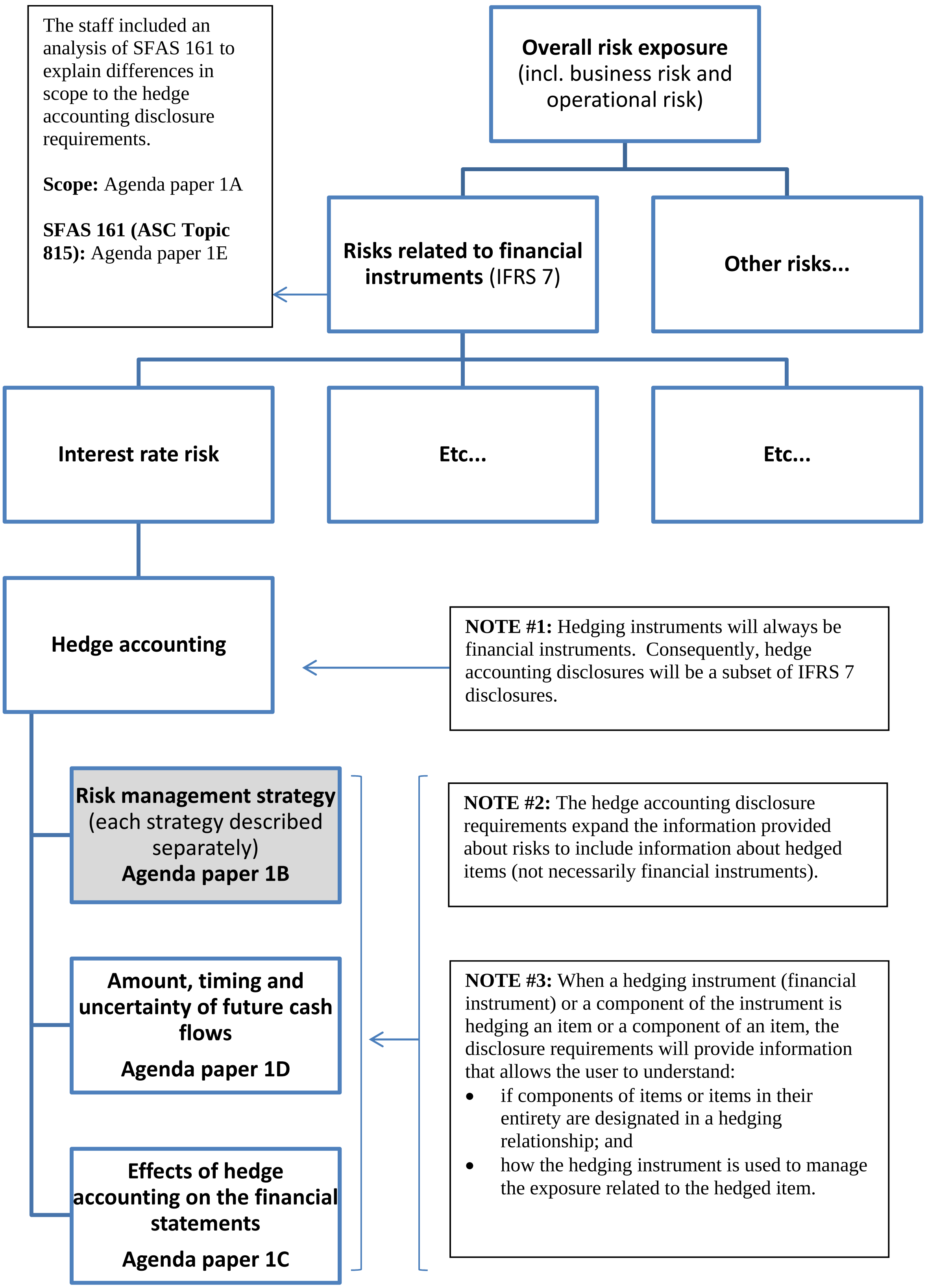
Project	**Financial Instruments: Hedge Accounting**
Topic	**Disclosures—Risk management**

Purpose of this paper

1. This paper asks the Board to confirm the proposed disclosure requirements in the exposure draft *Hedge Accounting* related to the entity's risk management strategy.
2. The Appendix to this paper contains the relevant extract from the exposure draft.
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.


