IFRS

IASB Meeting | Agenda reference **1A**

Staff Paper | Date **28 July 2011**

Project **Financial Instruments: Hedge Accounting**

Topic **Disclosures—Scope**

Purpose of this paper

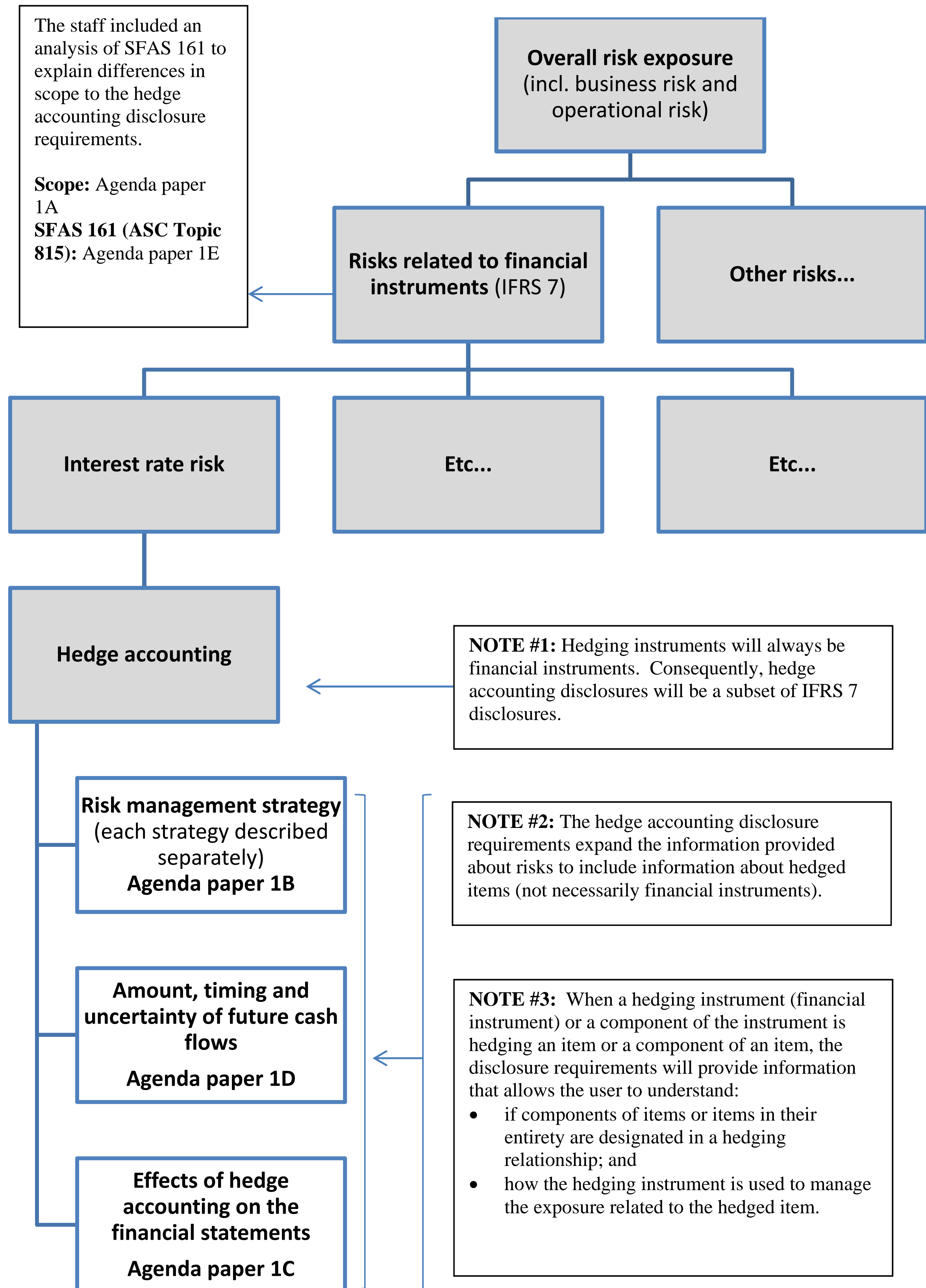
1. This paper asks the Board to confirm the **scope** of the hedge accounting disclosures as proposed in the exposure draft *Hedge Accounting*.
2. This paper does not address specific hedge accounting disclosures. This paper only provides a discussion of the scope of the information to be disclosed as part of the hedge accounting disclosure requirements.
3. The diagram below illustrates the relationship between all the agenda papers that discuss hedge accounting disclosures. The items shaded in grey are relevant to the discussion points in this paper.

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.


