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| Project | Financial Instruments (Replacement of IAS 39)—Hedge Accounting |
| Topic | Hedge accounting disclosures—Illustrative example |

Purpose of this paper

1. This paper provides the Board with an illustrative example of the proposed disclosure requirements in agenda papers 20A, 20B and 20C. This example only provides an illustration of the proposed hedge accounting disclosure. This example does not provide disclosures required by other standards. This example uses a small oil company as a basis for the information presented.
2. The following are the relevant amounts on the face of the balance sheet and the statement of comprehensive income with respect to the example provided.

The statement of financial position had the following balances in the accounts at 30 June 20X9:

| | CU millions |
|----------------------------------|----------------|
| Assets | |
| Derivative financial instruments | 8.90 |
| Loans receivable | 15.00 |
| Firm commitment | 0.40 |
| Liabilities | |
| Derivative financial instruments | (15.00) |
| Accounts payable | 2.00 |
| Loan payable | 40.00 |
| Loan payable—hedge adjustment | 2.90 |
| Equity | |
| Cash flow hedge reserve | (9.00) |

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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The statement of profit or loss and other comprehensive income had the following totals at 30 June 20X9:

| | CU millions |
|--|------------------------|
| Profit or loss | |
| Other financial gains/losses (time value of options) | (1) |
| Hedge ineffectiveness | (7.00) |
| Foreign exchange gain | 0.60 |
| OCI | |
| Fair value hedges | |
| Changes in value of the hedged item | 2.50 |
| Changes in value of the hedging instrument | (2.60) |
| Ineffectiveness transferred to profit or loss | 0.10 |
| Cash flow hedges | |
| Changes in the value of the hedging instrument | 43 |
| Amounts transferred to profit or loss | (32) |

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Hedging activity for the year ended 30 June 20X9**Balance sheet information related to the designated hedging instruments**

| | Notional amount of the hedging instrument | Carrying amount of the hedging instrument | |
|--|---|---|----------------------------|
| | | Assets CU millions | Liabilities CU millions |
| Cash flow hedges | | | |
| Commodity price risk (see page 5) | | | |
| - Oil forward sales contracts | 9,540,000 barrels | 2.00 | 15.00 |
| - Oil put option contracts | 7,380,000 barrels | 3.90 | - |
| Fair value hedges | | | |
| Interest rate risk (see page 7) | | | |
| - Interest rate swaps | CU 50,000,000.00 | 3.00 | - |
| Foreign exchange risk (see page 8) | | | |
| - Loan | FC 10,000,000.00 | 6.00 | - |

Balance sheet information related to designated hedged items

| | Separate line item recognised in the balance sheet for the gain or loss on the hedged item ¹ | | Cash flow hedge reserve |
|---|---|-------------|-------------------------|
| | Asset | Liabilities | |
| Cash flow hedges | | | |
| Commodity price risk (see page 5) | | | |
| - Forecast sales | n/a | n/a | (9.00) |
| - Discontinued hedges (forecasted sales) | n/a | n/a | - |
| Fair value hedges | | | |
| Interest rate risk (see page 7) | | | |
| - Hedge adjustment loan payable | - | 2.90 | n/a |
| - Discontinued hedges (hedge adjustment—loan payable) | - | - | n/a |
| Foreign exchange risk (see page 8) | | | |
| - Firm commitment | 0.40 | - | n/a |
| - Discontinued hedges | | | |

¹ The Board tentatively decided to present the cumulative gain or loss on the hedged item attributable to the hedged risk as a separate line item in the balance sheet. That line item is presented within assets (or liabilities) for those periods for which the hedged item is an asset (or liability).

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Effect of hedging activities on the statement of profit or loss and other comprehensive income

| Cash flow hedges ² | Change in the value of the hedging instrument | Ineffectiveness in profit or loss | Line item in profit or loss (that includes ineffectiveness) | Amount transferred out of AOCI to profit or loss | Line item in profit or loss (that includes transfer) |
|--|---|-----------------------------------|---|--|--|
| - commodity price risk (see page 5) | 43.00 | (6.90) | <i>Hedge ineffectiveness</i> | (32.00) | <i>Revenue</i> |

| Fair value hedges | Change in the value of the recognised hedged item | Change in the value of the hedging instrument | Ineffectiveness in profit or loss | Line item in profit or loss (affected because of ineffectiveness) |
|---|---|---|-----------------------------------|---|
| - interest rate risk (see page 7) | 2.90 | (3.00) | (0.10) | <i>Hedge ineffectiveness</i> |
| - foreign exchange risk (see page 8) | (0.40) | 0.40 | - | n/a |

² The information disclosed in the statement of changes in equity (cash flow hedge reserve) should be presented using the same level of granularity as the proposed disclosure requirements.

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Risk management

Commodity price risk

Commodity price risk is the most important market risk for the company. The risk is managed in USD. The company has established guidelines for entering into contractual arrangements (derivatives) in order to manage its commodity price risk. Commodity price risk is managed on a mid-term basis. The commodity derivatives are priced using pricing benchmarks (mainly Brent). *(See paragraphs 5-7 of agenda paper 20C)*

The company estimates production to be on average 55,000 barrels of oil per day for 20X0 and hedges only a certain proportion of that production. This leaves the company in a position to benefit from rises in prices for crude oil while protecting a minimum level of profitability of its main production assets (refer to the management report, Section XX). To manage the commodity price risk, the company enters into commodity-based derivative contracts, which consist of exchange-traded put options and over-the-counter forward contracts. The company is able to integrate all their oil production (and forecasts) into a centralised risk management system because of the small size of its operations and the fact that production operations are managed from one subsidiary. *(See paragraphs 5 - 7 of agenda paper 20C)*

