
Hedge accounting under IFRS 9: an analysis of reforms

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Abstract

Pronouncements of regulatory bodies on 'hedge accounting' are aimed at ensuring that impact of price changes of hedging relationships are accounted for concurrently. However, it sometimes happens that certain provisions of these standards result in the reporting of enhanced earnings volatility being attributed to hedging relationships which is not economically justified. It is often perceived to be the case by stakeholders that the provisions of IAS 39 on 'hedge accounting' do not appropriately reflect and are not aligned with the risk management strategies of entities that attempt to mitigate risk using various hedging relationships. This occasionally results in a reporting entity adopting either a suboptimal hedging strategy that gives it eligibility to account for it using 'hedge accounting' or vice versa. Thus entities may be faced with the tradeoff between the benefits of risk mitigation strategies and the benefits derived from adopting 'hedge accounting'. This motivated the IASB to initiate action for the complete reformulation of the standard on 'hedge accounting'. The revised standard was pronounced in November 2013 as IFRS 9. In this article, we attempt to evaluate the upgradations introduced by IFRS 9 over its predecessor, IAS 39, with particular reference to the reporting of risk management strategies of affected entities.

Keywords: IFRS 9, IAS 39, hedge accounting, risk management, financial derivatives.

JEL Classification: M41.

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Introduction

The International Accounting Standards Board (IASB hereinafter) made phase wise pronouncement of a new International Financial Reporting Standard (IFRS hereinafter) entitled IFRS 9: Financial Instruments in three phases initiated in November, 2009. IASB's prescriptions on 'hedge accounting' are contained in the third and last phase of IFRS 9, which was notified in November 2013. The provisions contained in IFRS 9 on 'hedge accounting' will replace IASB's extant directives thereon contained in International Accounting Standard (IAS hereinafter) 39: Financial Instruments: Recognition & Measurement. The November 2013 pronouncement was issued on the basis of IASB's Exposure Draft of December 2010 that initiated the process of reform of 'hedge accounting'. It shall be mandatory for entities following IFRS based accounting to implement IFRS 9 with effect from January, 1, 2018. The extended transition period is allowed to accommodate certain fundamental alterations that need to be made by entities on adopting the new standard. The provisions of IFRS 9 make an attempt to simplify the 'hedge accounting' procedures and disclosures while enabling a stronger nexus between the risk management practices adopted by entities, and the accounting framework prescribed for the reporting of such practices. This would facilitate more accurate reporting of hedged positions and management's practices relating to the mitigation of risk (Ernst & Young, 2011, 3).

The replacement of IAS 39 is essentially motivated by the lack of alignment between the provisions of IAS 39 and the risk management strategies of the hedging entities in the sense that the decision on the choice of a particular strategy is influenced by the accounting treatment thereof, a factor that should ideally be completely extraneous (Panaretou, et. al., 2013, 116). A strategy's accounting and reporting should be concerned only with the reporting of its economic impact on the entity and should certainly not be a determinant in the economic optimality of the strategy in the given decision making scenario. Frequently, the desire by entities to adopt 'hedge accounting' under IAS 39 compels them to implement sub-optimal risk management strategies or, otherwise, the optimal strategy does not qualify for 'hedge accounting' under IAS 39 leading to reporting of non-existent enhanced earnings volatility.

This article reports the results of a conceptual study aimed at analyzing the provisions of IFRS 9 and their possible impact on the adoption of risk management strategies by affected entities. The study performs a critical review and assessment of the various statutory provisions, the pronouncements of professional accounting and other regulatory bodies (IASB, in particular) and accounting norms and theories insofar as they relate to accounting for various types of hedges.

As mentioned above, the perceived lack of coherence/alignment between the provisions of IAS 39 in relation to hedge accounting and the risk management strategies adopted by reporting entities sometimes results in the adoption of either a suboptimal hedging strategy that gives the entities, eligibility to account for it using 'hedge accounting' or vice versa. Thus, entities may be faced with the tradeoff between the benefits of risk mitigation strategies and the benefits derived from adopting 'hedge accounting'. The IASB, taking cognizance of the feedback on IAS 39, has introduced several changes in an attempt to align the provisions of 'hedge accounting' with the risk management strategies of entities. The upgradations introduced in IFRS 9 are, indeed, promising and would go a long way towards formulation of an ideal standard. The spectrum of hedging instruments eligible for 'hedge accounting' has also been considerably enlarged so that many more risk management strategies can be covered.

