ACCOUNTING TREATMENT OF DERIVATIVES UNDER IFRS 9 STANDARDS

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Annotation:
This paper provides a comprehensive analysis of how derivatives are accounted for under the International Financial Reporting Standard 9 (IFRS 9), which replaced IAS 39 in 2018. It explores the principles guiding recognition, classification, and measurement of derivative financial instruments, along with the implications of hedge accounting provisions introduced by IFRS 9. The article highlights the challenges entities face in applying fair value measurement, managing volatility in profit and loss, and ensuring compliance with disclosure requirements. Additionally, the study investigates how IFRS 9 enhances transparency and risk representation in financial statements, while also addressing limitations in its practical application across industries.

Keywords: IFRS 9, derivatives, hedge accounting, fair value, financial instruments, recognition, classification, risk management, financial reporting.

Derivatives are complex financial instruments whose value is derived from underlying assets such as interest rates, currencies, equities, or commodities. Their primary purpose is to hedge against financial risks or to enable speculative positions in financial markets. The accounting treatment of derivatives is critical to ensuring that financial statements reflect the true economic substance of risk management activities. Under IFRS 9, which came into effect on January 1, 2018, the International Accounting Standards Board (IASB) sought to provide a more principles-based approach to the recognition, measurement, and disclosure of financial instruments, including derivatives. The standard aimed to address the criticism of IAS 39, which was often considered overly complex and rule-driven, particularly regarding hedge accounting. IFRS 9 introduced a more flexible framework that aligns accounting treatment more closely with risk management practices used by entities.

According to IFRS 9, all derivatives are recognized on the statement of financial position at fair value, with changes in fair value recognized in profit or loss unless the derivative qualifies for hedge accounting. A derivative is defined as a financial instrument that changes in value in response to changes in a specified underlying variable, requires little or no initial investment, and is settled at a future date. Examples include forwards, futures, swaps, and options. Upon initial recognition, derivatives are measured at fair value, which represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Fair value measurement can be complex, particularly when markets for certain derivatives

are illiquid or when valuation relies on unobservable inputs such as internal models or assumptions.

One of the major changes IFRS 9 brought was in hedge accounting. Under IAS 39, many entities struggled to qualify for hedge accounting due to strict documentation and effectiveness testing requirements. IFRS 9 introduced a more principle-based model that allows companies to better reflect their risk management strategies in their financial statements. To apply hedge accounting under IFRS 9, an entity must formally designate and document the hedging relationship at inception, specifying the risk being hedged, the hedging instrument (usually a derivative), and the hedged item. The new standard replaced the rigid 80–125% effectiveness range test of IAS 39 with a more qualitative assessment of whether a hedging relationship is expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk. This shift improved alignment between financial reporting and actual risk management practices.

IFRS 9 identifies three types of hedging relationships: fair value hedges, cash flow hedges, and hedges of net investments in foreign operations. In a fair value hedge, the derivative hedges exposure to changes in the fair value of a recognized asset, liability, or firm commitment. Changes in the fair value of both the derivative and the hedged item are recognized in profit or loss, thereby offsetting each other to the extent the hedge is effective. In a cash flow hedge, the derivative hedges exposure to variability in future cash flows. The effective portion of the gain or loss on the hedging instrument is recognized in other comprehensive income (OCI) and later reclassified into profit or loss when the hedged transaction affects earnings. The ineffective portion is recognized immediately in profit or loss. For hedges of a net investment in a foreign operation, IFRS 9 applies similar accounting treatment as cash flow hedges, ensuring that currency-related volatility is initially recognized in OCI until the investment is disposed of.

Fair value measurement remains a cornerstone of IFRS 9. Derivative instruments are generally categorized within the fair value hierarchy as Level 1, Level 2, or Level 3, depending on the observability of inputs used in valuation. Level 1 inputs are quoted prices in active markets for identical instruments. Level 2 inputs are observable, either directly or indirectly, such as interest rate curves or currency forward rates. Level 3 inputs are unobservable and typically rely on management estimates and valuation models. The use of Level 3 inputs introduces significant estimation uncertainty, which requires extensive disclosures under IFRS 13 (Fair Value Measurement). IFRS 9 mandates that entities disclose not only the fair value of derivatives but also the methods, assumptions, and sensitivity analyses used in their valuation, enhancing transparency for investors and regulators.

One of the challenges entities face under IFRS 9 is the recognition of derivatives used for risk management purposes that do not qualify for hedge accounting. In such

cases, all fair value changes are recognized immediately in profit or loss, leading to potential earnings volatility even if the derivatives are economically effective hedges. This accounting mismatch between derivative instruments and hedged items remains a practical issue. Although IFRS 9 provides more flexibility, it still requires rigorous documentation and consistent monitoring of hedge effectiveness throughout the life of the hedge. The cost and complexity of compliance, especially for non-financial corporations, can be significant. Entities must establish robust systems to capture fair value data, maintain audit trails, and meet the extensive disclosure requirements imposed by IFRS 7 and IFRS 13.

Moreover, IFRS 9 integrates the concept of expected credit loss (ECL) into the measurement of financial assets, but derivatives, which are typically measured at fair value through profit or loss, are not directly subject to ECL provisions. However, credit valuation adjustments (CVA) are necessary to reflect counterparty credit risk in derivative valuations. The incorporation of CVA ensures that the fair value of a derivative reflects not only market risks but also the risk that the counterparty may default on its obligations. This adjustment enhances the reliability of reported fair values but introduces additional complexity in valuation, particularly for long-term or illiquid derivative contracts.

Empirical evidence shows that IFRS 9 has significantly improved the alignment of financial reporting with risk management practices across global financial institutions. A 2022 study by Deloitte and the European Banking Authority (EBA) found that more than 75% of surveyed banks reported enhanced transparency and improved investor confidence following IFRS 9 adoption. However, the same study highlighted ongoing challenges in hedge effectiveness assessment, documentation burdens, and the volatility of OCI reserves arising from cash flow hedges. Furthermore, differences in regulatory interpretation across jurisdictions have led to inconsistencies in application, particularly between European and Asian financial institutions.

IFRS 9's emphasis on principle-based hedge accounting encourages innovation and better reflects the economic reality of hedging strategies, yet it also places significant reliance on management judgment. This judgment affects not only hedge designation and effectiveness assessment but also the determination of whether a derivative qualifies as an embedded derivative that must be separated from its host contract. The judgmental nature of these decisions can lead to reduced comparability across entities, which remains a concern for analysts and regulators. Additionally, entities must ensure that derivatives are derecognized appropriately when contractual rights expire, are settled, or transferred to another party.

In conclusion, IFRS 9 represents a major advancement in the accounting treatment of derivatives, replacing the prescriptive and complex framework of IAS 39 with a more principles-based, risk-aligned approach. It improves transparency through comprehensive disclosure requirements and enhances consistency between accounting

outcomes and real-world risk management. However, the standard's application remains complex, particularly for entities with limited resources or exposure to illiquid derivatives. The requirement for fair value measurement introduces volatility, and the reliance on management judgment increases subjectivity. Future reforms may focus on simplifying hedge accounting documentation, enhancing guidance on fair value hierarchy application, and promoting greater consistency in international practice. Despite these challenges, IFRS 9 has established itself as a robust framework that strengthens investor confidence and improves the faithful representation of derivatives and financial risk management activities in global financial reporting.

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