BDO NATURAL RESOURCES TECHNICAL UPDATE

APPLICATION OF IFRS 9 TO THE NATURAL RESOURCES SECTOR

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The origins of IFRS 9 *Financial Instruments* stem from the global financial crisis and is a very significant standard for the banking sector. Whilst the impact on IFRS 9 is not as great on non-financial entities, those in the natural resources sector should not ignore its impacts.

The key features of IFRS 9 to be considered by those in the natural resources sector include:

- Moving from an incurred loss model to a predicted loss model
- The strict rules as to which financial assets can be recorded at amortised cost
- Investments in unlisted shares to be recorded at fair value
- Simplified hedge accounting rules.

PREDICTED LOSS IMPAIRMENT MODEL

Trade receivables

For most non-banking sectors, a key impact of IFRS 9 is applying the predicted loss model to trade receivables. Natural resources companies typically sell their commodity to a single or a limited number of customers, where typically there is low credit risk or history of default. Therefore, this aspect of the standard in respect of trade receivable impairment testing is not likely to be a major application issue for the natural resources sector.

Loans to associates, joint ventures and joint operations

The new financial asset impairment rules are however likely to have major implementation issues for loans provided to associates, joint ventures and joint operations.

The natural resources sector, perhaps more than any other sector, structures projects through joint ventures, joint operations and minority stakes.

It also is perhaps unique in that it funds start-up operations, for example greenfield exploration, through debt as well as equity.

These debt instruments are typically subordinate to any external project debt, with repayment dependent upon project success.

A common justification for such instruments is to minimise tax charges and withholding taxes as and when funds are repatriated from an overseas project.

These loans fall within the complex '3 stage' impairment model set out in IFRS 9, designed for banks to apply to their loan books.

The natural resources company as the investor will have to determine which stage the loan is in;

- Stage 1 - being the same credit position as when the loan was advanced
- Stage 2 - being that the borrower's credit risk has increased significantly since the funds were advanced, or
- Stage 3 - the loan is in default.

Stage 3 equates to the current point for impairment in IAS 39, the incurred loss model.

The investor is required to make a provision for expected credit losses regardless as to which stage the loan is in.
When the loan is in stage 1, the provision is to be based on the likelihood of an impairment event occurring in the next 12 months.

In stages 2 and 3, the impairment provision is based on the likelihood of an impairment event occurring in the lifetime of the loan.

Default events are likely to be directly related to:

- The progress of exploration activity
- The success or otherwise of drilling
- The commodity price and costs of production, and
- Changes in sovereign risk and tax rates.

In many cases the loan will only be repaid through production or sale of assets. The expected timing and amount of cash flows to be generated from the project will need to be modelled out to determine the expected credit loss at each reporting period.

RESTRICTION ON MEASURING ASSETS AT AMORTISED COST

IFRS 9 introduces strict rules as to which financial assets can be recorded at amortised cost. The test applicable to the natural resources sector is the SPPI test (solely payments of principal and interest).

Under this test if the return on the loan is not 'vanilla interest', being the credit risk of the borrower and the time value of money, the loan must be recorded at fair value.

This requirement is again likely to impact loans made to joint ventures, joint operations and associates, particularly if these entities are in the earlier stages of exploration.

In many cases, the only means of repaying the loan and paying interest is dependent upon the success of the project.
Such loans are likely to fail the SPPI test and require the lender to measure them at fair value.

UNLISTED EQUITY INVESTMENTS

IAS 39 allowed investors to carry their investments in unlisted shares at cost if it was determined that the fair value of the investment could not be reliably measured.

IFRS 9 does not have this exemption, requiring ALL investments in equities to be measured at fair value. Determining the fair value of unlisted equity investments will require additional effort and judgement to value the unlisted investment in accordance with IFRS 13 *Fair Value Measurement*.

IFRS 9 allows investors an irrevocable choice to elect for any movement in fair value of an investment in a share to go through other comprehensive income (OCI) rather than through the income statement.

Although it might appear similar to the available for sale category in IAS 39, on disposal of the investment the cumulative change in fair value is required to remain in OCI and is not recycled to profit or loss.

HEDGE ACCOUNTING

IFRS 9 contains changes to simplify the strict hedge accounting rules contained in IAS 39. The hedge accounting model in IAS 39 has been criticised as being complex, rules based and failing to reflect risk management activities of organisations.

Simplified hedge accounting may result in natural resources companies entering into more hedging contracts. IFRS 9 should enable a wider range of economic hedging strategies to achieve hedge accounting.

The changes include:

- Removing the 80 to 125% hedge effectiveness rule
- Allowing fair value movements in options (including time value) to be recorded in OCI
- Hedging a non-financial component of a hedged item
- Resource companies can more effectively hedge account exposures that give rise to two risk positions (e.g. commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods.

The natural resources sector is heavily exposed to market risk, arising from:

- Price risk of commodities produced and sold
- Price risk of fuel used in production
- Interest rate risk on borrowing
- Foreign exchange risk.

Despite the market risk inherent in the natural resources sector, since the adoption of IAS 39, companies have tended not to enter into option and other derivative contracts to hedge exposures to these risks.

IAS 39 made achieving hedge accounting very difficult. The introduction of IFRS 9 should be a catalyst for entities in the sector to re-examine their treasury strategies.

For more information on the application of IFRS 9 to the natural resources sector, contact our IFRS Advisory experts:

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