**How to Establish an ROI for Early Adoption of IFRS 9 Hedge Accounting**

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## Executive Summary

*IFRS 9: Financial Instruments is the replacement for International Accounting Standard (IAS) 39: Financial Instruments - Recognition and Measurement. Corporates that operate in jurisdictions where early adoption of IFRS 9 is allowed should be seriously considering whether to early adopt the new standard, which aims to simplify the accounting for financial instruments. Questions they should be asking are: How do I build a business case for early adoption of IFRS 9? What are the returns on investment? Can I now hedge risks on my balance sheet I previously disallowed?*

*To help answer these questions, Reval shares some key elements of the standard's hedge accounting model and illustrates how these elements can help companies better manage financial risk and deliver ROI.*

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## Introduction

IFRS 9 was issued in July 2014 in its entirety and will come into effect on 1 January 2018 with early application permitted. Some countries, such as Canada, Australia and Hong Kong have already ratified this standard, and therefore, early adoption is permitted and has occurred in those jurisdictions. Apart from the EU, which by November 11th 2015 still had not endorsed the standard, companies in IFRS-reporting jurisdictions have a rare opportunity around the early adoption decision[1]. That opportunity manifests itself differently, depending on who you are and what your focus is within your organisation:

- **The Outward Facing Treasurer** - The outward looking, investor relations-focused individual reflects: *"How can I reduce P&L volatility in my results under this standard?"* and *"How can I let risk management drive my hedging decisions rather than the accounting rules?"*

- **The Inward Facing Treasurer** - The inward looking, 'the business is my client' treasurer thinks: *"How can I better protect my company's balance sheet under this standard?"*

- **The Benchmarking Treasurer** - Those focused on benchmarking against their competitors weigh up: *"What benefits can my organisation achieve through early adoption that are not available to my competitors?"* or perhaps even *"What competitive advantage will my competitors receive if they adopt this standard before I do?"*

Compared to the incumbent IAS 39 accounting standard, the changes in IFRS 9 are vast and significant. They were devised primarily in response to criticism of the current rules and feedback on how they could be improved. Given the IASB have followed through with many of their constituents' suggestions, we can now expect the accounting will be much more aligned with risk management and the economic activities of organisations.

As such, there are a number of clear benefits arising from early adoption of this standard, particularly if you are the type of organisation that suffers accounting challenges under the current standard or if you had changed your hedging policy to minimize issues under the current standard.

[1] Under the new UK GAAP rules, UK companies applying FRS 102 can elect to early adopt the rules of IFRS 9 when applied to financial instruments without waiting for this endorsement.

### About Reval

*Reval is the leading, global provider of a scalable cloud platform for Treasury and Risk Management (TRM). Our cloud-based offerings enable enterprises to better manage cash, liquidity and financial risk, and to account for and report on complex financial instruments and hedging activities. The scope and timeliness of the data and analytics we provide allow chief financial officers, treasurers and finance managers to operate more confidently in an increasingly complex and volatile global business environment. With offerings built on the Reval Cloud Platform companies can optimize treasury and risk management activities across the enterprise for greater operational efficiency, security, control and compliance. Founded in 1999, Reval is headquartered in New York with regional centers across North America, EMEA and Asia Pacific.*

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Many corporations are now realizing the full benefits of advanced risk management techniques, like Cash Flow at Risk, and how these can help change how risks are managed within the organisation. In fact many companies are seeing between 40 and 60% of their risk reduced by considering netting arrangements and correlations across multi-asset portfolios. With the introduction of IFRS 9 companies can now take advantage of these dynamic hedging strategies as they will no longer be hindered by complex hedge accounting rules.

## Return on Investment

Just like any other significant project, treasurers and finance departments must present a strong business case for change – transition to IFRS 9 comes at a cost in terms of training, process change and, very importantly, technology change as a start. Potentially there is also the cost of changing hedging strategies, and therefore, risk management policies. The best business cases tend to include a Return on Investment (ROI) analysis – a selection of tangible and intangible benefits an organisation is likely to achieve through the early adoption of this standard.

