



IFRS Today

KPMG's podcast series on IFRS and financial reporting

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EPISODE 5 TRANSCRIPT

IFRS 9 – Hedge accounting for corporates

Speakers

- Eric Peterson
- Sarah Kindzerske
- James Bowe (Host)

Host

Hello and welcome to episode 5 of *IFRS Today*, KPMG's podcast series on IFRS and financial reporting.

In this podcast, we'll take a look at some of the key issues arising when applying IFRS 9 *Financial Instruments* to hedge accounting, particularly for corporates – that's to say non-financial services companies.

Today I'm pleased to have with me two KPMG colleagues, both well-experienced in this area.

First up, we have Eric Peterson – a Director in the UK firm who leads a team advising corporate clients on the impacts of IFRS 9.

Also with us today is Sarah Kindzerske, a senior manager with particular expertise in IFRS 9 implementation, and a member of KPMG's International Standards Group.

So, Sarah and Eric – Thanks for joining us on *IFRS Today*...

Sarah, what's your impression of the new IFRS 9 hedging model?

Sarah

In a nutshell, I think the new IFRS 9 hedging model brings corporates the opportunity for more effective hedge accounting, which really could result in a more stable earnings environment. So it's definitely good news for corporates...

This model under IFRS 9 is really a principles-based approach. It's geared toward how a company manages its risk.

Eric

That's absolutely right. The hedge accounting model under IFRS 9 results in the greater alignment of accounting with the entity's risk management activities. And as you say, Sarah, this results in opportunities to apply hedge accounting to risk management strategies that just weren't available under the previous IAS 39 model.

Sarah

But, you know, it's still possible for hedges to fall foul of the new principles, so it's important to get the hedge documentation right since that is the document that governs the whole hedge relationship.

Eric

That's right. While there are opportunities under the new model, companies still need to clearly document their overall risk management strategy and the objective of the hedge to demonstrate that important economic relationship.

Sarah

That's interesting. Are you seeing a lot of interest in companies who haven't applied hedge accounting before to now applying hedge accounting under the IFRS 9 model?

Eric

Well I wouldn't say that they haven't ever applied hedge accounting previously, but we're definitely seeing a number of companies considering new risk management strategies under the new model and there are three things that I'm regularly talking to my clients about: the extension of this **risk components** concept, this new **cost of hedging** concept and the removal of **voluntary de-designation**.

So let's take those three in turn, starting with risk components...

Sarah

Yes, the risk component concept seems to be one of the more significant changes from IAS 39, particularly for companies that are exposed to non-financial risks. In reality, many of these companies have been managing exposures such as commodity price risk using derivatives for a really long time, but the risk was always managed economically rather than by applying hedge accounting. This is because many companies weren't able to achieve hedge accounting under the IAS 39 framework.

Eric

That's right and, Sarah, this would not be a hedge accounting podcast without a bit of detail – so let's get into that detail...

When companies enter into their materials or sales purchase contracts, the price of those contracts is often linked to commodities. Companies can now apply hedge accounting to the individual risk component in that contract creating flexibility, particularly for commodity-linked contracts. Before, the whole contract – including delivery charges and other price adjustments within the contract – had to be designated, making hedge accounting difficult.

So, if I give an example: I have a contract to purchase cocoa for use in the production of chocolate bars. The contract might have a pricing formula that says I'll pay for the cocoa index, plus delivery costs, plus a profit margin. I always wanted to just isolate that cocoa index when I am doing my hedge accounting for cocoa and as long (now under IFRS 9) as it is separately identifiable and reliably measurable, I can do that.

Sarah

So that's really good news for a lot of companies. Are you seeing this risk component criteria being difficult to meet? It sounds like it could be a little tricky to meet the eligibility criteria if the price risk is not contractually specified...

Eric

So, I'm seeing a number of companies now implementing and applying hedge accounting to risk management strategies that hedge just the commodity risk components specified in their sales and purchase contracts.

I would say that the tricky part comes when you get to the potential to designate non-contractually specified risk components as the hedged item under IFRS 9. This is definitely more complex and judgemental, which requires a thorough analysis of the market structure to demonstrate that the risk is truly separately identifiable in the pricing structure.

Sarah

While we're discussing non-financial risks, another significant change is this notion of basis adjustments. 'Basis adjustment' is when the hedged forecast transaction subsequently results in a company recognising a non-financial asset or liability.