The analysis and consequential findings in this work shall be immensely useful to corporate executives in appreciating the nuances of hedge accounting under IFRS 9 and thereby tailoring their risk management strategies in such manner as to avail the benefits of hedge accounting while ensuring optimality. The analysis would also be of use to standard setters in further refining the provisions relating to hedge accounting and making them aligned with the reporting entity's risk management strategies. Furthermore, this study fulfils an identified need to evaluate how the provisions of IFRS 9 would fare compared to IAS 39 insofar as reporting of risk management strategies of reporting entities is concerned.

1. Hedging and hedge accounting

Very often entities take up open positions in various accounts that are exposed to or respond to various exogenous (usually uncontrollable at the level of the

entity) stimuli, as part of their regular business operations or investment activities. These responses, sometimes, result in potential losses to the entities and represent the risk with respect to that particular stimulus. Frequently, such entities try to hedge against (offset the potential losses due to) various risk factors by taking appropriate positions in some derivative or non-derivative instruments. Thus, a hedging activity usually comprises of two constituents' regarding the hedged item and the hedging instrument. The hedging instrument is positioned to offset gains and losses of the hedged item due to a pre-specified risk factor. Adoption of general accounting practices would result in identification of the hedged item and the hedging instrument as two separate and uncorrelated accounts and their consequential independent accounting. Accordingly, price changes from these two accounts may not be recognized simultaneously to the income statement. Contrary to the factual position, this often results in a reporting of increased volatility of earnings. On the other hand, adoption of 'hedge accounting' enables the entity to match the price changes of the hedged item with those of the hedging instrument thereby making the income less volatile with respect to the risk factor being hedged. 'Hedge accounting', therefore, protects entities that use hedging instruments from a reporting of economically non-justifiable volatility escalation in earnings consequent to the volatility of the hedged risk factor.

2. Accounting for the hedging instrument

As mentioned above, in the normal course i.e. in the absence of 'hedge accounting' IAS 39 requires the hedged item and the hedging instrument to be measured on an item-by-item footing. An immediate fallout is that, the hedging instrument, being a derivative, would be measured, valued and carried in the books at fair value through profit or loss (FVTPL hereinafter). On the other hand, a different measurement and valuation prescription would exist for the hedged item, being differently classified. The recognition of the impact of price changes on the hedged item and the hedging instrument, in the absence of 'hedge accounting' in the income statement, thus, becomes out of phase causing a perception of increased volatility of earnings which cannot be validated on economic grounds (Glaum and Klöcker, 2010, 6).

Nevertheless, IAS 39 does have enabling provisions to attend to the aforesaid anomaly (Kablan, 2014, 102) by allowing entities to voluntarily adopt 'hedge accounting' subject to the 'hedging relationship' meeting certain conditions. For this purpose, 'hedge accounting' is defined (IASB, 2012) as a mechanism by which the financial statements of reporting entities reflect their risk management activities. The pre-requisites that need to be satisfied by a 'hedging relationship' in order that the entity concerned may choose to adopt 'hedge accounting' are: (i) the hedging relationship needs to be formally designated and documented as such at inception; (ii) it has to be established to be "highly effective"; (iii) in the case of cash flow hedges, the probability of occurrence of the underlying transactions should be estimated as high. However, feedback on IAS 39 from the users and other interest groups was strongly vocal about the lack of coherence between the reporting envisaged under the 'hedge accounting' rules of IAS 39 and economic realities of the activities in relation to risk management by entities (Ernst & Young, 2014, 3; IASB, 2008).

IFRS 9 has broadened the ambit of 'hedge accounting' by allowing entities that hedge their risks using non-derivative instruments, the choice to adopt 'hedge accounting' as well (Schiller et al., 2013, 157). In the event that non-derivative hedging instruments are used for hedging, they need to be carried at FVTPL. Additionally, the hedging instrument must have participation by an external party (Du Plooy et al., 2014, 2). In contrast, IAS 39 allows 'hedge accounting' only in cases where either the hedging instruments have a derivative character or such hedging is of foreign currency risk, in which case, the use of non-derivative financial assets or liabilities is also allowed.

This extension of the benefit of 'hedge accounting' by IFRS 9 is likely to benefit, in particular, entities that do not have access to derivative markets, are short on collaterals or do not have sufficient faith in uncollateralized OTC instruments (Ernst & Young, 2014, 28).