Working with our early adopting clients, Reval has identified two core categories to consider when building out a ROI:

1. **REDUCE P&L VOLATILITY** - Given current hedge accounting activities, how much less P&L volatility can you expect to incur as a result of early adoption. In addition, to which hedges could you now apply hedge accounting, and as a result, encounter less P&L volatility.

2. **BETTER MANAGE RISK** – Which different hedge accounting strategies can be deployed to better meet your risk management objectives and still meet the hedge accounting criteria laid out under IFRS 9.

This whitepaper will examine potential ROI from both of these perspectives for each of the following key advantages embedded in IFRS 9:

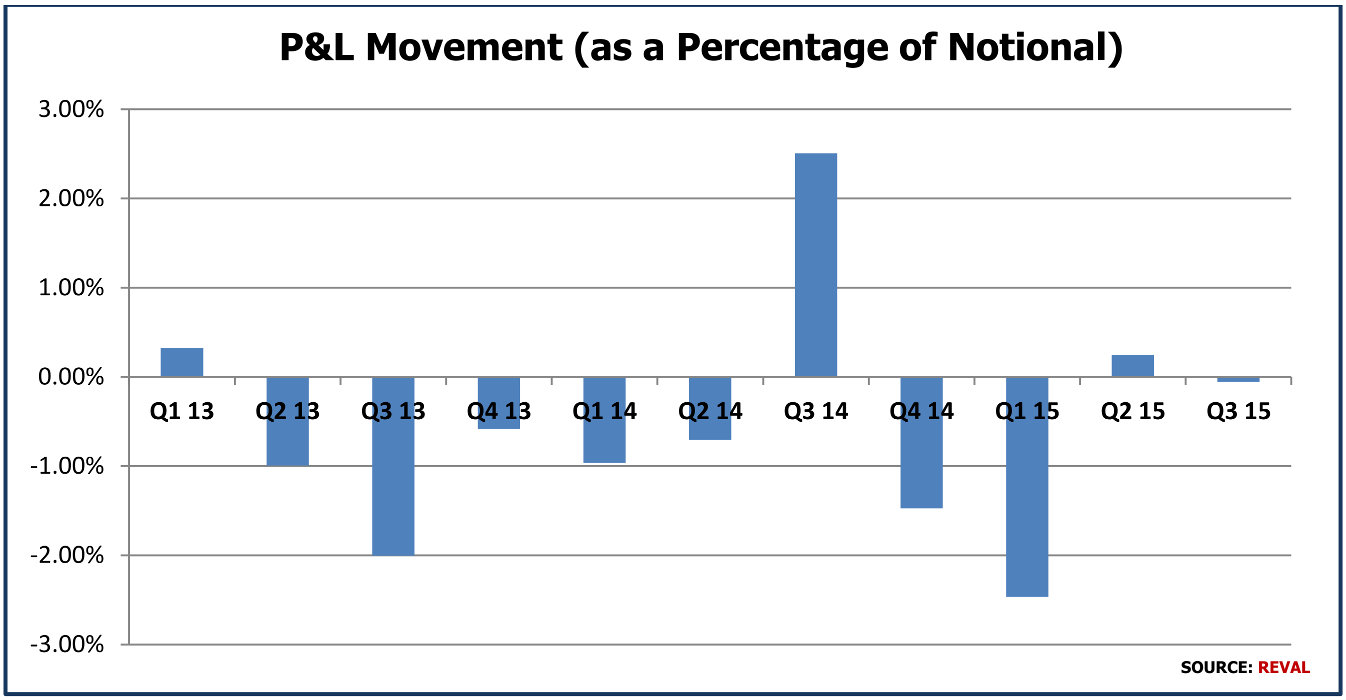
1. Hedging Instruments – Option Time Value
2. Hedging Instruments – Currency Basis On CCIRS
3. Hedged Item – Component Hedging Of Commodity Risk
4. Hedged Item – Derivatives As Hedged Items
5. Net Position Hedging
6. Structured Products

## ADVANTAGE 1: HEDGING INSTRUMENTS – OPTION TIME VALUE

**GUIDANCE:** Para 6.5.15 b) allows for changes in time value of an option to be recognized in Other Comprehensive Income (OCI). This contrasts to the current guidance under IAS 39, in which movements in time value flow through to P&L.

