For corporations, the management of financial risks (usually market price risk) is of fundamental importance. As a rule, such risks are mitigated using derivatives. Hedge accounting provisions should be applied so that derivatives are properly recognized in the balance sheet. The less restrictive requirements for hedge accounting under IFRS 9 allow the recognition in the balance sheet of many new types of hedging relationships, whereas the main focus used to be mainly on hedging strategies for commodity risks.

Expanding the possibilities of hedge accounting for protecting against risks in line with IFRS 9 – when it hits the ground

Apart from hedging normal market price risk, such as interest rates, currency and even commodity price risk, it is also possible to hedge share-price risk using derivative financial instruments. For instance, share-price risks could also arise from share-based remuneration models, such as share-based payments or stock option plans. These are increasingly prevalent in order to incentivize and encourage key management personnel, thus interlinking employee remuneration plans and share price development.

However, for share-based remuneration plans to qualify for hedge accounting, they must meet the relevant application criteria of hedge accounting. One form of hedging share price risk is cash flow hedge accounting. Here, the risk arising from fluctuating future cash flows (which affect the period results and hence the share-based remuneration plan) is being hedged. A highly likely underlying transaction of cash flow hedges could be expected claim of key management personnel resulting from share-based remuneration plans.

Depending on the fulfillment of the share-based remuneration plan, these can be divided into ‘equity settled’ and ‘cash settled’, leading to a significantly different recognition in the balance sheet pursuant to IFRS 2:

- In accordance with IFRS 2, share-based remuneration plans that are equity settled are recognized in the balance sheet at fair value (only) at the time of they are granted. Up to the relevant cut-off date, no follow-up fair value measurement is necessary during the expected maturity period. Instead, there is simply an appraisal whether certain key performance indicators have been reached. As a result, there is no impact on the company’s income statement over the course of
time, so that there is no indication of an underlying transaction that would allow the use of cash flow hedge accounting.

- For share-based remuneration plans that are settled with cash, on the other hand, IFRS 2 foresees a recognition in the balance sheet at fair value on the cut-off date. As such, the volatility of the share price is therefore reflected in the income statement through changes in performance indicators, in addition to other effects that may occur.

The underlying transaction therefore represents an expected claim, for which a high probability of occurrence must be demonstrated at the beginning and during its maturity period. IFRS does not provide a conclusive definition of “highly probable” but does imply that a probability of occurrence of 50% is not sufficient. In practice, such a probability of occurrence uses a reference value of at least 90%.

In view of the volatility of the expected cash flows, it is useful to designate a hedge for the bottom layer of the cash flow when defining the hedge ratio. This procedure takes into account any possible uncertainties regarding the probability of occurrence of the underlying cash flows. If certain cash flows turn out to be lower than expected, the streams of income taken in beyond the bottom layer would then form a buffer, without further implications on the hedging relationship. IFRS 9 also allows for the designation of a so-called top layer, so that in theory even the last streams of income could be hedged.

Depending on the structure of the cash-settled share-based remuneration, the option of hedging individual risk components as extended under IFRS 9 may also be appropriate. When cash-settled share-based remuneration plans depend on further performance factors, this specifically improves their probability of occurrence as well as the measurement of effectiveness. The conditions for this are the proof of the identifiability of separate component(s) and a reliable valuation of changes in the streams of income from the underlying transaction. In this context, it is also possible to hedge only one side of a change in value of individual risk components (i.e. above or below a certain market price, as is possible for options).

Hedging instruments in hedge accounting could take on the form of share-based forwards, share swaps, share options or option constructions. For the sake of completeness, we would also like to mention that the relevant hedging instruments should take on the form of cash settlements in order not to be mistaken for an equity derivative under IAS 32. We recommend concluding individual hedges (i.e. over-the-counter hedges) so that the specific features of the underlying transaction can also be taken into account in the hedging instrument. As an alternative, an (economic) hedge may also be possible by holding treasury shares but because this does not count as a hedging instrument, it cannot be treated with hedge accounting.

Below we list the various conditions as well as implementation challenges that apply to cash flow hedge accounting for share-based remuneration plans.

A fundamental prerequisite for applying hedge accounting is the use of a relevant documentation and designation of the hedging relationship. In addition to describing the risk management strategy and objectives, the company must also designate the risk hedged, the underlying as well as the hedging instrument. Moreover, the effectiveness measurement must be described as well as the possible sources of ineffectiveness (IFRS 9.6.4.1(b)). It is possible to designate a hedge relationship either as a spot-to-spot component or the full fair value, forward-to-forward.

As a further condition for the effectiveness measurement, the company should be able to prove a (prospective) economical relationship between the underlying and the hedging instrument. A change in value of the hedging instrument may not be dominated by credit risk, and the hedging relationship must be based on the actually used volume needed to fulfill the risk management goals (IFRS 9.6.4.1(c)). In practice, proof of prospective effectiveness and the calculation of any possible ineffectiveness often takes place with the hypothetical derivative method, where the change in value of the hedging instrument is related to the change in value of the underlying transaction. It is important to note that changes in value of the underlying transaction are not subject to credit risk because it is simply an expected and highly probable claim.
changes in value of the underlying transaction are not
When measuring the effectiveness of a spot-to-spot designation, the impact of the forward component becomes obsolete because it is not part of the hedging relationship. The forward component may be captured in other comprehensive income (OCI) with the concept of cost of hedging pro rata temporis and not affecting the operating result. Alternatively, the forward component is treated as ineffective or as an undesignated component and therefore recognized in the income statement. If a forward-to-forward designation is selected instead, this could cause ineffectiveness resulting from the forward components.

