Project: **Financial Instruments (Replacement of IAS 39)—Hedge Accounting**

Topic: **Hedge accounting disclosures—Cover note and approach**

Papers to be discussed at this meeting

1. In addition to this paper, the Board will discuss five other papers:

   (a) **Agenda paper 20A**: Disclosures about the effects of hedge accounting on the balance sheet.

   (b) **Agenda paper 20B**: Disclosures about the effects of hedge accounting on the income statement and on the statement of other comprehensive income and the cash flow hedge reserve.

   (c) **Agenda paper 20C**: Disclosures about each of the risks that the entity manages through hedging activities.

   (d) **Agenda paper 20D**: Illustrative example of the recommended hedge accounting disclosures.

   (e) **Agenda paper 20E**: Staff recommendations and questions to the Board.

2. This cover note only provides the Board with background information. Agenda papers 20A, 20B and 20C will ask the Board to consider possible hedge accounting disclosure requirements. Agenda paper 20D provides the Board with an illustrative example of the recommended disclosures. Agenda paper 20E considers the alternative approaches that the Board can adopt for hedge accounting disclosures and asks the Board for decisions.

3. The staff recommend that all the proposed disclosures should be provided in one location in the financial statements. However, because relevant information may be described in other locations, the entity does not have to duplicate that information, but rather needs only to provide clear cross-references.

Tentative decisions reached by the Board at previous meetings

4. At the September 2010 meeting the Board decided on the scope of the hedge accounting disclosures[1] . At that meeting, the Board tentatively decided:

   (a) to expand disclosures in IFRS 7 *Financial Instruments: Disclosures* to include the exposure to a specific risk for financial and non-financial items when an entity applies hedge accounting; and

   (b) that hedge accounting disclosures are restricted to the risks that an entity hedges and for which hedge accounting applies.

Purpose of this paper

5. This paper provides the Board with background information. This paper is organised as follows:

   (a) summary of feedback received from users;

   (b) approach followed in developing the proposed disclosures; and

   (c) overview of the approach to hedge accounting disclosures.

Summary of feedback received from user outreach

6. During its deliberations on the hedge accounting project, the Board and staff reached out to preparers and users. A specific effort was made to gain an overall

[1] See agenda paper 17 of the September 2010 IASB meeting.

understanding of how users view hedging and of how an entity's hedging activities affect their analysis and decisions. Our outreach included soliciting views on presentation and disclosure. The staff used the feedback received from users as a starting point from which to develop the proposals for possible hedge accounting disclosures.

7. At the March 2010 meeting, the staff provided the Board with feedback from its outreach activities with users[2]. This section provides a brief summary of the feedback that the staff provided to the Board at that meeting.

The main points

8. The main points from the user feedback were:

   (a) users specifically want information on:

      (i) gross exposures and hedged volumes;

      (ii) how exposures are mitigated;

      (iii) the effects of the risk management strategy (ie the resulting net exposure);

      (iv) notional amounts; and

      (v) time horizons of the hedges.

   (b) users want a (meaningful!) description of the entity's hedging strategy; and

   (c) users want information on the derivatives that qualify for hedge accounting and the ones that do not qualify for hedge accounting but that are economically used to hedge.

[2] Agenda paper 12 of the March 2010 IASB meeting.

Other points

9. Overall, there was a broad spectrum of views regarding other points from the user feedback:

   (a) many analysts were not greatly concerned about hedge ineffectiveness;

   (b) analysts are interested in long-term, recurring value drivers that impact the cash flows of the business;

   (c) many analysts want information that allows them to unwind the effects of hedge accounting so they can see how the business performs before the effect of hedging; this provides information on underlying value drivers and risks of the business (this is relevant for hedges of operating activities like sales and purchases rather than hedges that eg change financing between fixed or floating interest exposure);

   (d) analysts of non-financial institutions were not greatly concerned about management speculation with derivatives that are portrayed as hedges;

   (e) buy-side analysts tend to look at hedge activities in less detail compared to sell-side analysts;

   (f) overall, analysts are interested in an entity's risk exposures and how the entity manages those exposures through the use of hedging instruments;

   (g) most analysts believe that hedge accounting should reflect the entity's internal risk management approach;

   (h) many users noted that today's hedge accounting requirements are overly complex, and they do not understand why hedge accounting is achieved in some situations and not in others;

   (i) analysts think that hedge accounting information would be more useful if it were concise, focusing on the key points (rather than providing abundant detail) so that the 'message' does not get lost; and

   (j) some analysts think that providing disclosures on hedging activities in one note helps them to save time in their analysis.

Considerations in developing the proposed disclosures

10. Accounting is inherently limited in its ability to provide *all* the information that *all* users of financial statements will find useful.