The company's hedge position can be summarised as follows: *(See paragraphs 8-12 of agenda paper 20C)*

| | 20X0 | 20X1 | 20X2 |
|--|-------------|-------------|-------------|
| Basis of total price risk exposure (barrels of oil per day) | 55,000.00 | 60,000.00 | 65,000.00 |
| Exposure hedged | | | |
| <i>Forward sales contract</i> | | | |
| Basis of hedged exposure (barrels of oil per day) | 14,500.00 | 6,000.00 | 6,000.00 |
| Average hedged rate USD/per barrel | 81.75 | 85.50 | 88.00 |
| <i>Put options</i> | | | |
| Basis of hedged exposure (barrels of oil per day) | 14,500.00 | 6,000.00 | nil |
| Average hedged rate USD/per barrel | ≥75.00 | ≥70.60 | nil |

The oil hedges of the company involve basis risk. The grade of the oil that the company produces differs from the grade of the oil referenced in the derivative contracts. Those contracts (both for the OTC and exchange traded derivatives) mainly refer to the Brent crude oil price as a benchmark. The company's oil production trades on average at about 80 per cent of Brent crude oil prices. Hence, fluctuations around this average create hedge ineffectiveness. *(See paragraphs 13-14 of agenda paper 20C)*

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OTC derivatives involve credit risk. The company uses collateral arrangements with its main lenders that are also the counterparties to the company's OTC derivative contracts to reduce credit risk (see Note XX.b on Financial Risk Management—Credit Risk). However, some credit risk remains and can result in hedge ineffectiveness. (*See paragraphs 13 - 14 of agenda paper 20C*)

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Interest rate risk

The company manages its interest rates by converting the cash flows from long-term loans payable (CU 50 million) with fixed interest rates into floating rate interest payments. The company applies this strategy because it wants its funding costs to flow in step with market changes. (See paragraphs 5-7 of agenda paper 20C)

Loans payable are normally borrowed at a fixed rate in local currency. These loans are converted to floating rate loans using interest rate swaps. Under interest rate swaps, the group agrees with other parties to exchange, at specified intervals, the difference between interest amounts calculated by reference to an agreed notional principal and agreed fixed and floating interest rates. The company hedges only the benchmark risk component. (See paragraphs 5-7 of agenda paper 20C)

The company's interest rate risk exposure can be summarised as follows: (See paragraphs 8-12 of agenda paper 20C)

| Fixed interest—loans payable | | | | |
|--|-------------|-------------|-------------|-------------|
| | 20X0 | 20X1 | 20X2 | 20X3 |
| Basis for total interest rate risk exposure (CU million) | 40.00 | 30.00 | 20.00 | 10.00 |
| Average fixed interest rate | 6% | 6% | 6% | 6% |
| Exposure hedged | | | | |
| Basis for the exposure hedged | 40.00 | 30.00 | 20.00 | 10.00 |
| Receive fixed interest payments | 5.90% | 5.90% | 5.90% | 5.90% |
| Pay floating interest rate | LIBOR+2% | LIBOR+2% | LIBOR+2% | LIBOR+2% |

At the year end the entity had only receiver swaps. With effect from 1 January 20X9 a notional amount of CU 50 million with a 6% fixed rate was swapped for a floating rate of 3m LIBOR +200bps³. This contract expires on 1 January 20X5. The result of the hedge is an effective interest expense of LIBOR +245bps (3m LIBOR + 200bps + 40bps [fixed leg differential] + 5bps [transaction cost]). (See paragraphs 8-12 of agenda paper 20C)

The company's interest rate swaps are subject to credit risk. The company uses collateral arrangements to mitigate credit risk (refer to the disclosure of commodity price risk above). However, the remaining credit risk can result in hedge ineffectiveness. (See paragraphs 13-14 of agenda paper 20C)

³ Basis points.

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Under the approach used by the company, the fair value hedging of fixed rate liabilities gives rise to limited hedge ineffectiveness because of the reset interval (3 months) of the floating leg of the interest rate swap. *(See paragraphs 13-14 of agenda paper 20C)*

Foreign exchange risk

The company has limited exposure to foreign exchange risks. Its purchases and sales are mostly denominated in its functional currency. *(See paragraphs 5-7 of agenda paper 20C)*

The company's hedge position can be summarised as follows: *(See paragraphs 8-12 of agenda paper 20C)*

| USD/EUR exposure—Assets | 20X0 USD million |
|--|-----------------------------|
| Basis for total foreign exchange risk exposure managed (firm commitment) | 6.00 |
| Exposure hedged | |
| Basis for the foreign exchange risk hedged | 6.00 |
| Average hedged rate | n/a |

During the year the company entered into a firm commitment transaction to purchase property, plant and equipment of EUR10m. The investment appraisal was based on the functional currency because of the related cash flows generated by the equipment. Consequently, the cost of the investment was locked in as an amount in the functional currency using foreign currency hedging. *(See paragraphs 8-12 of agenda paper 20C)*

The company designated EUR10m of a high credit quality loan of EUR25m as the hedging instrument for foreign exchange risk. The loan is denominated in the same currency as the currency of the firm commitment. The company did not hedge the remaining EUR15m of the loan. This is because that loan is naturally offset against other assets and liabilities of the entity. *(See paragraphs 8-12 of agenda paper 20C)*

This hedge is fully aligned with the exposure regarding the hedged FX risk, which is measured using the spot rate method. *(See paragraphs 13-14 of agenda paper 20C)*