The European Proceedings of
Social & Behavioural Sciences
EpSBS

Future Academy ISSN: 2357-1330

https://dx.doi.org/10.15405/epsbs.2018.12.167

RPTSS 2018 International Conference on Research Paradigms Transformation in Social Sciences

FINANCIAL INSTRUMENTS AND HEDGING: NEW RULES OF IFRS

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Abstract

In the system of International Financial Reporting Standards (IFRS), the issue of financial instruments is the most complex one. Among instruments accounts standards, IAS 39 is the most complicated document and it rightly brings up a lot of users' questions. The International Accounting Standards Board (IASB) decided to simplify financial instruments accounts standards. In July, 2014, IASB adopted the final version of IFRS 9 "Financial Instruments" that integrated stages of classification and assessment, impairment and hedge accounting approving provisions of the IASB's project of replacing IAS 39 and by overruling all previous revisions of IFRS 9 (IFRS 9, 2017). IASB tried to address the concern that appeared in terms of financial crisis and was related to the problem that the model of incurred losses in IAS 39 contributed to the recognition of credit losses with a delay. During the financial crisis, the recognition of credit losses related to loans and other financial instruments with a delay was regarded as a drawback of the current accounting standards. First, it is conditioned by the fact that according to IAS 39, current requirements for impairment are based on "model of incurred losses", that is, credit losses cannot be recognized until the event, causing credit losses, occurs (IAS 39, 2016). Actually, the new standard introduced the model of expected credit losses based on projections. New IFRS 9 in its final version will completely replace IAS 39 from the 1st of January, 2018.

Keywords: International standards, financial accounting, financial reporting, financial instruments, risks.

https://dx.doi.org/10.15405/epsbs.2018.12.167
Corresponding Author: E.A. Vovseenko
Selection and peer-review under responsibility of the Organizing Committee of the conference
eISSN: 2357-1330

1. Introduction

The problem of impairment of financial assets became extremely topical in the period of financial crisis. The recognition of losses on financial assets with a delay including the loans issued was evident proof of the drawbacks of the current system of international accounting. Therefore, nowadays, *the model of expected and not incurred losses* is proposed. The standard requires that the companies recognize losses at the moment of the primary recognition of the financial assets and revise the low allowance regularly. When reassessing the reserve, not only occurred negative events, but also current and future circumstances should be taken into account (Sokolova, 2016).

In *Investor Perspectives* (July, 2014) – the information report for investors focused on IFRS 9 "Financial Instruments" – Sue Lloyd, a member of IASB published the article where she introduced the following information. According to her opinion, the most distinctive difference of the new standard will be accounting of impairment. IFRS 9 requires organizations to assess and take into account the expected credit losses on all the financial instruments and it is not important whether they are related to simple money launderings or investments in financial instruments. The new requirements for impairment should help those investors who are worried about the impairments recognized "too late and insufficiently".

2. Problem Statement

It is evident that the new rules and regulations will mostly affect the financial institutions, but it is a mistake to think that the employees working in some other departments of the organization may not worry about them.

The new rules apply to almost all organizations as any of them has some financial instrument on their balance sheets – accounts receivable, trade obligations, loans or debt obligations (PwC, 2017).

In IFRS 9, the approach to accounting in the following spheres was not changed at all or was changed a little:

- recognition of financial assets and obligations on balance;
- derecognition of financial assets and obligations;
- classification of financial obligations.

Significant changes were introduced to:

- classification and assessment of financial assets;
- impairment;
- assessment of the own credit risks influence on the assessment of financial obligations;
- accounting for provisions.

IFRS 9 solves the problem of financial instruments accounting proposing the *mixed model* of their accounting at fair value and at amortized cost (Deloitte, 2017).

Below are the unified *rules of conducting the test for impairment of financial assets* presented in a brief way:

- a part of the expected credit losses (during the 12-month period) is recognized including all the financial instruments from the moment of their initial acquisition or issue. Later if there is a significant increase of the credit risk of the financial instrument from the moment of its initial acquisition, the expected losses will be recognized during the entire period of handling the asset;

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- calculating the interest income depends on the fact if the asset is really impaired. Initially, the interest is calculated applying the effective rate to the total inventory value of the asset (GROSS). These are the new regulations. However, in the case when the asset is already regarded as impaired, the effective rate is applied to the value of the asset less provision for impairment (NET).

The general rule of conducting the test for assets impairment according to IFRS is very simple: any asset (including a financial one) is considered impaired when its estimated replacement value is lower than its net book value (GAAP, 2018). So on paper, an accountant recognizes and reflects the larger value of asset than the volume of economic benefits this asset can generate. Let us consider the provisions of IFRS 9 in detail.