### ROI – REDUCE P&L VOLATILITY

There is clear ROI here as this new guidance allows what used to be recorded through P&L to now be taken to OCI. But how do you best determine the level of ROI? While you cannot predict future P&L volatility arising on time value, you can look at previous movements in time value over a period of time. Look at the amount of P&L volatility generated over the last three years and reported in the financial statements. If this is not easily identified, you can consider typical option positions held by the business in the past, and back test the time value movements that must have impacted your P&L over that time. For example, consider EUR/USD put option @ 1.25 for 100m EUR – the time value movements back tested over the last 11 quarters would be as follows:




In this analysis, we can see swings of nearly $2.5m (or 2.5% of notional value) simply due to time value. This would have to be taken to P&L under IAS 39 but on a perfectly aligned exposure under IFRS 9, all of this time value would be deferred to OCI. Compare this P&L swing to your EBITDA values - in ROI terms, early adoption of IFRS 9 would remove this volatility from the reporting profits.

**ROI – BETTER RISK MANAGEMENT**

Ever since IAS 39 rules meant that option time value would move through the P&L, many companies either reduced their option-held positions, never held options over a reporting period or stopped trading options altogether. Here we have accounting rules having an undue influence over risk management decisions and one of the key issues the IASB was looking to overcome with the introduction of IFRS 9.

A detailed measure of the potential ROI here is to back-test what would have happened had you deployed a greater level of option-based hedging over the past two years, compared to your actual hedging strategy over that same period. Beware that this can be a lengthy exercise and involve a number of assumptions. Tools such as Cash Flow at Risk can significantly help with this analysis.

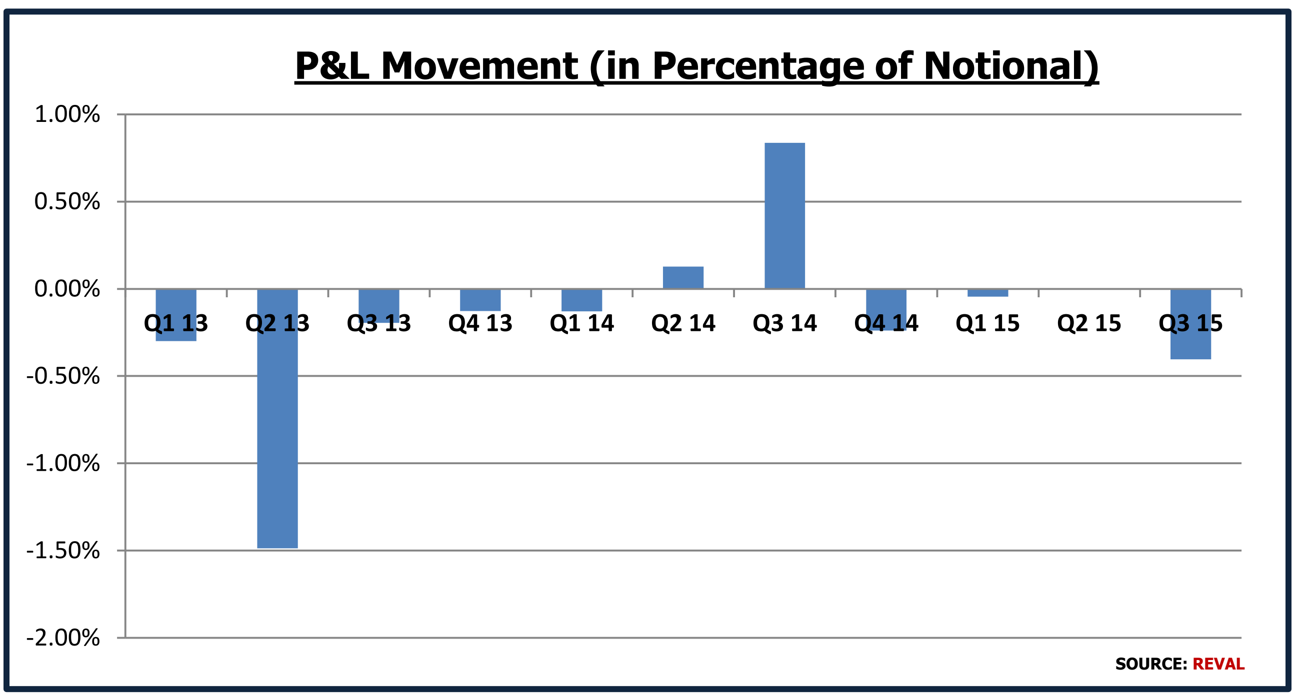
An alternative, more holistic ROI is to simply highlight that accounting will no longer drive the decisions around when and to what level an option-based hedging strategy should be applied.

