Rough seas ahead, as deadline looms for transitioning existing hedges to new accounting standard, IFRS 9

Background

Companies reporting under international accounting standards (IFRS), or their Hong Kong equivalents (HKFRS), need to be ready to transition to the new financial instruments standard by 1 January 2018.

IFRS 9, “Financial Instruments”, replaces IAS 39, “Financial Instruments: Recognition and Measurement” and addresses the classification and measurement of financial assets and liabilities. It also includes a new expected credit loss model, which replaces the incurred loss impairment model used for financial assets today.

However, one often overlooked aspect of IFRS 9 is the substantially-reformed approach to hedge accounting.

Hedge accounting v2.0

Many commentators have, quite rightly, focused on the improvements brought about by the revised hedge accounting model embedded in IFRS 9. These improvements can be substantial (see box opposite). However, IFRS 9 is not all plain sailing. There are choppy waters ahead for those hedging foreign currency risk, particularly for forecasted transactions.

Improvements in IFRS 9 include:

1. Elimination of ‘bright line’ effectiveness test for eligible hedges. IAS 39 requires both forecast and actual effectiveness to fall within a range of 80% – 125%. These effectiveness tests are no longer a barrier to hedge accounting.

2. Components of non-financial items eligible for hedge accounting. Previously, hedging only certain risk components within a single hedged item was only possible for financial instruments or the foreign currency component of other items. IFRS 9 allows risk components of non-financial items to be hedged under certain conditions, such as the crude oil component of jet fuel. This will reduce volatility and/or ineffectiveness for corporates undertaking commodity hedging.

3. Hedging net positions. IFRS 9 allows treasury centres that hedge FX positions on a net basis to designate a net derivative as a hedge of the offsetting, gross positions such that profit margins are better protected.

4. Aggregated exposures. Companies can now designate a combination of derivatives and non-derivatives, for example a floating rate loan and an interest rate swap together, as a hedged item.

5. Options as hedging instruments. Volatility arising under IAS 39 when hedging with options is significantly reduced or eliminated under IFRS 9.

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1. Applies to companies with a financial year ending on 31 December.
No matter whether you’re an experienced skipper, or novice sailor, if you’re feeling queasy about the thought of transitioning to IFRS 9 we’re here to help. Our IFRS 9 specialists have helped several companies sail into these previously unchartered waters.

**Hedging spot risk**

Just as the ‘black spot’ was feared by pirates in Robert Louis Stevenson’s novel, “Treasure Island”, the introduction of the concept of ‘discounted spot’ in IFRS 9 is equally unwelcome to many corporates that hedge on a spot basis.

Spot FX hedging involves using daily movements in the current market exchange rate (the ‘spot’ rate) to measure the impact of FX on the forecast amount, notional value or principal of the hedged item and hedging instrument. In simple terms, the spot effect on a highly probable forecast transaction of $100 and a $100 FX forward contract would be the same – measured as the change in the retranslated $100 in the entity’s own functional currency. Whether or not the timing of settlements matched would not affect this assessment.

IFRS 9, however, introduces the concept of time value in a spot hedge. To many, this might appear to be inconsistent with the notion of excluding forward points from the hedging instrument (essentially the timing-related component), and can lead to ineffectiveness in an otherwise perfect rollover strategy for hedging FX risk. Nevertheless, corporates will need to modify their existing spot FX hedge relationships to acknowledge this addition to IFRS 9.

**Currency basis**

Unfortunately, there is no obvious nautical analogy for currency basis, which is largely a post-GFC (global financial crisis) phenomenon. Currency basis is a charge (or gain) from the exchange of currencies in the future, which cannot be derived solely from market interest differentials and spot rates. It arises, in part, due to differences in liquidity preferences among market participants for each currency, sovereign credit risk and speculative forces.

Currency basis was largely ignored when cash flow hedging under IAS 39, as it had little or no impact on hedge ineffectiveness. However, its presence in hedging instruments often created ineffectiveness in cross-currency fair value hedges.

IFRS 9 introduces specific requirements for accounting for currency basis in FX hedges. These requirements are somewhat of a mixed bag for corporates: they introduce complexity and increased administrative burden for no apparent benefit in cash flow hedges, while reducing ineffectiveness in a fair value hedge. Fair value hedges benefit from the introduction of a new accounting model that defers currency basis in OCI, but this comes at the expense of additional administrative effort to keep track.

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