Using IFRS 9 when conducting the test for assets impairment.

The debt financial assets of just two categories are tested for impairment: carried at amortized value and at fair value with the attribution of the changes to other comprehensive income. The problem of impairment of the rental receivables related to leases (IAS 17 “Leases”), of assets related to the contracts with customers (IFRS 15 “Revenue”) or of the obligations to grant loans and financial guarantee contracts (IFRS 9 “Financial Instruments”) is examined separately. The single model of testing for impairment is used (Spiewak, 2017).

The test is not applied to equity assets, obligations to grant loans and financial assets carried at fair value with the attribution of the changes to PLS.

Credit losses and expected credit losses. Assessment of the expected credit loss.

A credit loss is a difference between all the cash flows foreseen in the contract and all the cash flows, the company expects to get discounted by the initial effective interest rate. The term “PV of cash shortfall” can be understood as the shortfall of money with regard to the cost of money during the definite period of time.

The expected credit losses are the weighted average of the credit losses defined with the usage of the corresponding risks of default as weighing coefficients. A company must assess the expected credit losses related to a financial instrument using the method that reflects:

- unbiased and weighed with the account of probabilities amount that is defined by assessing the range of possible results;
- time value of money and proved information about the previous events, current conditions and future projected economic terms that is available at the reporting date without entailing excessive costs.

The period of recognition of the expected credit losses.

At every reporting date, a company should create the loss allowance for the financial instrument in an amount equal to the expected credit losses for the entire period if the credit risk related to the given financial instrument significantly increased from the moment of its initial recognition. If at the reporting date there is no significant increase of the credit risk related to the given financial instrument from the moment of its initial recognition, a company recognizes the loss allowance for the given financial instrument in an amount equal to the expected credit losses during the 12-month period.

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According to the standard, the expected credit losses during the 12-month period are part of the expected credit losses for the entire period that may possibly occur due to defaults of the financial instrument during 12 months after the reporting date.

3. Research Questions

The goal of the standard is to recognize the expected credit losses for the entire period for all the financial instruments, the credit risk of which increased greatly from the moment of their first recognition, whether the assessment is based on group or individual aspects. Besides, all the proved and justified information including the projected one should be taken into account (IASB, 2016).

Approach to defining the significant increase of credit risk.

At every reporting date, a company should assess the degree of the credit risk increase related to the financial instrument from the moment of its initial recognition. When assessing, it has to focus on the change of the default risk during the expected period of using the financial instrument and not on the amount of the expected credit losses (Dyachenko, 2017).

To make such assessment, a company compares the default risk of the financial instrument at the reporting date and the default risk of the financial instrument at the date of the first recognition. The proved and justified information is analyzed that is available without entailing excessive costs.

A company may make assumptions that the credit risk related to the financial instrument did not increase significantly from the moment of the initial recognition if it found out that the financial instrument had low credit risk at the reporting date. In the guide to enactment of IFRS, there is a list of indicators that can be used when analyzing the changes of the credit risk.

Let us compare three organizations. One of the extremes is Organization A that reassesses the risk regularly but does not do anything to minimize the credit risks on the basis of these reassessments. Another one is Organization B; it reassesses risks and deletes the unutilized limits of some instruments for which the credit risks increased. This means that the measures will be taken only to address the partial increase of the credit risk, whereas no measures addressing other instruments with the higher credit risks will be taken. Organization C deletes the unutilized limits of all the credit instruments that showed the higher credit risk during the reassessment.

If an organization takes measures addressing any increased risk defined during the reassessment (as Organization C), the expected term of all the instruments having higher credit risks will be limited by the date of the next credit risk reassessment. If no measures are taken (as in Organization A) – the reassessment does not limit or shorten the term of the instruments. If the taken actions address only some instruments (as in Organization B), the scale of responses is reflected by the expected term.

Organizations differ from the point of view of practice and policy of credit risk management, and these differences lead to the fact that they bear credit risks during the different periods of time. This is consistent with the objectives of the item *B5.5.40* IFRS 9 related to the definition of this very period, during which the organization is exposed to the credit risk influence (IASB, 2017b).

It was, of course, a simplistic example. Generally, the response measures aimed at minimizing the credit risk amount to the full deletion of unutilized limits. If an organization is going to delete unutilized limits partially, the result will differ: an organization will not limit the expected term of all these instruments by the date of the next reassessment.

Acquired or created credit-impaired financial assets. How to make reserves if the asset is "bad" from the very beginning?