3. Grouping, netting and aggregation of positions of hedged items

IFRS 9 allows entities to hedge their positions in recognized assets or liabilities, unrecognized firm

commitments, highly probable forecast transactions and net investments in foreign operations provided that their fair value can be reliably measured and an external party is involved (Ernst & Young, 2014, 6).

The provisions of IAS 39 are enacted primarily with the objective of enabling 'hedge accounting' on an item to item basis i.e. where a single hedged item is hedged by a hedging instrument (micro-hedge). Nevertheless, designating groups of items that are hedged together, as a single hedged item is permitted under IAS 39 subject, however, to the fulfillment of certain stringent conditions. These restrictions are to be eased in IFRS 9 so that more group hedging strategies can come under the umbrella of 'hedge accounting'. Precisely, if the items constituting the group or the components thereof are individually eligible for the benefit of 'hedge accounting', the entire group shall be allowed to be designated as a hedged item under IFRS 9. The entity has to manage all items above as a group (Ernst & Young, 2014, 18f; BDO, 2014, 9). These provisions are aimed at aligning the 'hedge accounting' rules of IFRS 9 with the risk management strategies physically implemented by the entity that are very often set up at the 'group' level.

It is common practice for entities to manage group risk exposures by first netting off the projected cash flows from the various hedged items constituting the group and thereafter hedging the residual with the hedging instrument. IAS 39 does not recognize net positions for 'hedge accounting'. IFRS 9 proposes to eliminate this anomaly by permitting 'hedge accounting' for the fair value of net positions. However, this is so provided that the entity's risk management strategy is represented by the designation of the above net position as a hedged item. Additionally, IFRS 9 allows recognition of cash flow hedging of net positions for foreign currency risk for 'hedge accounting'. In this case, the entities are required to determine and record the commencement of the hedge and the timing and manner of the impact on the income statement of each item constituting the net position (BDO, 2014, 29).

Another issue that has been attended to in IFRS 9 with regard to hedging of group positions is that it permits 'hedge accounting' for groups of items even if the change in fair value of each constituent of the group is not proportional to the overall change in fair value of the group, a condition which is mandated in IAS 39 (IAS 39.83f). The aforesaid provisions of IFRS 9 with regard to 'hedge accounting' make the standard significantly more compatible with ground realities of hedging.

A composition that comprises of exposures in a derivative and non-derivative constitutes an aggregated exposure (Ernst & Young, 2014b, 7). IAS 39 prohibits a hedged item from including a derivative position within its designation. If new derivatives enter a subsisting hedging relationship, such relationship needs to be re-designated on entrance. This implies that the derivatives already participating in the hedge shall not be accounted for at zero fair value on such re-designation, thereby causing hedge ineffectiveness and imprecision in hedge effectiveness testing. However, IFRS 9 upgrades these provisions while coining the term 'aggregated exposure' for the first time and permits entities to identify compositions of derivative and non-derivative positions as aggregated exposure and include the same within the ambit of a hedged item provided that the entity manages the aggregated exposure as a single item of exposure (BDO, 2014, 14). Furthermore, such derivatives as constitute part of aggregate exposure must be identified as a separate asset or liability. They must also be carried at FVTPL. Future expected transactions likely to lead to aggregate exposures are also eligible for aggregation with such exposures.

4. Hedge accounting for hedges employing credit derivatives

IFRS 9 introduces enabling provisions for the adoption of hedge accounting in hedge relationships involving credit derivatives subject to certain prerequisites. Credit exposures that are measurable at FVTPL and are hedged, fully or partially, with credit default swaps are allowed to be assessed provided that the hedged entity is appropriate to the reference party of the credit risk hedging instrument and the seniority of the borrowing is compatible with the hedging instrument (BDO, 2014, 35).

Nevertheless, some safeguards have been incorporated in IFRS 9 while allowing 'hedge accounting' for hedging of credit exposures. In particular, FVTPL measurement is prohibited for use by an entity that has credit exposures that are hedged with credit derivatives. While accounting for credit risk instruments that are initially recorded at FVTPL for future periods, differential of book and fair value needs to be transferred to the income statement at the stage of such designation. Consequently, the differential represents the aggregate of changes due to credit risk as well as changes in fair value due to other risk factors e.g. interest rate risk.

