Project: **Financial Instruments: Hedge Accounting**

Topic: **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 1B, 1C and 1D. This example only provides an illustration of the proposed hedge accounting disclosures and does not provide disclosures required by other standards (refer to agenda papers 1A, 1B, 1C, 1D and 1E). This example uses a small oil company as a basis for the information presented. **This is the first year of trading for this company.**

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	42.90
Short term liability	10.00
Equity	

Cash flow hedge reserve	(8.50)
Reserve for time value of options [1]	0.10

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

	CU millions
Profit or loss	
Hedge ineffectiveness	(0.50)
Foreign exchange gain	0.60
OCI	
Cash flow hedges	
Changes in the value of the hedging instrument	8.50
Amounts transferred to profit or loss	-

[1] In this example, an illustration of changes in equity is not provided. In such a disclosure, the entity should provide a reconciliation of the time value of the option deferred in accumulated other comprehensive income.

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. The commodity derivatives are priced using pricing benchmarks (mainly Brent).

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 of 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.

> If the entity designated the intrinsic value of the hedging instrument, the time value would have to be deferred in OCI and recognised in P&L on a rational basis.

The company's hedge position can be summarised as follows:

	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			
Forward sales contract			
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
Put options			
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

> If the entity decided to opt out of these disclosure requirements because this information is commercially sensitive, it would provide a disclosure that details the following:
>
> - a description of why the information would be sensitive if the requirements in the standard were followed;
> - the principal, stated, face or other similar amount related to the hedging instrument;
> - the timing of maturity, expiry or execution of the hedging instrument; and

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.

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.

If the entity hedged a component it would also have to provide qualitative or quantitative information that allows users to understand:

- how the entity determined the component that it is designated as the hedged item; and
- how the component relates to the item in its entirety (ie an indication of the size of the component compared to the whole).

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 interest rate changes.

Loans payable are normally borrowed at a fixed rate in local currency. These loans are converted to floating rate loans using interest rate swaps whereby 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.

The company's interest rate risk exposure can be summarised as follows:

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	6%	6%	6%	6%
Pay floating interest rate	LIBOR+2%	LIBOR+2%	LIBOR+2%	LIBOR+2%

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- a description of why the information would be sensitive if the requirements in the standard were followed;
- the principal, stated, face or other similar amount related to the hedging instrument;
- the timing of maturity, expiry or execution of the hedging instrument; and

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 +200bps[2].

[2] Basis points.

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.

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.

> If the entity hedged a component it would also have to provide qualitative or quantitative information so that users can understand:
>
> - how the entity determined the component that it is designated as the hedged item; and
> - how the component relates to the item in its entirety (ie an indication of the size of the component compared to the whole).

Foreign exchange risk

The company has limited exposure to foreign exchange risks. Its purchases and sales are mostly denominated in its functional currency.

The company's hedge position can be summarised as follows:

CU/FC exposure—Assets	**20X0 CU 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

If the entity decided to opt out of these disclosure requirements because this information is commercially sensitive, it would provide a disclosure that details the following:

- a description of why the information would be sensitive if the requirements in the standard were followed;
- the principal, stated, face or other similar amount related to the hedging instrument;
- the timing of maturity, expiry or execution of the hedging instrument; and

During the year the company entered into a firm commitment transaction to purchase property, plant and equipment for FC10m. 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.

The company designated FC10m of a high-credit quality loan of FC25m as the hedging instrument for foreign exchange risk. The loan is denominated in the same currency as that of the firm commitment. The company did not hedge the remaining FC15m of the loan because that loan is naturally offset against other assets and liabilities of the entity.

This hedge is fully aligned with the exposure regarding the hedged FX risk, which is measured using the spot rate method.

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		Line item in the balance sheet where the hedging instrument is recognised	Change in fair value used to calculate ineffectiveness
		Assets CU millions	Liabilities CU millions		
Cash flow hedges					
Commodity price risk (oil price) - Oil forward sales contracts	7,540,000 barrels	-	15.00	Financial liabilities	(15.00)
- Oil forward sales contracts	2,500,000 barrels	2.00	-	Financial assets	2.00
- Oil put option contracts	7,380,000 barrels	3.90		Financial assets	3.90
Fair value hedges					
Interest rate risk (full interest rate risk) - Interest rate swaps	CU 50,000,000.00	3.00	-	Financial assets	3.00
Foreign exchange risk (EUR/USD) - Loan	FC 10,000,000.00	6.00	-	Loans receivable	0.40

Balance sheet information related to designated hedged items

	Carrying amount of the hedged item		Accumulated gain or loss on the hedged item included in the carrying amount of the hedged item		Line item where the hedged item is recognised	Change in the value used to calculate the ineffectiveness	Cash flow hedge reserve
	Asset	Liabilities	Asset	Liabilities			
Cash flow hedges							
Commodity price risk (oil price)							
- Forecast sales	n/a	n/a	n/a	n/a	n/a	8.50	(8.50)
- Discontinued hedges (forecasted sales)	n/a	n/a	n/a	n/a	n/a	n/a	-
Fair value hedges							
Interest rate risk (full interest rate risk)							
- Hedge adjustment loan payable	n/a	42.90	-	2.90	Long term liabilities	(2.90)	n/a
- Discontinued hedges	-	-	-	-	-	-	n/a
Foreign exchange risk (EUR/USD)							
- Firm commitment	0.40		0.40		Other assets	0.40	n/a
- Discontinued hedges	-	-	-	-	-	-	n/a

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

Cash flow hedges[3]	Change in the value of the hedging instrument OCI	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 (oil price)	(8.50)	(0.60)	*Hedge ineffectiveness*	-	*Revenue*

Fair value hedges	Ineffectiveness in profit or (loss)	Line item in profit or loss (affected because of ineffectiveness)
- interest rate risk (full interest rate risk)	0.10	*Hedge ineffectiveness*
- foreign exchange risk (EUR/USD)	-	n/a

[3] 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.