

IFRS industry insights

Energy and resources industry implications of the new IFRS 9 general hedge accounting model

The bottom line

- The International Accounting Standards Board (IASB) has issued an amendment to IFRS 9 *Financial Instruments* to include the new general hedge accounting model.
- IFRS 9 is set to be the replacement of IAS 39 *Financial Instruments: Recognition and Measurement*, however, the effective date of IFRS 9 is yet to be determined. In the time being, IFRS 9 is available for early adoption (subject to any local endorsement requirements).
- The new general hedge accounting model will allow entities to reduce profit or loss and balance sheet volatility by applying hedge accounting in more circumstances. The change in accounting treatment is expected to prompt some companies to review their risk management activities which may have been restricted by the requirements in IAS 39.

What's happened?

The IASB has issued an amendment to IFRS 9 to include the new general hedge accounting model. The IASB's objective with the new model is to more closely align it with risk management, resulting in more useful information for users of financial statements. The requirements are less rules based than IAS 39 and allow companies more opportunities to mitigate earnings volatility that may arise from the IAS 39 requirements.

Points of focus for the energy and resources industry

Some of the key areas impacting the energy and resources industry are highlighted below.

Own use contracts

IFRS 9 introduces a fair value option for physically settled forward commodity contracts that meet the "own use" criteria and would otherwise be measured at cost (often nil and hence effectively off balance sheet). This option would be a practical alternative to applying fair value hedge accounting for entities that hedge such own use commodity contracts with financial derivatives measured at fair value through profit or loss.

Risk component hedging

The new requirements increase the range of economic hedges eligible for hedge accounting. IAS 39 restricts hedge accounting for non-financial items to hedges of foreign exchange risk or all price risk (or all price risk excluding foreign exchange risk). Therefore, if an entity is hedging only a component of risk it cannot apply hedge accounting for that component in isolation. Under the new requirements a risk component of a non-financial item is eligible provided it is "separately identifiable and reliably measurable". This opens the door to hedge accounting that more closely reflects the economics of the hedge. Allowing a closer match between the hedged risk and the hedging derivative could result in more stable profit or loss.

Hedging with option contracts

Under the new standard, the accounting treatment of option contracts designated as hedging instruments would be less volatile in profit or loss than under IAS 39. The new requirements would apply to a variety of vanilla and structured option contracts including those that hedge commodity price risk, interest rate risk and foreign exchange risk. IFRS 9 would require the change in the time value of an option, which can be volatile, to be recognised initially in other comprehensive income with subsequent recognition in profit or loss on a more predictable basis (e.g. amortised over the life of the hedge or recognised as a single amount when the hedged item affects profit or loss).

Synthetic exposures

In contrast to IAS 39, under IFRS 9, exposures that include derivatives (i.e. synthetic exposures) can be designated as eligible hedged items. For example, consider a GBP entity with a forecast USD oil exposure hedged at \$100 with a forward oil contract designated in a hedging relationship. Unlike IAS 39, IFRS 9 would allow the synthetic fixed price \$100 exposure to be treated as a hedged item in a subsequent hedge of the FX risk even though this hedged item includes a derivative (i.e. it includes the forward oil contract). This change should enhance the effectiveness of such hedges and make hedge accounting more achievable in practice.

Effectiveness testing

Hedge accounting relationships would no longer have to meet the 80-125% offset criteria currently required for prospective and retrospective effectiveness testing in IAS 39. Instead an entity would need to demonstrate that an 'economic relationship' exists between the hedged item and hedging instrument on a prospective basis. This will reduce the burden of complying with the hedge accounting requirements. Under IFRS 9, provided the economic relationship is present at the beginning of each hedged period, come the end of the period, actual hedge ineffectiveness is measured regardless of the amount. For example, if the hedge happens to be only 60% effective, then that is the effectiveness recorded (unlike IAS 39 where no hedge accounting would be applied because it falls outside the 80-125% range). This change could result in more hedging relationships qualifying for hedge accounting (especially when combined with other changes to the requirements).

Accounting policy choice

In overhauling the hedge accounting requirements of IAS 39, the IASB divided its project into two components: (1) general hedge accounting and (2) portfolio (or "macro") hedge accounting. Macro hedge accounting is mainly applied by financial institutions when hedging interest rate risk. The IASB's project on macro hedging is still on-going with a discussion paper due to be published later in 2013.

Whilst the IASB continues to develop a new macro hedging model, *all* adopters of IFRS 9 have the option to continue to apply the hedge accounting requirements of IAS 39 (i.e. as an accounting policy choice under IFRS 9).

Timing

The mandatory effective date of IFRS 9 is yet to be determined because IFRS 9 is not yet complete. The IASB is in the process of developing a new impairment model to be included in IFRS 9 and is also making amendments to the existing classification and measurement requirements of IFRS 9. Once IFRS 9 is complete, the IASB will set the mandatory effective date. In the time being the standard is available for early adoption (subject to any local endorsement requirements).

Things to consider now

The IAS 39 requirements have caused some risk management activities to be restricted in order to limit periodic earnings volatility. Hence, the changes introduced in IFRS 9 should be well understood by not only the accounting function but also those responsible for risk management. Risk management policies should be reviewed in light of these changes and their effect on longer term risk management decisions considered. Furthermore, they should be considered as part of any planning and decisions around risk management, treasury and accounting systems.

Resources

A comprehensive summary of the requirements is provided in Deloitte's IFRS in Focus publication which can be found, along with video podcasts discussing the new requirements, at www.iasplus.com.

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