11. In addition to this inherent limitation, one of the main issues relating to the reporting of hedging activities is that existing recognition and measurement requirements allow for only partial reflection of these activities in the financial statements.

12. To address these issues there needs to be a clear objective of hedge accounting disclosures and a clear approach to developing such disclosures.

The approach

13. Users have indicated that hedge accounting disclosures are not transparent[3]. Enhancing the transparency of hedge accounting disclosures requires an approach that considers:

    (a) information that provides a clear picture of the entity's risk management activities with respect to hedge accounting, which is not necessarily provided in the primary financial statements; and

    (b) the information provided in the primary financial statements.

The objective

14. The staff have approached the development of hedge accounting disclosures with a view to the following objectives—providing information about:

(a) the effect that hedge accounting has had on the entity's balance sheet, income statement and statement of comprehensive income (see agenda papers 20A and 20B);

[3] See agenda paper 13 of the March 2010 IASB meeting.

(b) **how an entity's risk management strategy is applied to manage or transform risk (see agenda paper 20C); and**

(c) **how the entity's hedge activities may affect the amount, timing and uncertainty of its future cash flows (see agenda paper 20C).**

15. To meet these objectives there are some issues that need to be addressed:

(a) What information do we require about the effects of hedge *accounting* on the primary statements and how should it be presented?

(b) What information do we require with respect to the risk management activities of the entity and how should it be presented?

(c) How do we provide a clear link between the information in the primary financial statements and the additional information in the notes to the financial statements?

Information about the effects that hedge accounting had on the primary financial statements

16. Why do we need to understand the effects of hedge accounting on the primary financial statements?

17. One of the functions of hedge *accounting* is to mitigate the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items. Hedge accounting disclosures therefore must increase transparency on how an entity has mitigated these recognition and measurement anomalies. Doing so will help users identify how hedge accounting has affected the performance statement and the balance sheet of the entity.

18. Consequently, the first step is to understand what amounts have been recognised or deferred as a result of hedge accounting.

19. Agenda papers 20A and 20B discuss proposed disclosure requirements about the effects of hedge accounting on the primary financial statements.

Information about the entity's risk management activities

20. The second step in providing useful information to users of financial statements is to provide disclosures about the entity's risk management activities and how they relate to the primary financial statements.

21. Agenda paper 20C discusses proposals about disclosures that could be provided to allow users to understand how an entity manages each of the risks that it identified as part of its risk management activities. These proposals focus mainly on information that is *not* available in the primary financial statements.

Providing a link between information presented in the primary financial statements and additional information that is specific to hedge accounting

22. Information captured in the primary financial statements represent the elements of financial statements (assets, liabilities, equity, income and expenses). However, for the purpose of hedge accounting, we are interested in the exposure that an entity manages. Consequently, we need to 'link' (a) the information in the primary statements to (b) the additional information specific to each risk and how it is managed.

23. A good link would be to list each of the risks that the entity manages as part of its risk management activities. In other words, the entity should disclose the effects of hedge accounting on the primary statements by risk. This way, when the entity provides additional disclosures on the risk management activities, there is a natural link to the information that explains the effects of hedge accounting on the primary financial statements.

24. For the purpose of hedge accounting disclosures, the entity should categorise risks based on how that entity manages risks. In other words, the disclosure requirements will not prescribe these *particular categories*: an entity will have to apply judgement on how to categorise these risks. However, these categories should be used consistently throughout all the proposed hedge accounting disclosures.

Other considerations

25. There will not be any prescribed level of aggregation or disaggregation for the purpose of these disclosures. However, entities will have to consider the level of aggregation and disaggregation used for other disclosures (for example, fair value disclosures in IFRS 7). This is because users should be able to eg link fair value disclosures with hedge accounting disclosers where this is necessary to better understand the fair value movements of the relevant amounts disclosed.

26. As a general principle, entities are encouraged to disclose any additional information they feel is necessary to meet the objectives of hedge accounting disclosures.

Hedges of groups of items of net positions

27. The Board has tentatively decided that some hedges of groups of items and net positions should be eligible for hedge accounting.

28. Because the disclosures proposed for hedge accounting are based on clear objectives, there are no additional disclosures specific to hedges of groups or net positions, other than providing the required information (as set out in agenda paper 20A, 20B and 20C) in the context of a hedge of a group of items or a net position.

29. In other words, when an entity provides information about the risk and how it is managed in accordance with the proposed disclosures, it should provide that information for hedges of groups of items and hedges of non-groups of items in the context of that particular risk. Consequently, the proposed disclosures are required by type of risk and then within each risk by hedges of groups of items and hedges of non-group items.

An overview

30. A diagrammatic representation of the proposals for hedge accounting disclosures is shown below.

Overview of the approach to hedge accounting disclosures