New Hedge Accounting Model Will Improve Investor Understanding of Risk Management

Pat McConnell, a member of the IASB, discusses the benefits of the new hedge accounting model

The new hedge accounting model more closely aligns accounting for hedging activities with a company's risk management strategies, and provides improved information about those strategies.

In November 2013, the IASB added a new Hedge Accounting chapter to its financial instruments Standard (IFRS 9 *Financial Instruments*). It is a major overhaul of hedge accounting. The new model more closely aligns accounting for hedging activities with a company's risk management strategies, and provides improved information about those strategies.

Investors in non-financial companies are likely to see the most improvement in financial reporting for risk management activities. Banks and similar financial institutions will be more affected by the outcome of the IASB's dynamic risk management (macro-hedging) project which is currently underway[1].

When will you start to see the new model?

The new hedge accounting model can be applied when a company adopts IFRS 9. Because the IASB is still finalising amendments to the classification and measurement chapter in IFRS 9 and completing a chapter on expected credit losses, the effective date of IFRS 9 has been revised to 1 January 2018. However, companies may choose to apply it now. We expect companies that will be significantly affected by changes to accounting for the classification, measurement and impairment of financial instruments to postpone adopting IFRS 9 until its effective date. However, companies whose primary exposure to financial instruments is derivatives used for risk management may adopt it sooner to take advantage of the improved hedge accounting model.

Why did the IASB develop a new hedge accounting model?

Not all risk management activities are reflected in the financial statements through hedge accounting. The risk management activities represented by hedge accounting are those risks that management chooses to manage

[1] Click here to read the investor perspective on this project.

with financial instruments such as derivatives, and for which they elect to use hedge accounting. In addition, because hedge accounting is elective it does not need to be applied even if a company is engaging in hedging activities. Because of IAS 39's onerous record-keeping requirements some companies simply chose not to make use of hedge accounting for some or all of their hedging activities. In addition, because of the rule-based nature of IAS 39, there are instances in which companies cannot apply hedge accounting even though they are using financial instruments to mitigate risk.

When a company enters into derivatives for risk management purposes but hedge accounting cannot or is not applied, the derivatives are accounted for as if they were trading instruments. This creates volatility in profit and loss that is inconsistent with the economics of the related risk management strategy. As a result, the hedging relationship is not apparent to investors. A company that has reduced its risk by entering into the derivatives for risk management purposes may paradoxically appear more risky.

Objective of the new hedge accounting model

The objective of the new hedge accounting model is an enhanced link with risk management. It will be simpler for companies to apply, and it will permit them to apply hedge accounting to many more risk management strategies that use financial instruments. Enabling hedge accounting to be applied to more risk management strategies will improve investors' understanding of how the company is managing risk. This will better align the financial accounting result to the economics of the strategy, resulting in less artificial volatility in profit and loss.

Disclosures

Analysts and investors complain that financial results produced by the IAS 39 model are often confusing and do not provide sufficient information to understand a company's risk management activities. For example, the disclosures today are more focused on individual instruments than in providing information about risk-management, which is not helpful or transparent for investors.

The new model's enhanced disclosure requirements aim to improve investors' understanding of a company's hedging activities. The new disclosure package will meet many of the recommendations put forward by the CFA Institute in its study, *User Perspectives on Financial Risk Disclosures under IFRS – Derivatives and Hedging Activities Disclosures (Volume 2)*[2].

[2] A copy of this study can be found at: http://www.cfainstitute.org/ethics/Documents/cfa_institute_user_perspectives_on_financial_instruments_under_ifrs.pdf

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Currently, information about hedge accounting is required to be provided only by type of hedge (eg cash flow and fair value hedges for accounting purposes). It is difficult for investors to relate this information to the types of risks being hedged such as interest rate, currency and commodity price risk. To make these relationships more transparent, the new model requires that all disclosures about hedge accounting be provided in a single location making use of tables.

For example, a company may manage its floating interest rate risk by using an interest rate swap to change it to a fixed interest rate. For accounting purposes this is known as a cash flow hedge. The company may also use a cross-currency interest rate swap to manage the floating interest rate and foreign exchange risk of another financial instrument. This is also known as a cash flow hedge for accounting purposes. Now, the company will be required to disclose, in a tabular format, the two risk mitigating strategies separately under the heading of cash flow hedges. It will disclose information about the interest rate swap under a risk category for floating interest rate risk and information about its cross currency swap under a separate category for foreign exchange risk combined with floating interest rate risk.

The following example illustrates how a company might disclose amounts related to items designated as hedging items in a tabular format.

	Nominal amount of the hedging instrument	**Carrying amount of the hedging instrument**		**Line item in the statement of financial position where the hedging instrument is located**	**Changes in fair value used for calculating hedge ineffectiveness for 20X1**
		Assets	**Liabilities**		
Cash flow hedges					
Floating interest rate risk: Interest rate swap contracts	xx	xx	xx	Line item XX	xx
Foreign exchange risk combined with floating interest rate risk: Cross currency swaps	xx	xx	xx	Line item XX	xx

Investors want to understand the risks that a company faces, how it manages those risks and how effective the company's risk management strategy was. In addition, they want to be able to understand the difference between the economic outcome of the risk management strategies and the financial reporting outcome.

Fair value hedges					
Interest rate risk - Interest rate swaps	xx	xx	xx	Line item XX	xx
Foreign exchange risk - Foreign currency loan	xx	xx	xx	Line item XX	xx

These tabular disclosures will significantly improve the information about the risks being hedged and for which hedge accounting has been elected. Companies will also be required to explain their risk management strategy, provide details about derivatives they have entered into including their potential effect on future cash flows, and explain the effect hedge accounting has had on their financial statements.

A company will not be required to disclose information about risks that are not being hedged, or risks that are being hedged but for which hedge accounting has not been elected. However, IFRS 7 *Financial Instruments: Disclosures* already requires companies to provide qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments to which it is exposed and how it manages those risks. We hope that, as part of these disclosures, companies will provide information to help investors understand how they manage risks for which hedge accounting **is not** applied.

Conclusion

As mentioned above, the new hedge accounting model will not be mandatory until 1 January 2018 when IFRS 9 becomes effective. However, a company may elect to adopt IFRS 9 at any time between now and 2018. That means that for the next few years, investors will need to pay particular attention to the hedge accounting model being applied by companies.

Note that even though a company may not be applying the new hedge accounting model, it can adapt the improved disclosure format to its hedge accounting under IAS 39. This alone is likely to improve an investor's understanding of a company's risk management strategies.

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Better aligning the hedge accounting to a company's risk management activities and addressing some of the criticisms of the former model should also go a long way in addressing [investors'] concerns.

Because in the IASB 39 model not all risk management activities are reflected in the financial statements even when management is using financial instruments to hedge those risks, it is no wonder investors are dissatisfied with financial reporting for hedging activities. Consequently, investors often rely on non-audited, non-GAAP information to understand a company's risks and the outcome of its strategies for managing those risks. Better aligning the hedge accounting to a company's risk management activities and addressing some of the criticisms of the former model should also go a long way in addressing those concerns.

About the author

Pat McConnell is a member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB or the IFRS Foundation. The IASB/IFRS Foundation encourages its members and staff to express their individual views. This article has been developed by the author as an individual. It is has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

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