Eric

Absolutely. So following on from that example where we are hedging a cocoa purchase, when we make the actual purchase, the gain or loss on the cocoa derivative should now be included as an adjustment to the cocoa inventory I've recognised. This adjustment is not considered to be a reclassification adjustment and does not impact other comprehensive income (OCI).

It's important to draw attention to this as an explicit requirement under IFRS 9, so companies no longer have the choice of when and where they recognise the effects of the hedge. It's a change from IAS 39 that's often overlooked.

Sarah

So with risk components, the idea that companies can now more easily apply hedge accounting to contractually specified risk is definitely a positive.

Eric

That's right. But IFRS 9 has introduced some additional complexity around the mechanics of applying hedge accounting. I'm particularly thinking of the 'cost of hedging' concept.

Would you agree, Sarah?

Sarah

Yes, absolutely. So the new cost of hedging concept is definitely an improvement, because – for instance – if companies want to take out an option around exchange rates for a forecast sale, then cost of hedging (which is the premium you pay) may be deferred in equity and only recorded in P&L at the same time as the sale actually occurs. So this is also likely to reduce volatility.

Where are you seeing most questions come up, Eric?

Eric

With the cost of hedging for options, it is reasonably straightforward, with that option premium being deferred until the transaction occurs, such as for a foreign currency option on a sale, or spread if the option is time-linked – for example, an interest rate cap. But I'm receiving the most questions on currency basis and particularly currency basis embedded in a cross-currency swap.

Sarah

Makes sense Eric. The cross-currency basis spread is a cost that has always existed in the cross-currency basis swap, but now the standard explicitly calls a cross-currency basis spread a cost of hedging!

Eric

Yes, and previous industry practice resulted in the effects of the cross-currency basis spread being buried with other changes in fair value.

Sarah

So I guess companies are now left with two choices:

1. Do I want to include the cross-currency basis spread in my hedge designation? If so, then I'll recognise ineffectiveness driven by the difference between my hypothetical derivative and my actual derivative; or
2. Do I want to exclude the cross-currency basis spread and account for it as a cost of hedging or fair value through P&L?

Eric, what are you seeing most frequently?

Eric

So I see most groups excluding currency basis and treating it as cost of hedging as the volatility under option one is just not attractive. In the UK, a number of groups use cross-currency swaps in net investment hedging arrangements. They were surprised when they realised that that cost of hedging in the currency basis for net investment hedging is time-linked and creates P&L volatility that they didn't have previously.

So, on that note of potential P&L volatility that didn't exist under the old standard, let's talk about the easier topic of voluntary de-designation.

Sarah

I don't know if it's much easier because the devil is definitely in the detail on this one! But let's face it, hedge accounting can be very burdensome at times. For cash flow hedges, for instance, it can require a lot of effort to track the probability of forecast transactions. And for fair value hedges, it can require a lot of effort to amortise the basis adjustments.

So hedge accounting obviously introduces additional audit risks and IFRS 9 doesn't change that fact. You know, honestly, I've seen a lot of my clients just throw up their hands at times.

Eric

That's right. So you used to be able to do it but now IFRS 9 precludes voluntary de-designation.

Sarah

Are companies handling that ok or do they feel more restricted by the standard?

Eric

Well, voluntary de-designation can be done but care should be taken.

Sarah

That's right. Really the only way to de-designate is if the company's risk management objective changes, in addition of course to the usual scenarios where the hedging instrument is sold, terminated or expires, or an economic relationship between the hedged item and hedging instrument no longer exists.

Do you see companies changing their risk management objective frequently?

Eric

I'm not sure I'd say frequently, but it certainly, certainly happens, and it's natural for a company's risk management strategy to change as market risks change. But that market risk really should be the catalyst and not some sort of desirable accounting outcome.

Sarah

Let's not forget the pain involved with applying hedge accounting to a derivative with a non-zero fair value. That can create ineffectiveness which creates many more headaches.

Eric

That's right. So, to summarise our three points:

- **Risk components** – there are opportunities;
- **Cost of hedging** – there is a bit of complexity; and finally
- **Voluntary de-designations** – take care.

Host

Thank you Eric and Sarah. So it sounds like there's a real mix of opportunities to make the most of and pitfalls to avoid...

For now, thank you all very much for taking the time to listen to this edition of *IFRS Today*, and look out for our next episode, which will be released in the coming weeks...
