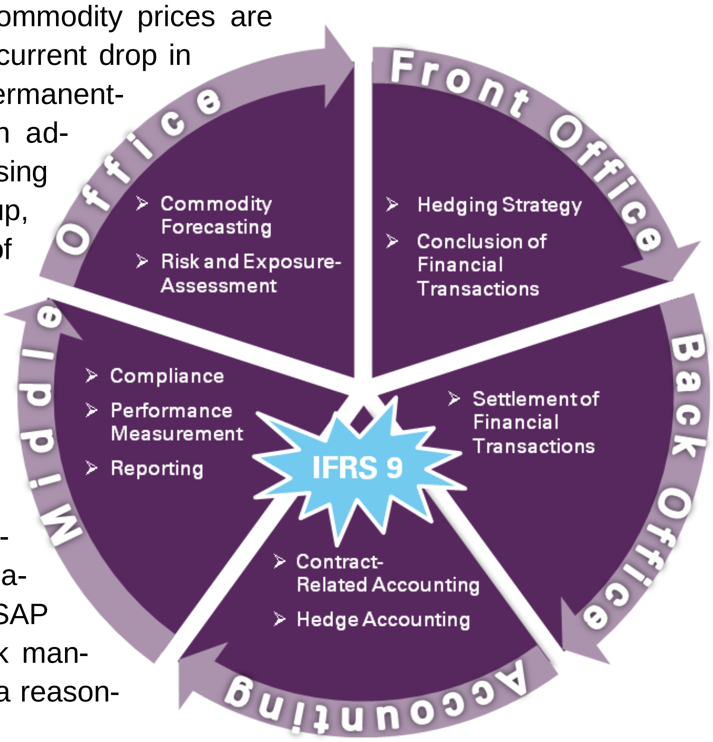
Commodity Management in Times of IFRS9: Easier than You Think!

Hedging commodity price risks is also efficient for small and medium-sized enterprises

Brent oil -30% YOY, iron ore +50% since November 2015, cocoa +15% YOY: The current developments on the commodity markets make it clear that, compared to other indicators important for treasury management such as exchange and interest rates, commodity prices are clearly considerably more volatile. It is indeed the current drop in some commodity prices that offers possibilities to permanently hedge the price level achieved and to gain an advantage over the competitors. In times of increasing kerosene prices, that is just how the Lufthansa Group, one of the pioneers in the sector in the hedging of fuel price risks, saved up to $150 million per year on the corresponding costs.



In spite of this fact, the hedging of these risks is often still in an early stage, since many companies associate it with increased complexity and recoil at the thought of the associated, supposedly higher expenditure in commodity hedging. With the introduction of an adequate process and the implementation of a corresponding system solution (like the SAP solution for Commodity Management), efficient risk management for commodities is more than possible at a reasonable expense.

In principle, the handling of risks from the change in commodity prices does not differ from the corresponding processes in currency and interest management: Both the derivation of risk exposure and the conclusion of hedging transactions and their mapping in the back office and accounting, follows the methods already established here.

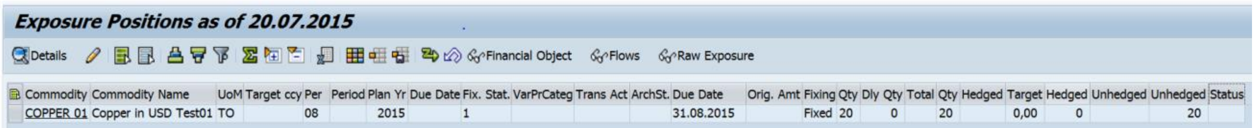
Calculation of the risk exposure may be difficult, but doesn't have to be

The basis for any effective risk management process is to determine the correct exposure. Similar to the hedging of currency risk, the expected future commodity requirements – or the expected sales quantity in the case of commodity trade respectively – are to be determined. The basis for this is adequate, cash flow-based planning, essentially, the existing purchase or supply agreements which as a general rule, are already captured in an ERP system like SAP MM. In particular, for booking in hedge accounting, which may be planned for later a transparent calculation is essential, especially for the external auditors.

In the processing industry, risk exposure is frequently derived not directly from the target figures or agreements. Admittedly, the prices of the upstream products used here often depend on the rates of the commodities used in this respect. However the risk volumes only result from the corresponding percentage shares of the respective commodity. In this case, a good integration between procurement and exposure calculation is helpful – for instance, SAP's Commodity Management solution offers the opportunity for percentage share values to be stored directly in the system and automatically calculates the risk from the captured orders.

The corresponding forward exchange rates have to be used to assess the risk volume, which can be calculated from the traded futures contracts on the commodity exchanges. This calculation can be complex and requires a certain amount of expense but there are also considerable advantages to be gained by using an adequate system solution and the related direct connection to a market supply.