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 our outreach Users of financial statements told us that they need to understand how an entity's risk management strategy is applied to manage risk. Understanding an entity's risk management strategy for each risk helps users to understand the accounting information disclosed.

5. Consequently, the Board proposed in the exposure draft that an entity should provide an explanation of its risk management strategy for each category of risk. Such an explanation should enable users of financial statements to evaluate (for example):

   (a) how each risk arises;

   (b) how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component(s) of an item; and

   (c) the extent of the exposures that the entity manages.

6. If the Board confirms the scope of the hedge accounting disclosures, the risk management strategy disclosures would relate to only those risks that an entity has decided to hedge and for which hedge accounting is applied (see agenda paper 1A).

Comments received

7. Almost all respondents to the exposure draft agreed with the proposal to require disclosures about the entity's risk management strategy for each type of risk. They believe that this will improve transparency and provide useful information. In addition, they believe that it is an improvement over IFRS 7's hedge accounting disclosures because it specifically requires a description of the hedging strategy for each type of risk that an entity hedges and for which it applies hedge accounting.

8. However some respondents commented that the exposure draft was not clear about how detailed the description of the entity's risk management strategy should be. They were also not sure at what level the risk management strategy should be considered for the purpose of providing the proposed disclosure. For example, they did not think it would be useful information if an entity simply disclosed that it hedges interest rate risk using interest rate swaps. On the other hand, they did not think it was practical for an entity to disclose the objective for each hedging relationship either. These respondents were mainly concerned that the proposed disclosure requirement did not give them enough guidance to determine what balance should be struck in terms of the extent of the information that is required.

Staff analysis

9. The staff think that there are two separate issues that need to be addressed based on the comments received on the proposed risk management strategy disclosure requirements:

   (a) At what level should the description of the risk management strategy be considered for the purpose of providing a description in the notes to the financial statements?

   (b) What guidance should the Board provide to help preparers strike the right balance for the extent of describing the risk management strategy for each risk category?

Providing a description of the risk management strategy

10. The proposed objective for hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments in order to manage exposures arising from particular risks that could

affect profit or loss[1]. Therefore, a qualitative disclosure about how an entity manages different risks and how it uses those financial instruments to reach the desired risk management strategy[2] is paramount.

11. However, the actual description of the risk management strategy depends on how an entity manages risk and the level of aggregation or disaggregation of information being disclosed.

How does the entity manage risk?

12. As mentioned above, providing a description of the risk management strategy will depend on how an entity manages risk using a financial instrument. For example, some entities may:

    (a) use option contracts while others use forward or future contracts;

    (b) hedge only a single risk component or a combination of risk components; or

    (c) hedge only a layer component rather than the entire population.

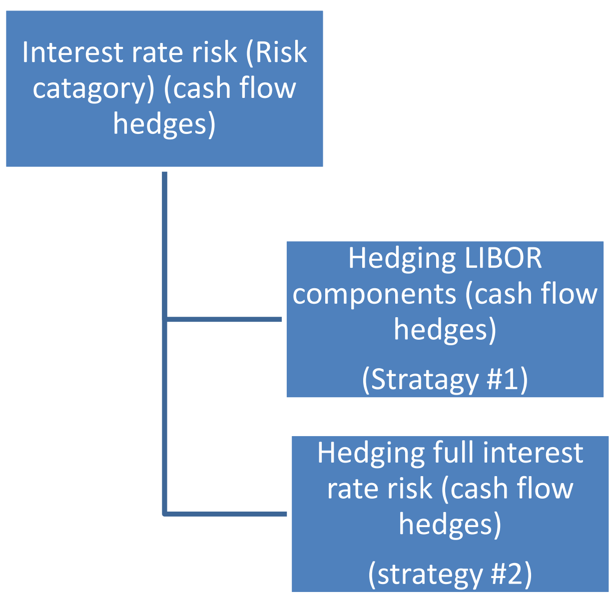
13. The exposure draft also proposes that entities provide the proposed hedge accounting disclosures by risk category. Even this breakdown will depend on how an entity manages risk. For example, an entity manages its floating interest rate risk using interest rate swaps (to change it to fixed interest rate) for some hedging relationships (cash flow hedges), while it also uses cross-currency interest rate swaps to manage both the floating interest rate and foreign exchange risk of other hedging relationships (cash flow hedges). Consequently, the entity would have one risk category for floating interest rate risk and another risk category for foreign exchange risk combined with floating interest rate risk. The entity would need to provide a description of the risk management strategy