## ADVANTAGE 2: HEDGING INSTRUMENTS – CURRENCY BASIS ON CCIRS

**GUIDANCE:** Para 6.5.16 extends the application of option time value highlighted above to the forward element on forward contracts and foreign currency basis spread on cross currency interest rate swaps ("CCIRS"). Currency basis has typically caused P&L volatility under the current guidance for Fixed to Float CCIRS, particularly since the financial crisis when basis spreads became a lot more volatile. This new guidance effectively allows these movements to be deferred into OCI.

**ROI – REDUCE P&L VOLATILITY**

Similar to option time value, a simple back test on the movements in currency basis over an historical time period can be a good estimate of future value of early adopting IFRS 9 in relation to currency basis. For example, if we consider a USD/HKD CCIRS for $100m USD which swaps fixed USD Debt to synthetic floating HKD-based debt - the currency basis movements back tested over the last 11 quarters would be as follows:



In this analysis, we can see swings of up to nearly 1.5% of debt notional due to movements in currency basis. For fixed to floating CCIRS, this movement would typically have been taken to P&L under IAS 39 and potentially even caused some hedges to fail but under IFRS 9, all such currency basis would be deferred to OCI. As with option time value, compare this potential P&L volatility to your EBITDA levels - in ROI terms, early adoption of IFRS 9 would remove this volatility from the reporting profits.

**ROI – BETTER RISK MANAGEMENT**

Protecting offshore debt positions against adverse currency movements usually is applied with CCIRS regardless of the accounting consequences, so we see less application for ROI here around better risk management.

## ADVANTAGE 3: HEDGED ITEM – COMPONENT HEDGING OF COMMODITY RISK

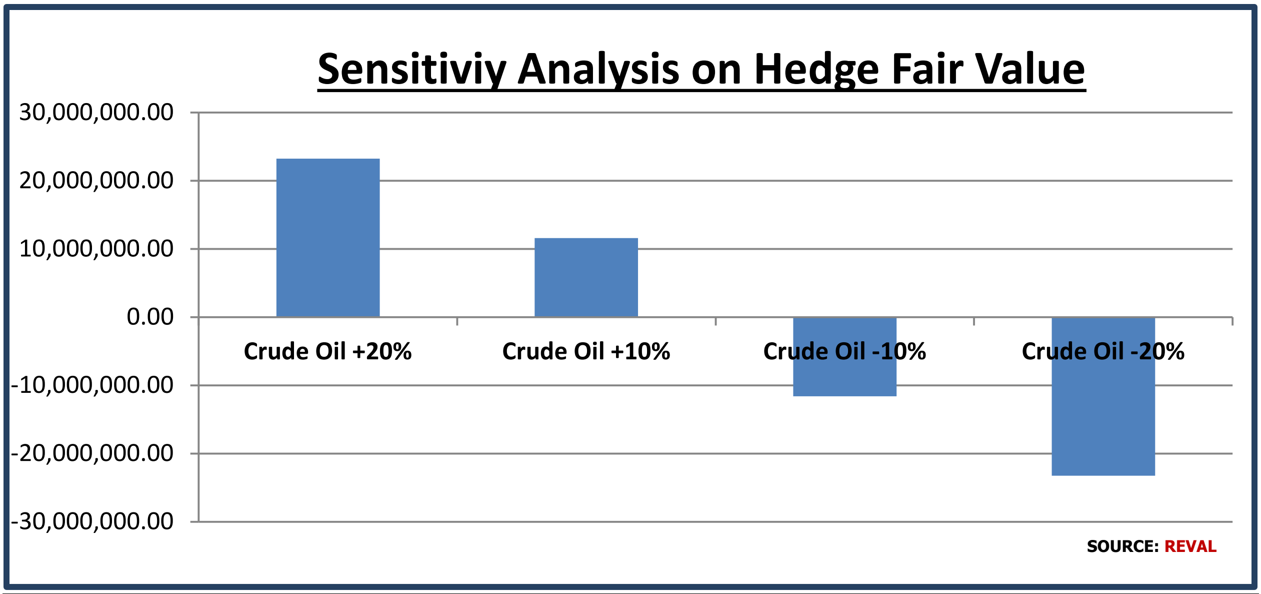
**GUIDANCE:** Para 6.3.7 opens up the definition of risk components available for designation to include non-financial items, as long as they are "separately identifiable and reliably measurable". Component hedging was not allowed under IAS 39 for non-financial items (most commonly commodities) and often resulted in hedge ineffectiveness, or no hedge accounting at all was applied on commodity hedging. This new guidance allows much greater flexibility in the way companies can define their hedged items such that hedges will be more effective in offsetting the hedged risk. You may now be able to hedge the rubber component of a tyre, the aluminum in a can, the crude component of jet fuel etc.

