of the future effects, but a number expected to adopt new strategies and take on new derivative products.

IFRS 9's significantly higher disclosure requirements around risk management and effect of hedging, require significant change. It is essential to have the right technology and data, and over 40% of event delegates warned that the necessary changes to processes, controls and systems would create the greatest burden.



Kavanagh said many companies, may use the new rules "as reason to implement or upgrade their treasury management system" alongside the process and policy changes.

A number of software suites are available to businesses as they tackle these challenges. These include Bloomberg's own Treasury and Risk Management system, which helps companies run a fully integrated treasury workflow from execution and management to reporting.

The urgency to act, with the right processes, people and technology, is clear. "Businesses need to think about this over the next year," said Patel. "Do not underestimate the change."

Bloomberg