1 At the April 2011 IASB meeting, the Board decided that an entity may also apply hedge accounting to investments in equity instruments designated as at fair value through other comprehensive income with ineffectiveness presented in other comprehensive income.

[2] Refer to Agenda paper 9 of the June 2nd IASB meeting for distinction between an entity's risk management strategy and risk management objective.

in such a way that users of financial statements will understand how the entity uses those instruments to manage the particular risk. If applicable, the entity would also provide a separate description for its fair value hedges of interest rate risk (ie fixed interest rate exposure being changed to floating interest rate).

14. Further to the above example, an entity may have different strategies under a particular risk category. For example, it may decide for some interest rate risk exposures to only hedge a component (such as a LIBOR component) of the interest rate risk, while it may decide to hedge the entire interest rate risk for other hedging relationships. Consequently, entities would have to distinguish sufficiently between different strategies for users of financial statements to understand how the entity uses the different financial instruments to meet the stated risk management strategy. This is illustrated below:



15. Another example of a specific strategy under a risk category that would need to be addressed separately from other objectives is an entity that hedges a group or net position. Separating the different objectives will be necessary otherwise users will not be able to link the risk management strategy description with how the hedge accounting has affected the financial statements.

16. **It is important to note that the exposure draft proposes that the separation of risk categories be applied consistently throughout the disclosure requirements (ie when describing the strategy, the timing and uncertainty and the effects of hedge accounting).**

What is the level of aggregation or disaggregation for the hedge accounting disclosures?

17. How an entity manages risk exposures will be the main driver that determines the information that an entity will disclose to comply with the proposed risk management strategy disclosure requirements. However, the level of aggregation or disaggregation used to comply with the other proposed hedge accounting disclosures will also play a determining factor. For example, when the entity discloses information related to the effects of hedge accounting (ie the tabular disclosure requirements), the level of aggregation or disaggregation used in those tables (ie by type of instrument) would require an entity to provide a sufficient description of the risk management strategy so that it gives the necessary context of how that instrument is used to reach the desired risk management objective.

18. The diagram below illustrates how the disclosure requirements work together to provide context for each other:

Information disclosed by risk category	**Risk management strategy**	**Amount, timing and uncertainty of future cash flows**	**Effects of hedge accounting**
Risk X			
Strategy 1			
- **Hedging instruments**			
- **Hedged items**			
Strategy 2			
- **Hedging instruments**			
- **Hedged items**			
Risk Y			
- **Hedging instruments**			
- **Hedged items**			
Risk Z			
- **Hedging instruments**			
- **Hedged items**			

19. Because the risk management strategy disclosure depends on how the entity manages risk and the level of aggregation or disaggregation, it will be very difficult to create a 'shopping list' of information that needs to be disclosed. The staff thinks a clear disclosure objective is more appropriate and will result in better quality information. Such an objective, and the related guidance, is discussed below.

20. Refer to Agenda Paper 1C for a discussion of the level of aggregation or disaggregation of information in the tabular disclosures.

Guidance to be provided for disclosures on the risk management strategy

21. Once an entity has determined at what level to consider risk management strategies for disclosure purposes (taking the level of aggregation and disaggregation into account) it is important that the entity provide enough information to give context to the other hedge accounting disclosures.