The staff included an analysis of SFAS 161 to explain differences in scope to the hedge accounting disclosure requirements.
Scope: Agenda paper 1A
SFAS 161 (ASC Topic 815): Agenda paper 1E
Overall risk exposure (incl. business risk and operational risk)
Risks related to financial instruments (IFRS 7)
Other risks...
Interest rate risk
Etc...
Etc...
Hedge accounting
NOTE #1: Hedging instruments will always be financial instruments. Consequently, hedge accounting disclosures will be a subset of IFRS 7 disclosures.
Risk management strategy (each strategy described separately)
Agenda paper 1B
NOTE #2: The hedge accounting disclosure requirements expand the information provided about risks to include information about hedged items (not necessarily financial instruments).
Amount, timing and uncertainty of future cash flows
Agenda paper 1D
NOTE #3: When a hedging instrument (financial instrument) or a component of the instrument is hedging an item or a component of an item, the disclosure requirements will provide information that allows the user to understand:
• if components of items or items in their entirety are designated in a hedging relationship; and
• how the hedging instrument is used to manage the exposure related to the hedged item.
Effects of hedge accounting on the financial statements
Agenda paper 1C

Background

4. In the exposure draft, the Board proposed disclosure requirements related to **risk exposures that an entity decides to hedge *and* for which hedge accounting is applied**.

5. Even though the objective of hedge accounting is related to how an entity manages risk, the Board did not think it was appropriate to require disclosures about risks outside those for which hedge accounting is applied. This is because hedge accounting provides a clear boundary of the information that is required. Otherwise, the Board would need to develop guidance to define which risks should be excluded from these disclosures. Consequently, reporting on an entity's risk position is a much broader proposition than focussing on hedge accounting and the related risks being managed.

Comments received

6. Most respondents to the exposure draft agreed with the Board's proposed scope for hedge accounting disclosures. However, some did request that the Board clearly show the scope of the hedge accounting disclosures in the introduction to the disclosure requirements. This would avoid any uncertainty as to what information the disclosure requirements are meant to capture.

7. Most respondents acknowledge that there are constraints in providing information about the entity's overall risk exposure and how that is being managed. However, some still believe that the disclosures should go beyond just the risk exposures for which *hedge accounting* is applied. These respondents believe that it is equally important to see the hedging activities for which hedge accounting is applied as well as the hedging activities for which hedge accounting is not applied[1]. They argue that the Board is seeking to

[1] These respondents did not provide suggestions on how the Board could scope such disclosures or any indications of how such a scope for an entity's hedging activities would operate.

represent an entity's risk management activities in the proposals in the exposure draft, yet these risk management activities will only be represented if the entity **elects** to apply hedge accounting.

Staff analysis and recommendation

8. When discussing whether the scope of hedge accounting disclosures should go beyond the exposures for which hedge accounting is applied, there are two separate issues to consider:

    (a) providing information about an entity's overall risk exposure; and

    (b) providing information about why and how an entity uses financial instruments irrespective of whether it elected to apply hedge accounting.

What is the problem with requiring disclosures of an entity's overall risk exposure?

9. Information on an entity's overall risk exposure would undoubtedly be useful to users of financial statements. However, providing such information as part of a disclosure package on hedge accounting raises some problems. For example, to really understand how hedging activity reduces or mitigates the overall risk of the entity, the disclosures would need to describe each and every one of the risks that the entity in its entirety is exposed to. The problem is where to draw the line. In other words:

    (a) What is the overall risk exposure (definition)?

    (b) Does it only relate to items recognised in the financial statements at year-end?

    (c) Should exposures that arise from future transactions be included in such a disclosure?

10. As stated in the Basis for Conclusions on the exposure draft, reporting an entity's overall risk position is a much broader proposition than focusing on

hedge accounting and on the related risks being managed. Consequently, the Board proposed in its exposure draft that such disclosures fall outside the scope of this project.

11. The Board stated that it did not believe it was feasible as part of the hedge accounting project to define disclosures for risk exposures other than those for which hedge accounting is applied.

12. It is worth noting that the IFRS Practice Statement *Management Commentary* proposes that management should disclose information about:

    (a) the principal risk exposures and changes in those risks;

    (b) its plans and strategies for bearing or mitigating those risks; and

    (c) disclosures of the effectiveness of its risk management strategies.

    Such disclosures would not be limited to risks for which hedge accounting is applied although it would form part of such a discussion. thus a more general picture of risks and their management can be achieved through the management commentary.

What are the problems with requiring information to be disclosed about how and why an entity uses financial instruments irrespective of applying hedge accounting?

13. Because an entity can choose to apply hedge accounting, it creates situations where information cannot easily be compared, for example:

    Entities can hold financial instruments for the same reason, but one entity may decide not to elect hedge accounting. Consequently, different information will be available for the entity applying hedge accounting compared to the entity which does not apply hedge accounting.

14. Thus, the concern here is not with disclosures about the entity's overall risk exposure but rather about providing information about why an entity holds financial instruments and how they are being used (irrespective of applying hedge accounting).