**ROI – REDUCE P&L VOLATILITY**

Hedge ineffectiveness for commodities under IAS 39 often arises from the unhedgable component of the exposure – the processing element to turn it into a usable good, the location of the commodity, the freight cost and so on. While some of these costs are not predictable, looking at past ineffectiveness can give a clear indication of likely future savings since IFRS 9 often allows these components to be excluded from the hedge relationship. Finance departments should be able to provide reported hedge ineffectiveness over the past years resulting from commodity basis risk.

A secondary point may be hedges that never had hedge accounting applied to them because of the restrictive rules in force in IAS 39. If such hedges would now qualify given the new criteria in IFRS 9, all of that potential fair value could be deferred to OCI. A good way to measure this potential ROI is to consider sensitivity analysis on market rate movements based on your typical hedge levels – this is an indicator of the potential P&L volatility that could be avoided if IFRS 9 was early adopted.

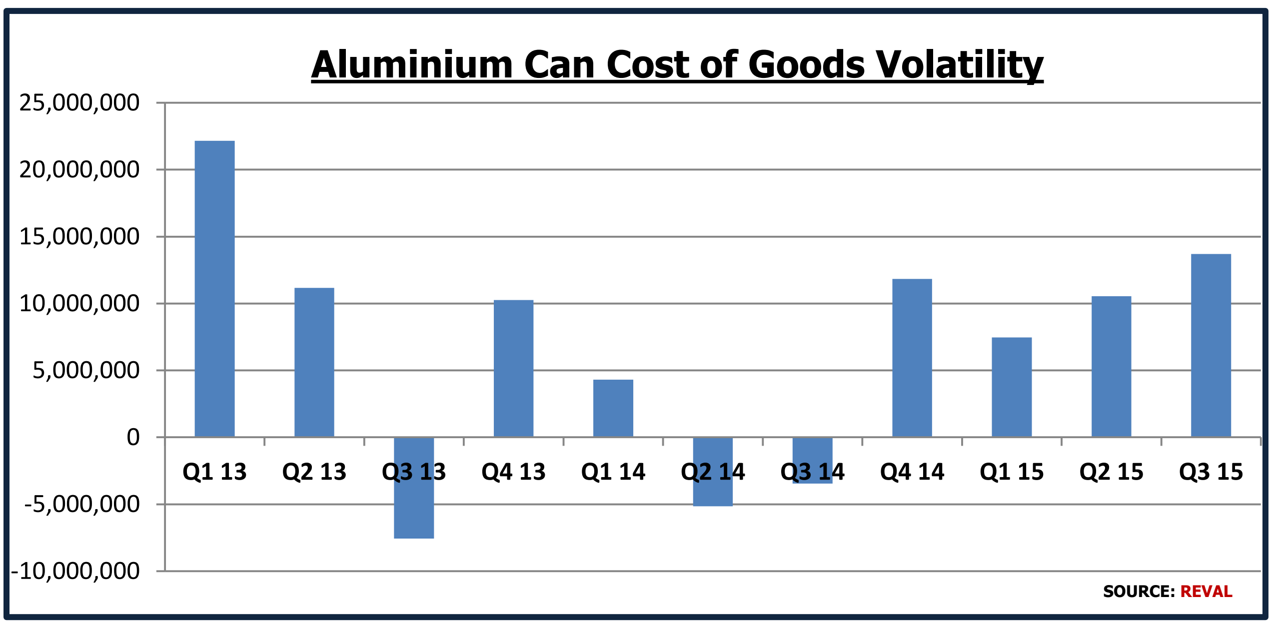
The following page shows an example where a crude oil hedge position was stressed for +- 10 and 20 percent movements in the crude oil price. For a significant position such as this, the company was exposed to a $23 million USD hit to P&L for a 20% movement down in price.