The financial asset is considered to be credit-impaired if one or several events negatively influencing the expected future cash flows related to this asset occur. The evidence of the credit impairment of the financial asset is empirical data. To account "bad" (credit-impaired) assets, it is necessary to assess all the possible expected credit losses not for the 12-month period, but for the entire period of handling the asset. A company has to apply the effective interest rate adjusted for the credit risks to the amortized cost of the financial asset from the moment of its initial recognition.

A simplified approach to trade receivables, contract assets and rental receivables for leases.

It is allowed to assess the expected credit losses for the entire period of handling this group of assets (Tereshko, 2018). The chosen approach must be registered in the accounting policy of a company, this permission is concerned with trade receivables, assets related to contracts with customers having financial components.

Therefore, when recognizing financial assets, the loss allowance is created AT ONCE and ONLY for the period of 12 months. It is only a part of the expected credit losses as the period is limited. Then during other reporting periods, if the financial instrument credit risk increases significantly (from the moment of its initial acquisition), the losses will be assessed and recognized for the entire period of handling assets. These possible credit risks are called lifetime risks.

When measuring the loss allowance, it is necessary to take into account all the topical and reliable information including the projected one that is available. This means that when the bank begins to expect the worsening of credit terms, it must reflect it in the calculations of the credit losses immediately (Noskov, 2015).

4. Purpose of the Study

The purpose of the study is to analyze the new rules of recognizing the expected credit risks for all financial instruments, as well as the new rules of hedging in accordance with the experience of risks management and to work out the recommendations for practical application.

5. Research Methods

The theoretical and methodological basis of the research is the usage of principles and methods of scientific cognition, theory provisions and the methodology of development of the financial reports indicators. While researching the problems of transition to the new standards of financial reporting, the specialized scientific works of foreign and Russian scientists were used as well as legislative and normative documents and articles on the studied issue on the special Internet sites. Such general scientific methods as analysis and synthesis, consistency and integration, abstraction, comparison and logical generalization were used.

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6. Findings

In order to apply hedge accounting in accordance with IAS 39, it is necessary to follow strict rules and criteria (IASB, 2017a). So a lot of companies that use hedging strategies very often cannot use hedging accounting in IFRS as they do not follow the necessary criteria for hedging accounting.

IAS 39 was criticized a lot because it did not apply the economically justified methods of risks management used by companies in real life. That was the reason why the new standard IFRS 9 made hedging accounting relevant to the experience of risks management which was the great improvement in the given sphere.

6.1. Differences in hedging accounting between IAS 39 and IFRS 9.

The fundamental provisions in hedging accounting remained the same. The most significant difference is the enlargement of the number of situations where hedging accounting is allowed (IASB, 2017a).

Let us consider the most important changes related to hedging accounting:

6.1.1. What can be considered a hedged item?

IFRS 9 allows using more items regarded as hedged ones.

IAS 39 allows applying hedging only to the whole object if the case is non-financial assets; it cannot be applied to the separate components of non-financial assets risks.

IFRS 9 allows hedging the components of non-financial items risks if these components can be separated and reliably assessed. Let us consider the examples.

Example 1

An airline company regularly purchases aviation fuel and, consequently, it bears significant risks related to the price for aviation fuel. The price for aviation fuel may change due to different factors – inflation, changes of the price for crude oil, exchange-rate fluctuations etc. This airline company decides to hedge only one of the components influencing the price of aviation fuel, namely, the risk of crude oil price changes. It does it by entering into a forward contract for buying crude oil.

In accordance with the demands of IAS 39, the airline company cannot use hedging accounting for the similar forward contract. The crude oil price is only one of the risk components of the non-financial asset (aviation fuel), and IAS 39 allows hedging accounting only for the entire non-financial asset.

In accordance with the demands of IFRS 9, the item can be hedged if the airline company can separate the risk component of the non-financial item.

Example 2

A company producing aluminum cans can hedge its exposure to the risk of changes of aluminum price arising because of its deposits. The price of aluminum cans includes not only the price of aluminum, but also some other components (prices for other raw materials and labour costs).

In accordance with IAS 39, hedging of the risk of aluminum price fluctuations is not allowed.

In accordance with IFRS 9, it is allowed.

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6.1.2. What can be an instrument of hedging?

In accordance with the demands of IAS 39, companies have little choice while defining the hedging instrument. The instruments of hedging are as follows:

a) derivative financial instruments (derivatives – swaps, options, futures, etc.) or

b) non-derivative financial assets or obligations (*only* when hedging currency risk).

