

# ALERT

## IFRS 9 Financial Instruments – Considerations for corporate treasury

IFRS 9 became effective for annual reporting periods beginning 1 January 2018, so those companies with December year ends should have already implemented the changes required. For other companies, IFRS 9 will apply shortly.

In implementing the changes required, a company's treasury policy will also need updating to reflect the new requirements. IFRS 9 introduces some significant changes to accounting for financial instruments which offers benefits and challenges for corporate treasury. Due to the alignment of risk management and accounting under IFRS 9, corporate treasury has an opportunity to reassess how risk is managed within an entity. In this article, we look at the key considerations (with examples) for updating a company's treasury policy when implementing the new requirements.

| Area   | Key considerations  | Example   |
|--|---|---|
| Classification and measurement of equity instruments | Investments in managed funds must be classified as fair value through profit or loss (FVTPL) as the units held by the entity are not equity instruments as defined in IAS 32 Financial Instruments: Presentation. Therefore, the units cannot be classified under fair value through other comprehensive income (FVOCI) and so must be classified as FVTPL.<br><br>IFRS 9 has stricter requirements in relation to measuring equity instruments at cost. As such, in most cases equity instruments will need to be fair valued. Only in very limited circumstances can cost be an appropriate estimate of fair value. For instance, if there is insufficient recent information available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. | Company S buys units in a managed fund. Under IFRS 9 it is required to classify this as a financial asset held at FVTPL.<br><br>Company S holds shares in an unlisted entity W, which had been dormant for a few years. In the current period, entity W has begun operating and is incurring expenses. Under IFRS 9, Company S determines that cost is no longer an appropriate estimate of fair value due to the changes in entity W. At the end of the current reporting period, entity S fair values its investment in entity W, with changes recognised in other comprehensive income.  |
| Debtor factoring                                     | Where a company sells its debtors, consideration is required as to whether the company has transferred the risks and rewards to determine whether it should be derecognised. These types of transactions need to be assessed carefully to determine whether they are regarded as sales under an entity's business model.  | Company S sells its debtors to Company F in an arrangement where the debtors are required to make payment directly to Company F. However Company S provides a guarantee to Company F to compensate for any defaults. Under IFRS 9, Company S still retains the risks and rewards and continues to recognise debtors as a financial asset classified as FVTPL. The classification as FVTPL is because it fails the held-to-collect business model.   |
| Modification of debt                                 | If the terms of a debt instrument is modified, the amortised cost is recalculated and the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate is recognised in profit or loss. This is a new requirement under IFRS 9.  | Company S has a bank loan of \$500,000. The loan is modified to extend the term and reduce the interest rate. The present value of the modified cash flows is \$450,000. Under IFRS 9, the difference of \$50,000 must be recognised as a gain.   |
| Hedge accounting – qualifying criteria               | In order to apply hedge accounting under IFRS 9, it must comply with the entity's risk management policy. An economic relationship must exist between the hedging instrument and hedged item and credit risk cannot dominate the value changes in that relationship. Hedges cannot be terminated early or de-designated unless corporate treasury changes the risk management objective, since the accounting must comply with the entity's risk management policy. The other circumstances for discontinuing hedge accounting under IFRS 9 are if there is no longer an economic relationship or if credit risk dominates the value changes.   | An entity replaces a hedging instrument with a new one because the original instrument has a severe credit deterioration. This means that the original hedging relationship failed to achieve the risk management objective and is must therefore be discontinued in its entirety. The new hedging instrument is designated as the hedge of the same exposure that was hedged previously and forms a new hedging relationship.  |
| Hedge accounting – component of risk                 | A risk component of a financial item or a non-financial item is eligible to be a hedged item if it is separately identifiable and reliably measurable. Determining whether a component is separately identifiable and reliably measurable requires judgement.   | Company S holds a fixed-rate debt instrument. For these types of instruments in the market, their spreads are often compared to a benchmark rate while variable rate instruments are usually indexed to that benchmark rate. Interest rate swaps are used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate. Company S concludes that the benchmark rate is a component that can be separately identified and reliably measured. As such, Company S designates a hedging relationship for the fixed-rate debt instrument on a risk component basis for the benchmark interest rate risk. |
| Hedge accounting – rebalancing                       | IFRS 9 allows an entity to continue the hedge relationship even if the hedge ratio needs to be changed to achieve the required hedge effectiveness i.e. the hedge ratio has to be rebalanced to continue to meet the hedge accounting qualification under IFRS 9. This therefore allows corporate treasury more flexibility in managing exposures through rebalancing.  | Company S is required to buy 100 units of Commodity X in six months' time. However a commodity derivative is only available for Commodity Y. Through regression analysis it finds that Commodity X has an economic relationship with Commodity Y and determines that to offset price increase in 100 units of Commodity X, 125 units of Commodity Y is required i.e. hedge ratio is 1:1.25 at the current prices of these commodities.<br><br>After three months, Company S finds that due to a change in the underlying supply-demand position, the economic relationship has changed and that the price of Commodity Y has increased by 25% while that of Commodity X by 10%. Thus the hedge ratio is rebalanced to make it 1:1 to maintain hedge effectiveness.                    |