**ROI – BETTER RISK MANAGEMENT**

Many organisations have shied away from hedging commodity risks because of the difficulties of successfully applying hedge accounting under the current rules. A good ROI analysis to again consider back testing is to look at how much price volatility the company experienced without a commodity hedging programme in place.

Consider, for instance, a company that consumes aluminum cans in its production line. A large portion of the costs is associated with the price of aluminium; however, the company has never hedged as it could not be assured that hedge accounting was achievable under IAS 39. The graphic below illustrates the P&L volatility experienced over the last 11 quarters in USD, a large portion of which could have been eliminated with a hedging programme in place.



With an early adoption of IFRS 9, such a company could implement an aluminum hedging strategy with the confidence that hedge accounting could be successfully applied. This can be a key ROI benefit for many organisations looking at the early adoption decision. Companies in this sector will be clearly able to differentiate amongst their competitors and significantly change the bottom line results.

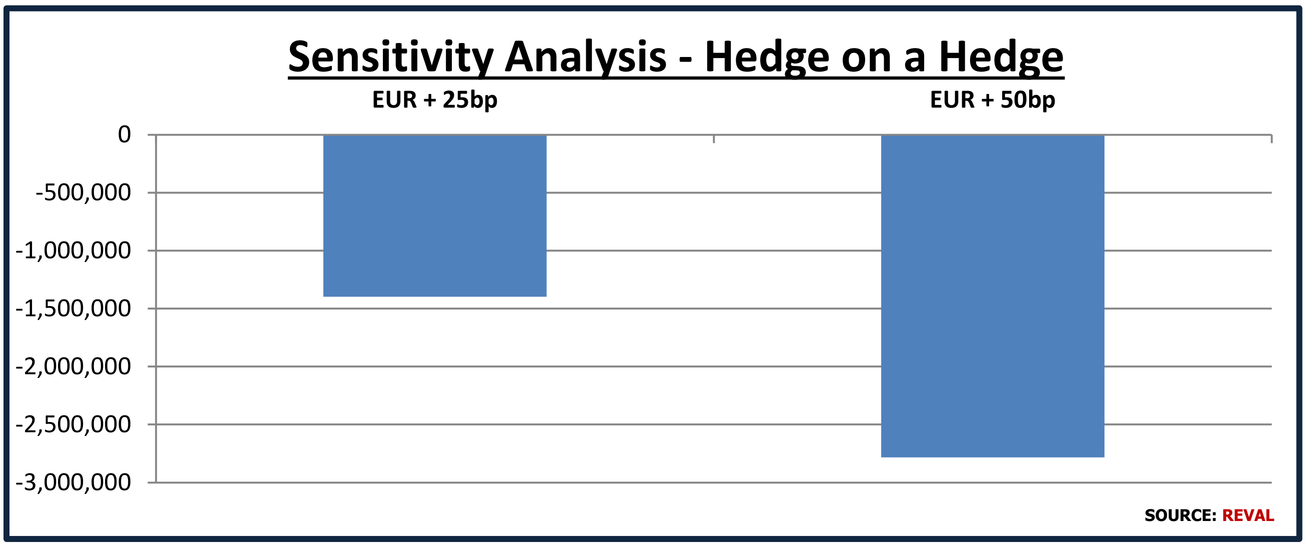
Many companies are also looking to transfer the management of commodity risk from procurement into the treasury department which will also increase the potential for financial hedging of commodity price risk.