However, IFRS 9 allows using a wider range of the hedging instruments. Therefore, the following instruments can be used as hedging ones:

a) derivative financial instruments

and

b) any non-derivative financial assets or obligations assessed at fair value via profit or loss.

Example 3

In the stockpile of a company, there is a lot of oil; the managers of the company want to apply hedging to the oil price at fair value. To do this, the company purchases the shares of a well-known oil producing company at the stock exchange.

In accordance with IAS 39, the company is not allowed to apply hedging accounting, as when hedging at fair value, only derivatives can be used as the hedging instruments, whereas shares are not derivatives.

In accordance with IFRS 9, it is possible to apply the special hedging accounting as IFRS 9 allows using non-derivative financial instruments as hedging ones.

6.1.3. Checking hedging efficiency.

IAS 39 requires checking hedging efficiency both prospectively and retrospectively. Hedging is considered highly-efficient only if it is within the limits of 80-125%. It means that if a company uses IAS 39, its accountants should calculate the hedging efficiency. The hedging efficiency was often checked only because of the IAS 39 requirements having no other objectives.

In accordance with the provisions of the new standard, checking the hedging efficiency became simpler and closer to the assessment of risks by the company's managers. IFRS 9 allows companies to use the information collected for internal purposes of risks management and it does not make companies conduct a very complicated analysis necessary only for accounting goals of IFRS (IASB, 2017a).

IFRS 9 overrules the requirement to the results of testing the hedging efficiency that had the range 80-125%. IFRS 9 does not require the quantitative assessment of hedging efficiency; sometimes the qualitative assessment can be sufficient.

Though IFRS 9 does not fully obviate the need to calculate something (for example, the inefficient part of hedging must be reflected in the profit and loss reports), these changes really simplify the hedging accounting.

6.1.4. Termination of hedging accounting.

IAS 39 allows the companies to terminate the hedging accounting of their own volition (IFRSprofessional, 2014).

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Whereas IFRS 9 does not allow the companies to terminate the hedging accounting of their own volition until the lifetime of the hedging instrument expires or the goal of risks management changes.

6.1.5. Rebalancing.

Rebalancing of hedging is an updating of hedging coefficient for the goals of risks management. This procedure is usually carried out when the quality of the hedging instrument or hedging item changes while interrelating with the hedging objects.

In similar situations, IAS 39 requires to terminate the current hedging and to begin new one. In reality, it means that the company must prepare new documents, assess the hedging efficiency, etc.

IFRS 9 simplifies the given situation as it allows changing the interrelations between the hedging objects without the termination of hedging and starting new one (Russian Federation Ministry of Finance, 2017).

7. Conclusion

Thus, it can be noted that the adoption of IFRS 9 leads to the expanded possible hedging relations in comparison with IAS 39.

In accordance with the new rules, companies have to change their approach to hedging assessment and accounting. These changes will simultaneously simplify and complicate the current approach and they will address the issues of hedging efficiency assessment, documenting this process and corresponding accounts. The example of the simplified requirements is the expansion of the list of risks that are allowed to hedge (e.g. the components of non-financial items risk). The example of the more complicated rules is the requirement for the degree and specification of the hedging accounting presented in the financial reports.

The strategy of risks management is of the highest importance when hedging in accordance with IFRS 9. However, hedging accounting is still regarded as an exception to the basic rules of bookkeeping. Consequently, there are some restrictions in the sphere of hedging accounting.

The novelty of IFRS 9 is in the assessment and separation of the amount of the own credit risk with its attribution to other comprehensive income. Primarily, this is related to the issued bonds having market quotation.

Thus, if a company chooses the model of obligations accounting at fair value, it must present the profit or loss of the fair value change as follows:

- the amount of the change of the financial obligation fair value which appeared because of the change of the own credit risk as part of the other comprehensive income;
- the remaining amount of the change of the financial obligation fair value as part of profit or loss;
- except for the cases when the influence of the change of obligations credit risks would lead to the occurring or increasing the accounting discrepancies in profit or loss (there is possibility to account by FVPL).

On 14 November 2017, IASB held discussions concerning two proposed approaches to the accounting model that reflects the dynamic management of risks in the final reports in the best way.

Particularly, the Board discussed the goals of the model and if it should follow:

– the mechanism of cash flows hedging; or
– the fair value of hedging.

The Board tentatively agreed that they should focus on the further development of the model based on the mechanism of cash flows hedging (IASB, 2017a).

Acknowledgments

The authors acknowledge receiving support from the state-funded research program of Irkutsk National Research Technical University. We are responsible for all errors as well as heavy style of the manuscript.

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