A significant challenge regarding the effectiveness measurement is the implementation of the relevant accounting routine. When applying cash flow hedge accounting, the compensating recognition in the balance sheet of underlying and hedge takes place with the capture of value changes in the hedge in other comprehensive income (OCI) between periods. The reclassification of the change in value recorded in the OCI to personnel expenses is made for the effective portion simultaneously with the portion of the shares earned from the underlying transaction affecting net income (adjustment of the commitment to the current share price). Like this, personnel expenses are generated at the hedged price to the extent that the hedging relationship is effective. The changes in value applicable to the shares to which the key managers are not yet entitled to, must remain in the OCI. As a result, personnel expenses do not depend on the share price.

Finally, the extensive disclosures on the hedge accounting that have to be made in the Notes should also be considered. Here, the changes in value in the underlying as well as the hedging instrument (including contract features, methods and calculations of effectiveness and ineffectiveness) as well as the items in the balance sheet and income statement must be disclosed (IFRS 7.21A-24F).
It is clear the **LIBOR transition** will have a huge impact on financial institutions. However, corporates are not immune to the changes. Have you assessed how the LIBOR shift will impact your business? Find out what steps your business can take to stay ahead of the curve.

The discontinuation of the London Interbank Offered Rate (LIBOR) after 2021 exposes corporates to a variety of risks and has generated a lot of unanswered questions. LIBOR is still currently quoted for USD, EUR, GBP, JPY and CHF and several tenors (primarily 1, 3, 6 and 12 months) continue to operate as if there is no end in sight. Yet, the discontinuation of LIBOR will impact corporates with far-reaching implications for commercial, legal, tax and accounting areas.

Despite the ambiguities, the LIBOR transition has already reached a few milestones – various central banks have now found their proxies for an alternative, nearly risk-free rate (CHF SARON, GBP SONIA, USD SOFR, JPY TONAR and EUR ESTER).

The LIBOR transition has a huge impact on financial institutions. However, the impact on corporates may also be significant, keeping treasurers busy over the next 2-3 years. Right now, corporates should observe market practices and timeline updates to evaluate the LIBOR shift’s impact on their operations and how should they plan for the transition.

**To best prepare for the LIBOR transition, we recommend taking the following actions:**

- **Define your exposure to LIBOR**
  
  LIBOR has become the reference rate for many cash and liquidity instruments, mid- and long-term funding including lease liabilities, trading and hedging derivatives, inter-company funding, commercial and procurement contracts or provision calculations. For all of these areas, you should review your current contracts and agreements to determine what actions are required and how a fallback scenario must be negotiated with counterparties.

  Given the broad implications, we recommend you start by educating all key stakeholders among the entire value chain to ensure all relevant areas are captured. This includes cross-functional collaboration between treasury, tax, controlling, procurement, credit- and transfer pricing teams. Additionally, you must get business cooperation (e.g. joint ventures) on board in case they have their own financing.
4 steps for corporates to prepare for LIBOR transition

April 2019

- Measure your transition efforts
  Defining your exposure to LIBOR will facilitate the impact assessment to determine how much effort must be invested. Those efforts depend to what extent the following areas need to be adapted:

  1. IT tools (e.g. TMS, ERP, etc.).
  2. Valuation models (e.g. adjusted interest curve, etc.)
  3. Hedge accounting (e.g. measurement of hedge effectiveness, etc.)
  4. Tax (e.g. treatment of debt instruments, etc.)
  5. Collateral management (e.g. interest calculation of cash pools, etc.)
  6. Pension models (e.g. method to calculate future pension benefits, etc.).

  Once you have determined those efforts, make sure that: project leaders are designated; Senior Management is aware of actions that need to be undertaken and followed; and, a proper budget allocation has been decided for the transition.

- Build a plan and prioritize exposure change
  While it is still early in the year to fully engage in transition efforts, it is not too early to establish a timeframe for the action points described above. Identify and prioritize areas with significant impact. On the most significant exposures, start to design go-live scenarios. Corporates should also seek to minimize any new exposure to LIBOR by choosing financial instruments and entering into contracts, which already reference replacement benchmarks.

- Stay on top of latest developments
  Closely follow the next developments of the LIBOR shift and discuss them with your counterparties such as banks, auditors, lawyers or system providers.

  Expect to see the following announcements in the next 3 to 6 months:

  1. The EURIBOR replacement rate, expected October 2019 (ESTER standing for EONIA) at the latest
  2. ISDA’s supplemental consultation on USD LIBOR feedback
  3. Further feedback from market participants on the RFR valuation methodology (parameters of the historical mean/median approach to the spread adjustment)
  4. ISDA amendment of its standard definitions
  5. IASB Exposure Draft on amendments of IFRS 9 hedge accounting.

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