22. It is important that whatever guidance is provided, it should not result in 'boiler plate' disclosures that do not provide useful information to users of financial statements. Consequently, the staff thinks it is important that, whatever guidance the Board provides, it should encourage the **types** of information rather than prescribe the specific information to be disclosed.

23. The exposure draft proposed the following as **examples** of the types of information that a description of the risk management strategy could include:

    (a) How each risk arises.

    (b) How the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component(s) of an item.

    (c) The extent of risk exposures that the entity manages.

24. The intended purpose of these examples was to serve as guide to understand how an entity can go about providing a description of a risk management strategy (ie what sort of information **could** be included). However, it seems that some have looked at this guidance as the exact requirement of what is to be disclosed. Consequently, some respondents did not feel this was the appropriate level of information that should be described.

25. The staff think that it would be in an entity's best interest to provide an appropriate disclosure of the risk management strategy as this will provide the relevant context for the rest of the proposed disclosures. However, it seems the

proposal was too principle-based for some. By not providing specific guidance on what it is that is required, some believe that entities would take a check list approach and disclose the minimum details rather than relevant and helpful information.

26. The staff think that the guidance should ultimately require entities to explain how the hedging instruments are used to manage/offset the risk attributable to the hedged item. In addition, the description of the risk management strategy should provide the relevant context for the other required disclosures.

27. Based on the feedback received in comment letters and the outreach activities undertaken, the staff think that the guidance could be improved by clarifying what types of information **could** be included (this will be dealt with during drafting). The staff think that the following examples would clarify the types of information required in a description of risk management strategy for each risk category (and each material strategy under each risk category, if applicable):

    (a) Whether the entity hedges an item in its entirety for all risks or hedges a risk component of an item and how each risk arises (and why it uses this approach).

    (b) The hedging instruments that are used (and how they are used) to offset the risk exposure.

    (c) How the entity determines the economic relationship between the hedged item and the hedging instrument for the purposes of testing hedge effectiveness.

    (d) How the entity establishes the hedge ratio and what the sources of ineffectiveness are.

Disclosure requirements when entities designate a risk component as the hedged item

28. During redeliberations, some Board members have raised concerns about designating risk components of items as hedged items. The concern is that users of financial statements will not understand how the component that is being

hedged relates to the item in its entirety. Some are also concerned that users might misinterpret that the entire item is being hedged rather than just a component. In other words, they may not understand that there are risks excluded when the entire item is not being hedged.

29. The staff thinks that the information disclosed about the risk management strategy could explicitly require information about components (nominal or risk components) designated as hedged items. Entities could provide qualitative or quantitative information that allows users to understand:

(a) how the entity determined the component that is designated as the hedged item (including a description of the economic relationship between the component and the item as a whole); and

(b) how the component relates to the item in its entirety (For example, the designated component historically covered 80% of the changes in fair value of the item as a whole)

Staff recommendation

30. The staff recommend that the Board confirm the disclosure requirements related to an entity's risk management strategy as proposed in the exposure draft. The staff will add clarity to the types of information to be disclosed as part of a description of the risk management strategy as explained in paragraphs 27 to 29.

Question
Does the Board agree with the staff recommendation in paragraph 30? If not, why not and what would the Board prefer instead and why?

Appendix
Extract from the exposure draft *Hedge Accounting*

40 Hedge accounting disclosures shall provide information about:

(a) an entity's risk management strategy and how it is applied to manage risk;

(b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

42 When paragraphs 44–52 require the entity to separate by risk category the information disclosed, the entity shall determine each category of risk on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. An entity shall determine risk categories consistently for all hedge accounting disclosures.

43 To meet the objectives in paragraph 40, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need any additional information to evaluate the quantitative information disclosed. However, when an entity determines the level of aggregation or disaggregation, it shall consider the level of aggregation or disaggregation it uses for other disclosure requirements in IFRS 7 *Financial Instruments: Disclosures.*

The risk management strategy

44 An entity shall explain its risk management strategy for each category of risk exposure that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate (for example):

(a) how each risk arises.

(b) how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item.

(c) the extent of risk exposures that the entity manages.