Full fair value based measurement is stipulated under IFRS 9 in the case of financial instruments that are hedged for credit risk. This may be contrasted with the treatment of a fair value hedge in which case recognition of the instrument is at the value adjusted for deviations that result from the actual risk hedged position. It follows that if and when credit risk exposures are hedged, the underlying instruments must be re-measured in terms of other risks e.g. interest rate risk. Conversely, on the de-recognition of the credit risk, this method of accounting needs to be stopped (Deloitte, 2012, 5).

Despite the above improvements over IAS 39 as regards credit risk management, IFRS seems to be fallible on the following counts. Entities facing credit risk usually hedge such risks using credit default swaps. However, such hedges may possibly result in non-concurrent accounting for price changes of the hedged item and hedging instrument, because the hedged item is usually carried at FVTPL. Furthermore, the provisions of IFRS 9 premise on the philosophy that it is practicable to isolate and measure the single credit risk component. But the 'credit risk component' fails to explicitly meet the stipulated qualifying criteria for 'risk components' (EY, 2014b, 26).

Financial institutions with credit risk exposures usually hedge their positions by employing credit derivatives or transfer such exposure, for compensation, to third parties. Now, under IAS 39, the loan portfolios of such institutions (that are hedged for credit risk using credit derivatives) are measured at amortized cost and are not considered to include commitments. However, the credit derivatives have to be carried at FVTPL (because of deviations of fair value) thereby causing accounting mismatches and non-representativeness of the entity's risk management strategy. This situation arises because of impracticability of segregating and isolating the price effect of the credit risk that instigates the changes in fair value of the hedged item. (PwC, 2014, 22). To partially rectify the above, IFRS 9 allows the financial institutions using credit default swaps for hedging their credit risk to measure their credit exposure to the extent of the coverage at FVTPL provided that the hedges (swaps) are measured at FVTPL.

5. Hedging of 'risk components'

IFRS 9 extends the spectrum of 'hedged items' to include 'risk components' provided that such

components are separately identifiable and fair value or cash flows attributable to them are reliably measurable. A hedged item may include even a financial position's non-contractual inflation risk. IAS 39, however, permits the designation of non-financial positions as hedged items only in their entirety inclusive of all the risks except in the case of foreign currency risk. The requirement of reliable measurability, although apparently necessary, severely impedes the practical usefulness of the above provisions (PwC, 2013, 18).

IFRS 9 makes no discrimination between types of hedged items. The only requirements for such classification are unambiguous identification and reliable measurability of such risk components. This easing of restrictions would facilitate enhanced use of 'hedge accounting' by entities and align the accounting with their risk management strategies (IFRS Foundation, 2013, 6).

In the case of non-financial items, the eligible risk components for classification as hedged items need to be segregated as contractual and non-contractual. For existing non-contractual risk components, the tests of unambiguous identifiability, reliability of measurement and nexus with some potential hedged item needs to be performed (KPMG, 2013, 32).

6. Testing for 'hedge effectiveness'

IAS 39 calls for a mandatory, periodic testing of 'hedge effectiveness' as essential for 'hedge accounting' (Ernst & Young, 2014c). In this context, 'hedge effectiveness' is the extent to which fair value or cash flows variations of the hedging instrument are able to offset variations in the fair value or cash flows of the hedged item. 'Hedge effectiveness' testing under IAS 39 is highly complex. Firstly, the hedging entity needs to establish that the hedge will be highly effective prospectively. Thereafter, the relationship has to be shown to have been retrospectively 'highly effective' which implies an effectiveness of between 80% and 125% in the past (Glaum and Klöcker, 2010, 7). 'Hedge accounting' needs to be discontinued forthwith if the effectiveness test is not qualified. Such discontinuance shall commence from the latest date till which the hedge had been shown as effective (IAS 39. AG113). Any changes in fair value thereafter shall be recognized immediately to the income statement (Hague, 2004, 25; IAS 39.91). If the hedge

ineffectiveness has been precipitated by an event or a change in circumstances, the hedging entity shall discontinue 'hedge accounting' from the timing of such event or change in circumstances provided that the entity can establish effectiveness prior thereto (IAS 39.AG113). A hedging relationship that has once become ineffective is not allowed to be rebalanced under IAS 39. Adjustments to the hedge not documented at the inception stage are not permitted. In case of an ineffective hedge, the original relationship has to be discontinued. The rebalanced relationship must be treated as a fresh hedging relationship and re-designated as such (Forsberg et al. 2013, 158). Very often, the performance of these effectiveness tests is extremely tedious and time consuming for the hedging entity since numerical tests need to be conducted to show that the amount of offsetting achieved by the hedge is in the permitted range. In the event of the hedge turning out to be ineffective as per the stipulated criteria, the entity cannot adopt 'hedge accounting' in reporting which will, therefore, not be representative of the entity's risk management strategies.