15. The proposed disclosures provide users with more information about **how an entity uses financial instruments** to manage risk exposures as opposed to the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*. This is because the focus of the disclosure requirements is different. This is illustrated in the table below:

Hedge Accounting exposure draft *Proposed disclosure requirements*	**IFRS 7** *Disclosure requirements*
Information about the risks arising from hedged items (**not necessarily just financial instruments**) for which hedge accounting has been applied.	Information about the risks arising from **financial instruments**.
Information about how the financial instrument (hedging instrument) is used to manage the risk exposure arising from the hedged item when hedge accounting has been applied.	Information about how the entity manages the risks arising from the financial instrument.

16. Does this mean that IFRS 7 does not require any disclosures about how and why an entity uses financial instruments?

17. No. IFRS 7 requires an entity to provide qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments. To provide information on risk exposures and how they are managed, entities would have to provide the necessary context by explaining how and why they use financial instruments (for example, by explaining hedging strategies). However, there are no *specific* disclosure requirements in IFRS 7 in this regard. Hence, the information being disclosed would be based on the judgement of entities and how they believe it is appropriate to provide the necessary context around the nature and extent of risks arising from financial instruments and how those risks are managed.

18. However, the proposed disclosure requirements in the hedge accounting exposure draft would require an entity to specifically disclose how it uses hedging instruments (financial instruments) to manage risk exposures related to the hedged items. These specific disclosures would only be required if the entity **elected** to apply hedge accounting. Consequently, if the entity elected not to apply hedge accounting it would not be required to provide these specific disclosures.

19. This begs the question: **should entities disclose the same information about how and why they use financial instruments irrespective of the choice to elect hedge accounting?**

20. If the Board wanted to require entities to disclose information about how financial instruments are used to manage risk exposures (irrespective of whether the entity elects to apply hedge accounting or not) the staff believes that it would require the Board to consider IFRS 7 more holistically and include guidance on how such disclosure requirements would operate. Such disclosure requirements would go well beyond the boundaries of just hedge accounting. This is because entities would need to explain the purpose and objective of holding all financial instruments and the strategies to meet those objectives. (This is similar to what the FASB Statement of Financial Accounting No. 161 *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161) requires. However, SFAS 161 only requires such disclosures for derivatives and not all financial instruments so the scope differs from ifrs 7. See agenda paper 1E for an analysis of SFAS 161)

21. The staff think that it is outside the scope of the hedge accounting project to address the disclosure of information for which hedge accounting is not applied[2]. The staff think that this would be better addressed by a future project that comprehensively looks at disclosure requirements in IFRS 7. The staff also

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[2] If the Board was to consider expanding the scope of the disclosures to hedging activities for which hedge accounting is not applied, it would require the Board to re-expose at least those proposals as they were not part of the Board's original considerations.

note that IFRS 7 is due for a post-implementation review. Considering disclosures about hedging activities for which hedge accounting is not applied could be considered during this process.

How big is the information 'gap'?

22. If the Board decides to confirm the proposed scope of the hedge accounting disclosures in the exposure draft, how big is the information 'gap'? In other words, what information will not be provided?

23. As explained earlier in the paper, the focus in IFRS 7 differs from the exposure draft. The exposure draft focuses on explaining the **purpose and effect** of financial instruments when hedge accounting is applied whereas IFRS 7 focuses on the **nature and extent** of risks arising from the financial instrument.

24. Because there is no specific disclosure requirement in IFRS 7 about how and why an entity uses financial instruments (other than the requirement for qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments and how they are managed), it is up to entities to apply judgement to give the necessary context of how and why entities use financial instruments to understand the nature and extent of risks arising from financial instruments and how they are managed.

25. On the other hand, the hedge accounting exposure draft proposes specific disclosure requirements that are specifically focused on providing information about the purpose and effect of financial instruments designated in hedging relationships for the purpose of hedge accounting.

26. Consequently, specific information about the purpose and effect of financial instruments will only be disclosed for those instruments for which the entity elected to apply hedge accounting. However, IFRS 7 requires information about risk exposures and how they are managed related to financial instruments. With respect to items that fall outside the scope of IFRS 7, there will not be any discussion about risk management strategies except to the extent that the non-financial items are designated as hedged items in hedging relationships.

27. As long as hedge accounting remains an option, users of financial statements will be faced with this potential 'gap' in the information disclosed regarding the use of financial instruments to manage risk exposures. That is unless the Board addresses the issue as part of a comprehensive project on disclosure requirements in the future.

28. The staff does not think that this 'gap' can be addressed in the hedge accounting project. Rather, the Board should consider a project about disclosures in IFRS 7 more comprehensively.

Staff recommendation

29. The staff recommend that the Board confirm the scope of the hedge accounting disclosures in the exposure draft—ie to disclose information for only those risks that the entity manages as part of its risk management strategy and for which hedge accounting is applied.

Question—scope of hedge accounting disclosures
Does the Board agree with the staff recommendation in paragraph 29? If not, why not and what would the Board prefer instead and why?