## ADVANTAGE 4: HEDGED ITEM – DERIVATIVES AS HEDGED ITEMS

**GUIDANCE:** Para 6.3.4 allows for a new concept whereby a non-derivative can be combined with one or more derivatives as an aggregated exposure for hedge accounting. Derivatives were never allowed as hedged items under the current guidance so this change brings more flexibility and is another example where the accounting will now more closely match how organisations manage their economic risk.

### ROI – REDUCE P&L VOLATILITY

Since derivatives could never be used as hedged items previously, the most likely source of ROI on existing hedging strategies is avoiding the mark to market on hedges of aggregated exposures that now currently flow through P&L. For instance, you may have some overlay interest rate swaps hedging a combined offshore debt and CCIRS position to which you are not currently applying hedge accounting. Once again, a stress test on potential interest rate movements for year-end positions is a good indicator of the levels of P&L volatility that could be avoided with early adoption of IFRS 9. Consider a Eur100m interest rate swap hedging an offshore debt combined with a CCIRS position. A stress test of fair values based on an upward movements of 25 and 50 basis points is shown in the graphic below:




If you foresee a tightening of monetary policy in the coming financial year akin to these types of stresses, this represents a strong ROI to early adopt IFRS 9.



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**ROI – BETTER RISK MANAGEMENT**

Perhaps it is with better risk management that even greater potential ROI is possible when considering derivatives as hedged items. This ruling allows treasurers to consider a more active risk management programme beyond the 'set and forget' type hedging strategies they may have used in the past. At the simplest end, you may have an offshore debt and CCIRS position in which you are paying floating rate in your functional currency. If you want to fix some of the interest rate risk, you can enter into an interest rate swap to convert the synthetic floating rate risk on the debt/CCIRS combination to fixed interest cash flows. Now under IFRS 9, that transaction is hedge accountable since you can designate the debt and CCIRS together as a hedged item. Further on, you may want to convert even more of the exposure to fixed using the same approach or even convert the fixed cash flows back to floating at a later date – all transactions could be hedge accounted under IFRS 9 but were specifically disallowed under IAS 39. The ROI here is clearly greater flexibility in your hedging activity.

Further, the ROI can be even more transformational. Consider the scenario where an organisation uses collar option structures to hedge their FX risk. Many organisations find that as the market moves, some of the strikes on their option protection can be so far out-of-the-money that they offer little further protection given current market circumstances. By layering a more 'dynamic' hedging strategy in which strike prices are adjusted over time depending on the delta position of each option, companies can improve their protection levels. This type of hedging strategy can be hedge accounted using the 'derivatives as hedged items' ruling of Para 6.3.4 as long as at no point, do the options constitute a 'net written option'. This would represent another significant opportunity for treasurers to better manage their risk profile under IFRS 9.

## ADVANTAGE 5: NET POSITION HEDGING

**GUIDANCE:** Para 6.6.1 allows for the designation of a net position for FX exposures as long as they can specify which reporting period they will impact P&L and this process is consistent with their risk management approach. Net hedging was never allowed under IAS 39 so this represents a new mechanism treasurers can deploy to ensure their accounting is aligned with their risk management outcomes.

**ROI – REDUCE P&L VOLATILITY**

The benefit of this ruling very much resonates for those organisations that run a centralised FX hedging programme whereby business units submit offsetting exposures/hedge requests to treasury for hedging. For example, one business forecasts 100 USD of sales in one period, another forecasts 80 USD of purchases in another period and the treasurer hedges the net 20 USD exposure. Under IAS 39, the hedge accounting would have defined the 20 USD hedge against the 100 USD of sales since you could not designate a net exposure. This meant the business unit with the 80 USD purchases often was reflected as 'unhedged' and the impact of the hedge would not be reflected in the gross margin during the period. Such treatment was not reflective of the risk strategy since effectively both exposures were hedged economically.

