IFRS

IASB Meeting

Staff Paper

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Contact(s)			
	Joao Santos	jsantos@ifrs.org	+ 44 207 246 6926
	Christian Garz	cgarz@ifrs.org	+ 44 207 246 6410
	Martin Friedhoff	mfriedhoff@ifrs.org	+ 44 207 246 6410

Project: **Financial Instruments – Hedge Accounting**

Topic: **Use of non-GAAP information to report the performance of hedging activities**

Introduction

1. At the September IASB meeting the Board discussed macro hedge accounting. The Board specifically discussed the practice of entities reporting the performance of hedging activities using non-GAAP information instead of reporting them using IFRSs.

2. As a result of this discussion the Board asked the staff to further investigate the type of non-GAAP information that entities provide when reporting the performance of their hedging activities using non-GAAP information.

Purpose of this paper

3. This paper provides a summary of the main topics reported within non-GAAP information in relation to hedging activities and an outline of the main arguments used by entities to justify the relevance and usefulness of the information provided.

4. The staff considered information provided in both annual reports and investor presentations by a sample of companies including banks and non-financial institutions.

5. This is an educational paper and as such does not contain any questions for the Board.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

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

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff Analysis

6. From the sample of annual reports and investor presentations analysed by the staff it can be derived that reporting an adjusted/normalised profit or loss is the most common way of reporting the performance of hedging activities on a non-GAAP basis. That commonly involves reversing the effects on profit or loss resulting from fair value measurement of hedging instruments for which hedge accounting has not been applied or hedge ineffectiveness resulting from applying the general hedge accounting requirements. Some entities present an 'ineffective' amount based on own definitions. Also, hedge ineffectiveness is sometimes addressed through disclosures of risk limits or the level of achieving the entity's own risk objectives.

7. Furthermore the following common themes were identified:

   (a) information is presented in different documents with different levels of detail, which were provided to the users of the financial statements;

   (b) reporting of an adjusted/normalised profit or loss;

   (c) presenting a three-column income statement; and

   (d) narrative descriptions of the undesired effect of not electing to apply hedge accounting, supplemented by a quantitative analysis as an alternative to providing detailed three-column income statements.

Presentation of non-GAAP information

8. Non-GAAP information is presented in various ways to users of the financial statements. These include the annual report, eg as part of the Management Discussion & Analysis (MD&A), and investor presentations.

9. Presentation within the MD&A is often a summary of the main adjustments made to reflect the entity's view of the performance of its hedging activities. This can either be done in different formats, eg as a three-column income statement or a narrative description. Narrative descriptions include some quantitative analysis to enable the user to understand those main adjustments made by the entity in order to arrive at its view of the performance of its hedging activities.

10. Finally, some companies mix non-GAAP information with the notes to the financial statements and indicate that this is done for the benefit of the user.

11. There is another subset of companies that opt for presenting a summary of the non-GAAP information within their annual report (particularly within the economic and financial review of the MD&A). Additionally, these companies then provide an in-depth analysis within their investor presentation, which often includes a breakdown of the entity's view of the performance of their hedging activities by profit or loss line item, product or business segment.

Reporting of adjusted/normalised profit or loss

12. This encompasses various levels of detail depending on where the information is reported. As described above, entities tend to report more detailed information in investor presentations than in annual reports.

13. The most common presentation format is a three-column income statement format that provides a reconciliation between the IFRS profit or loss and the adjusted/normalised profit or loss. These columns provide the user with an overview of the adjustments by line item. In some cases these are broken down by product and type of hedging instrument used. Entities that provide most of the non-GAAP information also present a reconciliation of key financial performance indicators, such as the EBITA, EBITDA and Free Cash Flow.

14. Another alternative presentation is aggregated data like profit or loss adjusted for the entity's view of the performance of its hedging activities. This is presented in the MD&A and is supplemented by a narrative description of the elements that lead from the IFRS-based number to the non-GAAP amount.

15. The main assumption made by entities is that changes in the fair value of the hedging instrument/hedged item should be neutralised. This includes neutralising the effect of hedge ineffectiveness where for example the hedge cannot be designated in a manner consistent with the economic hedge and situations where the fair value option was used as a substitute for hedge accounting. Entities argue that in those situations hedge accounting does not provide a fair representation of the company's economic hedge objectives. Depending on the type of hedge there are different arguments and adjustments performed to the IFRS profit or loss.

