

## IFRS 9 Hedge Accounting

Issue 1

John Clarson

May 2011

This article discusses some of the proposed changes to hedge accounting under the exposure draft for IFRS 9. This is the third phase of the IASB's project to replace IAS 39. The first section of this article will focus on the broad implications for risk management policy in relation to the objective of hedge accounting as defined in the Standard. In addition, a number of changes have been made to the restrictions in IAS 39 to align the accounting more closely with risk management. The second section will discuss one of these – accounting for option time value. Other changes will be discussed in future articles.

### **The objective of hedge accounting (and risk management)**

The IASB has received feedback on IAS 39 which said the hedge accounting requirements “were difficult to understand, apply and interpret”<sup>1</sup>. Users of financial statements said “hedge accounting should be more closely aligned to an entity’s risk management activities”. As a result of these comments, IFRS 9 defines the objective of hedge accounting as “to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures”.

This objective will lead to more focus on the entity’s risk management policies. In the section on assessing hedge effectiveness requirements “an entity’s risk management is the main source of information to perform the assessment of whether a hedge relationship meets the hedge effectiveness requirements”. What this means in practice is that the new hedge effectiveness testing methodology involves ensuring “that the hedge relationship will produce an unbiased result and minimise expected hedge ineffectiveness”. Importantly, the 80-125 per cent retrospective test of IAS 39 has been eliminated from IFRS 9.

These quotes taken together indicate that a good risk management strategy which details which risks are hedged and which risks of the same exposures are unhedged will be important. As the intention is to no longer require any retrospective testing, the new approach focuses on the hedge ratio of the exposure to the hedge. This must be set so that expected ineffectiveness is minimised. For more complex hedges (e.g. involving basis risk where the hedge ratio might not be 1:1), this may require some quantitative work and may lead to accounting complexity if the hedge ratio changes over time.

Along with the removal of retrospective testing, there is also more latitude for a critical terms test. If the terms of the hedge and the exposure “match or are closely aligned”, then it’s possible that no prospective test will be required. The IASB have provided an interest rate example which indicates if the hedge ratio is clearly 1:1, then a *qualitative test* could be acceptable<sup>2</sup>. With a clear risk management strategy and good risk reporting, it should be possible to apply the critical terms shortcut method far more often than under IAS 39.

## Accounting for the time value of options

Time value of options has always been one of the thornier issues in IAS 39. All the variation of *time value* of an option has to go through P&L and the only advantage of hedge accounting is to defer posting changes in *intrinsic value* to P&L until the maturity of the relationship. The IASB noted that under IAS 39 “this particular accounting treatment [of options] is disconnected from risk management”

They have devised a solution which takes an ‘insurance premium’ view. The choice of this solution has led to complexity because sometimes insurance costs are capitalised into the cost of the insured asset and sometimes they are recognised as expenses over the period of the insurance. This has been translated for options by stipulating that the time value can be accounted for in one of two ways depending on whether the hedged item is *transaction related* or *time period related*.

A *transaction related* hedged item results in a transaction that involves the notion of a transaction cost and a resulting capitalisation of that cost. For these items, the time value is all recognised in P&L when the transaction occurs. For example, for an option to hedge a capital equipment purchase in a foreign currency, under IFRS 9 the initial value of the equipment will be its purchase price converted at the applicable exchange rate (option strike or spot) plus the original time value of the option.

For *time period related* hedged items, the time value is “amortised on a rational basis” over the period of the hedge. There is still some debate on what a rational basis will mean in practice. The example of a time related hedge is using a 6 month commodity option to hedge commodity inventory. This example does not sound very likely in comparison with transaction related hedged items, so it remains to be seen how much time value amortisation will occur in practice if there is no change to the Standard. It is also unclear how options like interest rate caps that are purchased for hedging debt will be treated.

The IASB thought that this approach would be “more aligned with how preparers and users think about the issue”. However a number of comment letters considered this approach too complex and suggested only using the time related approach<sup>1</sup>. So the IASB seemed to have misjudged their audience in this case. Another comment on this issue was a suggestion to allow FX forward points to be amortised in the same way – another example of reverting the accounting for derivatives back to the old ways pre IAS 39!

Table A: Option time value and intrinsic value.

	Time Value	Intrinsic Value	Total Value
<b>Inception</b>	60,000	0	60,000
<b>Period 1</b>	90,000	60,000	150,000
<b>Period 2</b>	30,000	40,000	70,000

Table A shows the time value and intrinsic value of an option at 3 different times. Assume the option’s intrinsic value is designated in a fully effective hedge relationship. Under IAS 39 the changes in time value go to P&L. For this example assume that under IFRS 9 the time value of the option is amortised on a straight line basis which means the P&L entry is an amortisation of \$20k

of the original \$60k premium in each period. This will be the P&L impact regardless of the change in value of the option.

The following table compares the accounting entries for the two periods.

Table B: IAS39 & IFRS 9 Example

	IAS 39		IFRS 9	
	Period 1	Period 2	Period 1	Period 2
<b>Equity</b>	60,000	-20,000	110,000	-60,000
<b>P&amp;L</b>	30,000	-60,000	-20,000	-20,000
<b>Total</b>	<b>90,000</b>	<b>-80,000</b>	<b>90,000</b>	<b>-80,000</b>

Note that the change under IFRS 9 is that the P&L entry is -\$20k for each period whereas under IAS 39 the change in time value generates significant P&L volatility.

*Please note that this paper is for information purposes only. You should refer to your auditors for further clarification regarding IFRS 9.*

---

<sup>1</sup> All quotes refer to the draft Standard and basis for conclusions published by the IASB in December 2010 unless otherwise noted.

<sup>2</sup> IASB website, hedge accounting project page, project news on 24 February 2011

---

## About Visual Risk

Visual Risk is a specialist provider of superior treasury solutions for public and private sector corporations, debt management intensive entities and financial institutions from commercial banks to credit unions. We deliver a unique suite of treasury solutions covering risk, asset-liability management, hedge accounting and treasury back-office. These may be implemented as individual components or as a fully integrated front-to-back office treasury solution. With over 100 clients, Visual Risk is now the market leader and most widely used treasury system in Australasia.

For further information please call +612 9262 6969 or visit our website: [www.visualrisk.com](http://www.visualrisk.com)

---