Under IFRS 9, you can represent your hedged risk as the net of 100 USD sales and 80 USD purchases and as such, internally reflect a 100% hedged scenario to your business units. This will result in better alignment between economic risk activities and the underlying accounting outcomes being reported both internally and externally.

 

**ROI – BETTER RISK MANAGEMENT**

With Para 6.6.1 in place, this now opens up the prospect of net position hedging to companies that were uneasy with the seemingly inconsistent accounting treatment under IAS 39. The benefits to operating a centralised FX hedging programme across net positions are clear – greater efficiencies and reduced transaction costs as you leverage natural hedging positions. Although a decision to transition to a centralised programme involves more than just accounting implications, it is worth considering that under IFRS 9, there is a supportive framework towards a centralised approach.

## ADVANTAGE 6: STRUCTURED PRODUCTS

**GUIDANCE:** IFRS 9 no longer includes a bright line 80-125% effectiveness test requirement. This combined with the guidance of Para 6.5.15 b) allowing option time value to be deferred as a cost of hedging means that more flexible, structured derivatives can now potentially be hedge accounted under IFRS 9 compared to IAS 39. In addition, Para 6.2.6 allows users to combine different options together to create option structures – for instance, combining a purchased option with a sold option to create a collar instrument.

**ROI – REDUCE P&L VOLATILITY**

If your organisation already utilizes structured products, potentially you may have never attempted to apply hedge accounting previously or have failed the 80-125% test due to the misalignment with the hedge and the underlying vanilla exposure. In either case, IFRS 9 presents an opportunity to re-examine these hedge positions to see if hedge accounting can be applied now and what potential benefit may arise through hedge accounting. If you have experienced P&L volatility in the past from structured positions not being hedge accounted, the ROI is clearly the ability to remove a large portion of this volatility under the new flexibility enabled by IFRS 9.

**ROI – BETTER RISK MANAGEMENT**

For those organisations that disallow or have very low hedging using structured products, IFRS 9 represents an opportunity to increase the usage of those types of products and still achieve hedge accounting treatment (as long as the structures are not net written options). The benefits of using structured products can vary depending on the nature of your exposure, risk appetite and market view.

For example, a product such as a "Forward Extra" can allow a client to benefit from more advantageous moves in the underlying market up to predetermined strike rate at which point it knocks in and becomes a forward. Such a structure may have some ineffectiveness when compared against a hedged item modelled as a conventional 'collar' structure, however most P&L volatility will be avoided under IFRS 9. Your ROI sits with the added flexibility and potential upside gain in entering and successfully hedge accounting such structured products that simply was not feasible under IAS 39 in most circumstances.

**NOT WHEN, BUT HOW MUCH?**

We have all been waiting for IFRS 9 for a long time, and while some are happy to wait a little longer until it becomes mandatory, early adoption is a choice under this standard that all organisations exposed to market risks should consider. There are many advantages in IFRS 9 when compared with the current standard, IAS 39. Those treasurers looking to protect the balance sheet may be looking at adding new commodity hedging or overlaying interest rate swaps on existing CCIRS positions.

The Finance team's eyes will light up at potential P&L volatility reductions on option time value, currency basis and commodity hedging. Others may be looking at their competitors and eyeing up opportunities to bring more upside in their hedging portfolio utilising vanilla or structured option products or by building out more dynamic hedging strategies. The key element here is to take these technical concepts and evolve them into a robust and measurable ROI that senior management and the Board can act upon.

This whitepaper has illustrated some good examples of ROI on some of the most commonly applied aspects of IFRS 9 that we have seen our early adopter clients build a successful business case around. However, there are many more advantages such as hedging instrument combinations, the rebalancing mechanism etc. that could provide additional advantages to your company and should be considered.

You should also consider the additional disclosure requirements under this standard, which bring a much greater level of transparency around risk management objectives and activities to help users interpret the new financial outcomes. Similarly considering your compliance with IFRS 9 within your existing technology infrastructure and skill set within or outside the organization should play a part.

For those who have experienced P&L volatility and/or frustration under the current IAS 39 regime, there is no doubt there are advantages to be gained via early adoption, the only question is… how much?