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|--|--|--|-----------|--------|--------|----------|-------------|---|---------|-----------|--------------------------------|------------|-----------|-----------|----------------------------------|---|---|----------|-------------|------------|------------|---|--|--------|--------|----------|-------------|---|---------|-----------|-----------------------------|-----------|-----------|-----------|--------------|---------|---------|---------|-------------|---------|-----------|---|
| Hedge Accounting – layers of hedged item | IFRS 9 now allows for the hedging of a layer component in a fair-value hedge. A layer of a hedged item is a component of the nominal amount of the hedged item that is separately identifiable and reliably measurable and that is being hedged as per the risk management objective.  | <p><i>Monetary</i></p> <p>The hedged item can be the next USD10 cash flows from sales denominated in a foreign currency after the first USD20 in March 2020.</p> <p><i>Physical</i></p> <p>The hedged item can be the bottom layer, measuring 5 million cubic metres, of the natural gas stored in location Z.</p> <p><i>Nominal</i></p> <p>The hedged item can be the last USD80 million of a USD100 million firm commitment.</p>   |           |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Hedge accounting – options               | <p>The movement in the time value of an option can be deferred in other comprehensive income when only the intrinsic value of an option is designated in a hedging relationship. This will help minimise the volatility in profit or loss.</p> <p>For transaction related hedged items, the change in fair value is recorded in a separate component of equity and is subsequently included as a direct cost of the asset or liability recognised. For example, hedges of forecast purchases of inventory, property, plant and equipment.</p> <p>For time-period related hedged items, the change in fair value is recorded in a separate component of equity and is subsequently amortised to profit or loss as a reclassification adjustment. For example, hedges of interest expense.</p> | <p><i>Transaction related hedged item</i></p> <p>Company S enters into a contract to buy equipment worth USD 1,000,000, payable on delivery in 3 months. To minimise the foreign exchange risk, Company S purchases an option to buy USD 1,000,000 in 3 months. The intrinsic value is designated as a hedging instrument in a cash flow hedge. The fair value of the option initially is AUD 30,000, AUD 17,000 in the first month, AUD 8,000 in the second month and zero at maturity.</p> <p>The impact on profit or loss and OCI:</p> <table border="1"> <thead> <tr> <th></th> <th>Year 1</th> <th>Year 2</th> <th>Maturity</th> </tr> </thead> <tbody> <tr> <td>Opening OCI</td> <td>-</td> <td>(\$500)</td> <td>(\$1,500)</td> </tr> <tr> <td>Change in time value of option</td> <td>(\$13,000)</td> <td>(\$9,000)</td> <td>(\$8,000)</td> </tr> <tr> <td>Capitalisation of option premium</td> <td>-</td> <td>-</td> <td>\$30,000</td> </tr> <tr> <td>Closing OCI</td> <td>(\$13,000)</td> <td>(\$22,000)</td> <td>-</td> </tr> </tbody> </table> <p><i>Time-period related hedged item</i></p> <p>Company S purchases an interest rate option to protect against increases in the interest expense on floating rate debt. The intrinsic value is designated as a hedging instrument in a fair value hedge. The option term is three years while the debt term is five years. The time value of the option is amortised to profit or loss over the three years. The fair value of the option initially is \$9,000, \$6,500 in Year 1 and \$4,500 in Year 2 and zero at maturity.</p> <p>The impact on profit or loss and OCI:</p> <table border="1"> <thead> <tr> <th></th> <th>Year 1</th> <th>Year 2</th> <th>Maturity</th> </tr> </thead> <tbody> <tr> <td>Opening OCI</td> <td>-</td> <td>(\$500)</td> <td>(\$1,500)</td> </tr> <tr> <td>Change in option time value</td> <td>(\$2,500)</td> <td>(\$2,000)</td> <td>(\$4,500)</td> </tr> <tr> <td>Amortisation</td> <td>\$3,000</td> <td>\$3,000</td> <td>\$3,000</td> </tr> <tr> <td>Closing OCI</td> <td>(\$500)</td> <td>(\$1,500)</td> <td>-</td> </tr> </tbody> </table> |           | Year 1 | Year 2 | Maturity | Opening OCI | - | (\$500) | (\$1,500) | Change in time value of option | (\$13,000) | (\$9,000) | (\$8,000) | Capitalisation of option premium | - | - | \$30,000 | Closing OCI | (\$13,000) | (\$22,000) | - |  | Year 1 | Year 2 | Maturity | Opening OCI | - | (\$500) | (\$1,500) | Change in option time value | (\$2,500) | (\$2,000) | (\$4,500) | Amortisation | \$3,000 | \$3,000 | \$3,000 | Closing OCI | (\$500) | (\$1,500) | - |
|  | Year 1   | Year 2   | Maturity  |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Opening OCI                              | -  | (\$500)  | (\$1,500) |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Change in time value of option           | (\$13,000)   | (\$9,000)  | (\$8,000) |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Capitalisation of option premium         | -  | -  | \$30,000  |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Closing OCI                              | (\$13,000)   | (\$22,000)   | -         |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
|  | Year 1   | Year 2   | Maturity  |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Opening OCI                              | -  | (\$500)  | (\$1,500) |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Change in option time value              | (\$2,500)  | (\$2,000)  | (\$4,500) |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Amortisation                             | \$3,000  | \$3,000  | \$3,000   |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |
| Closing OCI                              | (\$500)  | (\$1,500)  | -         |        |        |          |             |   |         |           |                                |            |           |           |                                  |   |   |          |             |            |            |   |  |        |        |          |             |   |         |           |                             |           |           |           |              |         |         |         |             |         |           |   |

Let's discuss the possibilities.