In the overview of exposure positions of SAP TRM it is possible to derive the overall unhedged quantity of purchase orders for certain delivery date and certain commodity:

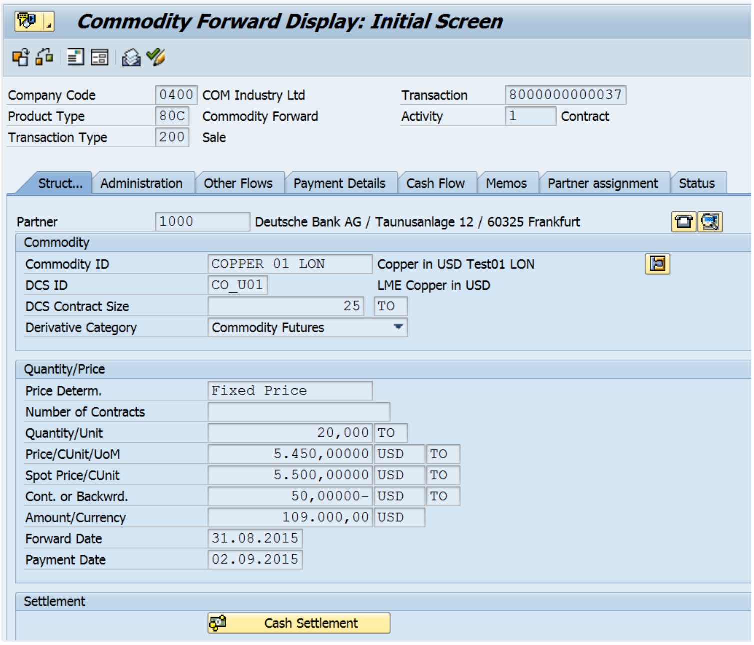

Exposure Positions as of 20.07.2015

Commodity	Commodity Name	UoM	Target ccy	Per	Period	Plan Yr	Due Date	Fix. Stat.	VarPrCateg	Trans Act	ArchSt.	Due Date	Orig. Amt	Fixing	Qty	Dly Qty	Total	Qty	Hedged	Target	Hedged	Unhedged	Unhedged	Status
COPPER 01	Copper in USD Test01	TO		08		2015		1				31.08.2015		Fixed	20	0		20		0,00	0		20	

Hedging strategy and conclusion of hedging transactions – systematic or situational?

Once the commodity exposure has been calculated, the next step to be taken in the hedging process must be decided. In principle, two fundamentally different approaches are available: a systematic process, i.e. the basic hedging of the risk volume according to a fixed target (e.g. full or half hedging) or a situational approach which is dependent on the current market estimate and selects a respective hedging strategy for each individual commodity. Both options have advantages and disadvantages - as a rule, fixed targets are associated with less expense but, react less flexibly to modified market situations just like the current fluctuations on the crude oil market. In fact, there is no universal recommendation since each company must make this decision based on individual preferences. It is advisable to look into this issue actively and once the decision has been made to implement it consistently, amongst others with the introduction of an appropriate benchmark for the hedging decisions made.

The conclusion of hedging transactions for the implementation of the strategy decision is associated with low organizational expense. This part of the process is hardly any different from the corresponding activities in currency or interest management. In this case, typical hedging transactions are also commodity forwards, swaps or options, which are also fundamentally captured with most system solutions on the market and which should be able to be processed through the settlement. There are differences in the evaluation: similar to the evaluation of risk volume, specific market data and algorithms are required to establish correct market values which, in the worst case, could lead to problems when booking the transactions. When selecting the IT solution for example, it should be verified whether the usual so-called average rate forwards or Asian options in the commodity sector can be processed.



Booking of the transactions and reporting – IFRS 9 on the horizon

The final steps in the risk management process are the booking of the transactions in the commodity hedging and informative reporting on the hedging results. Providing that an integrated system, with a sub ledger function and adequate market data, is available, the processing of the transactions in accounting does not pose any significant obstacle, since in this case there are also clear parallels to the procedure in the other risk categories.

It can be more complex in case that the hedging transactions are to be booked in a hedge relation. Both require the correct handling of the calculated exposure and the necessary calculations to prove an efficient hedge relation. As already mentioned above, if there is no direct exposure, but it can only be derived proportionally from the upstream products, the provision of this proof is made additionally more difficult and can only be mapped cost-efficiently by a consistent system solution.

But this cumbersome procedure is significantly facilitated at least for those entities reporting in accordance with IFRS: The forthcoming standard IFRS 9 “Financial Instruments”, which has to be applied from January 2018 on, replaces the existing rules according to IAS 39. Whereas the former standard emphasizes the continuous quantitative verification of an effective relation between hedge and underlying, IFRS 9 allows for a more qualitative approach. According to the new rules, a formal designation will still be mandatory, but the respective documentation will focus on the description of the company’s risk management strategy, the related targets and a prospective and more qualitative assessment of the hedge relation’s effectiveness. Especially, it will no longer be necessary to calculate effectiveness retrospectively on a quarterly basis – which is a major obstacle for hedge accounting of commodity derivatives. SAP Commodity Management, as one of the few standard applications offering a complete solution that is adaptable to the company's individual requirements, covers this partial process according to IFRS 9 as well.

Another advantage of an appropriate, integrated system support is the extensively automated creation of internal and external reporting. Not only the reports required for controlling the in-house risk management process (e.g. overview of the hedging exposures, position mapping, results reports) can be covered, but above all, the various requirements which have been stipulated by the regulatory authorities – referring above all in this context to EMIR and MiFID2, however also to REMIT for energy trading.

In short – commodity hedging is worthwhile!

This summary of a typical process in commodity management demonstrates that behind the hedging of this risk category, still considered as "exotic" for many companies, no insurmountable difficulties are concealed, but rather is similar to many of the processes already established in treasury management. Starting from January 2018, IFRS 9 will be mandatory and it will be easier even to do hedge accounting for companies reporting in accordance with IFRS. With the appropriate system solution like SAP for Commodity Management, and competent support in methodological and procedural issues, the introduction of efficient commodity hedging can be achieved within a few weeks and is thereby also available as a real alternative for small and medium-sized enterprises.

If you are interested in further information do not hesitate to contact Thomas Buettner, Manager
COMPIRICUS AG, Friedensstr. 6-10, 60311 Frankfurt, sales@compiricus.de