IFRS 9 - Opportunities and complexities for corporates

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Chance to better align hedge accounting with risk management policies

For once, some good news on the new standards! IFRS 9 brings corporates – i.e. non-financial sector companies – the opportunity for more effective hedge accounting that could produce a more stable earnings environment.

But if you don't manage it correctly, hedges could still fall foul of the new principles and lead to accounting errors – which is clearly something to be avoided.

And although it is true that IFRS 9 is unlikely to have a big impact for corporates, when the regulator comes calling they'll expect you to substantiate the conclusion *you* came to for *your* business, which means working through the complexities that lie in the detail of the new requirements.

Get your hedges in good trim

There are three pillars to IFRS 9 – classification and measurement, impairment and hedge accounting.

Although corporates may see some change in the first two areas, the hedge accounting changes are the ones that are likely to have the biggest impact.

IFRS 9 introduces an improved hedge accounting model that seeks to align hedge accounting with risk management policies and is more principles-based.

No more bright lines

In particular, the old 'bright line' requirement where any hedging treatment had to be shown to be 80–125% effective has been removed. That test often proved problematic because, where there are only small movements in the value of a hedged risk, it can be difficult to meet this test.

Under the new standard, companies can apply hedge accounting to more individual risk components of transactions, creating flexibility, particularly for commodity-linked contracts. Before, the whole contract had to be designated.

So if you want to hedge the cost of a commodity, such as oil in a contract, you may be able to hedge just that, whereas before you would have had to include other elements from the contract, such as transportation costs. The result should be less volatility and a more effective hedge.

Cost of hedging

Another significant improvement is the new 'cost of hedging' concept. So, for example, if you want to take out an option around exchange rates for a forecast sale, the cost of hedging – the premium you pay – may be deferred in equity and only recorded in profit or loss at the same time as the sale actually occurs. This is also likely to reduce volatility.

Classification and measurement

So what about the other two pillars of IFRS 9?

For classification and measurement, you will need to look at your assets across equity, debt and derivatives and consider whether they should be valued at amortised cost, fair value through profit or loss (FVTPL) or fair value through other comprehensive income (FVOCI).

There will be choices to be made – e.g. if you have an equity investment, you'll need to choose whether to mark it to market through profit or loss or make an irreversible election to take gains and losses to reserves. This represents a trade-off between volatility with the potential to boost earnings per share, and less volatility but no ability to book any profits.

So, although for most corporates the classification and measurement aspect won't have big effects, there could nevertheless be some interesting dilemmas to resolve.

Impairment

The new standard aims to generate a more forward-looking approach to impairment – booking expected losses rather than ones based only on known current or historical facts.

The change will impact trade receivables; however, the short-term nature of such assets makes it unlikely that a significant increase in the 'bad debt' provision will result. For simplicity, the standard provides for the use of a provisions matrix as a practical expedient.

The challenge will be dealing with the increased judgement for longer-term exposures, including the need to introduce forward-looking metrics to the valuation methodology. For example, economic indicators in a given territory or market, or recent events such as the impact of Brexit.

What now?

Here are the key considerations for treasurers and financial controllers.

If you get the process right, opportunities are there for the taking. Get it wrong, and you could be facing a restatement.

You know which side of the line you'd rather be on!

About the author

Eric Peterson leads a team that advises multinational clients on the impacts of IFRS 9.

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