16. Some companies prepare the impact of hedge accounting by product/segment separately, to give the reader their view on the performance of their hedging activities by product. Most of the entities analysed aim to report the information by product at the target hedged rate but on a cash flow basis. This means that the volatility created by the changes in the fair value of the hedging instruments including related hedge ineffectiveness is eliminated, and the adjustment arising from entering into the hedging relationship is only considered when the hedged item affects profit or loss and on an aggregated basis (for example commodity price risk is often presented together with FX risk).

17. Some other entities provide forward-looking statements, particularly target hedged rates (split between achieved and forecast), volumes locked for the time horizon of the hedging policy or time bucket, expected effect of the hedging policy on operating income and, in some cases, a progress report about the execution of the hedging policy.

Reporting of adjusted/normalised profit or loss by risk

18. For hedges of commodity price risks and FX risks the entities analysed expand the topics outlined in the section above to achieve the following:

    (a) Reflect the measurement of revenue or revenue net of purchases at the effective hedged rate. This encompasses adjustments resulting from hedging commodity price risk and FX risk on an aggregated basis.

    (b) Reflect the costs of hedging strategies employed by entities.

    (c) Neutralise the effect of changes in fair value, including the ineffective portion for all outstanding hedging instruments, with the view of eliminating the volatility from the adjusted income statement and thereby reflecting transactions at the effective hedged rate on a cash flow basis.

    (d) Elimination of volatility resulting from the measurement of hedged items and hedging instruments that is considered temporary and therefore not reflecting the actual economic performance. This has been specifically raised by financial institutions.

    (e) Adjust for the effect of portfolio optimisation/dynamic hedging, which is regarded as hedging from a risk management but not from an accounting perspective.

(f) Adjust for the impact of using complex option hedging strategies that are not possible to reflect within the scope of hedge accounting.

19. Specifically for hedges of interest rate risk, the profit or loss for the period often shows an outcome similar to the one that would have arisen had synthetic and accrual accounting been applied. The combined end result is similar to measuring the synthetic hedged item at amortised cost (this is commonly termed 'accrual accounting'). Entities applying this assumption argue that the remeasurement of the hedged item and of the hedging instrument introduces unnecessary volatility and therefore should be eliminated from the adjusted profit or loss.

Conclusion

20. In the staff's view entities choose to provide non-GAAP information instead of reporting the performance of their hedging activities using hedge accounting for various reasons such as:

    (a) complexity of the hedge accounting model;

    (b) costs involved in applying hedge accounting;

    (c) flexibility provided by the use of non-GAAP information;

    (d) user acceptance of such non-GAAP information in lieu of the hedge accounting disclosures;

    (e) established in-house practice of providing non-GAAP information instead of hedge accounting disclosures; and

    (f) to provide information on performance in line with actual business and risk management activities.

21. However, the staff notes that the use of non-GAAP information presents some drawbacks such as:

    (a) Because there is no clear set of principles defined for the presentation of non-GAAP information, the type and level of disclosure is left at the entities' discretion. Comparability is therefore difficult to achieve.

    (b) Non-GAAP information is perceived in different ways and has different levels of acceptance. Based on the outreach we performed, some preparers argue that if the company has a track-record of presenting reliable non-GAAP information users tend to use this as opposed to

hedge accounting disclosures. Conversely, if such a track-record does not exist users find non-GAAP information more difficult to use.

(c) The level of transparency about the adjustments done to the IFRS profit or loss varies, which makes the judgement as to whether these are appropriate or not difficult for the users.

(d) It is difficult to assess how effective hedging activities are because entities tend to take the view that if hedging instruments are held for hedging purposes all the changes in fair value should be eliminated, thus treating the relationship as if it were fully effective. This highlights the difference between the accounting view, which focuses on the recognition of the hedged item and of the hedging instrument in profit or loss in accordance with a predetermined measurement basis and related offsetting changes, and the risk management view, which focuses on the recognition on a cash flow basis at the effective hedged rate.

(e) There is not much clarity on the difference between the concepts of hedging and optimisation. This makes the analysis of the extent of hedging activities difficult, as hedging and optimisation are often presented as one group.