IFRS 9 has introduced some radical changes in the effectiveness assessment approach. This is, in fact, the cardinal upgradation of the provisions on 'hedge accounting' destined to facilitate precise reporting of the entity's risk management strategies. The new standard prescribes a prospective and principle-based effectiveness testing based primarily of the following: (i) the hedged item and the hedging instrument should enjoy an underlying economic relationship, that should be vindicated either by qualitative or quantitative means; (ii) credit risk should not be the dominant factor contributing to the value changes that result from the economic relationships; (iii) physical amounts of the hedge and hedged item should be indicated by the hedge ratio of the hedging relationship (Deloitte, 2012, 1ff; KPMG, 2013, 49). Provisions relating to the treatment of ineffective hedges have also been substantively modified. Hedging entities are encouraged by IFRS 9 to make efforts to rebalance an ineffective hedge, not requiring them to forthwith discontinue ineffective hedges. It is only when such rebalancing attempt fails that the entities need to discontinue the hedge. The methodology for hedge effectiveness testing of IAS 39 has, nevertheless, been retained in IFRS 9 (Forsberg et al., 2013, 158f; Ernst & Young, 2014c).

In the case of an aggregate exposure, for the assessment of effectiveness of a hedge, the outcomes

emanating from the aggregate of the constituents need to be taken into account. The hedged item and the hedging instrument may not be perfectly matched at the individual level. Any ineffectiveness at the first level gets carried to the second level. IFRS 9 does not specifically require first-level relationship for hedge accounting in the case of an aggregate exposure. Nevertheless, it becomes a much more complex situation if the first level relationship does not exist (Ernst & Young, 2014b, 7f).

Thus, in summary, there is some easing of the 'hedge effectiveness' requirement under IFRS 9 but a few areas still require refinement. The testing process continues to be inherently arduous requiring acquaintance with and application of complex statistical techniques and valuation models. While IAS 39 allows 'hedge accounting' only on the satisfaction of the effectiveness test, both prospectively and retrospectively, the latter requirement will be dispensed with in IFRS 9 and only a prospective effectiveness test will be required with an effectiveness close to 100%. In the event of failure of the effectiveness test, 'hedge accounting' is required to be discontinued although the hedging entity can re-designate the rebalanced hedge under IAS 39. IFRS 9 obligates the hedging entity to rebalance the hedge in the event of ineffectiveness of the original hedge, and if such rebalancing also fails, then 'hedge accounting' needs to be discontinued (Forsberg et al., 2013, 152).

7. Conclusion

The financial statements of an entity do not necessarily report all its risk management activities under 'hedge accounting' on two counts viz. (i) the entity may not be actively 'hedging' its risks using derivatives or other permitted hedging instruments; and (ii) it may not adopt 'hedge accounting' as such adoption, even for accounting of eligible hedging relationships, is purely voluntary. There is a secondary issue of cost as well, which has been elucidated earlier. IAS 39 and, to a lesser extent, IFRS 9 entail extensive record keeping, elaborate effectiveness testing and expert manpower hiring involving costs that erode away the benefits of 'hedge accounting'. It needs to be emphasized that such hedging instruments as cannot be or are not accounted for using 'hedge accounting' need to be carried at FVTPL (i.e. as trading instruments). This adds to the volatility of income and the situation is not representative of the underlying risk management strategy. The fallout

is that such an entity may appear to be more risky despite actually having reduced its risk through risk management. Thus, the impact of hedging relationships is not correctly portrayed by the financial reporting system, to enable stakeholders to take a correct informed decision.

As elucidated above, the IASB, taking cognizance of the feedback on IAS 39, has introduced several changes in an attempt to align the provisions of 'hedge accounting' with the risk management strategies of entities. The spectrum of hedging instruments eligible for 'hedge accounting' has been considerably enlarged so that many more risk management strategies can be covered.

Disclosures in the financial statements in relation to 'hedge accounting' under IAS 39 lay emphasis on individual instruments. Little is required to be disclosed about risk management, handicapping the investors' in interpreting the riskiness of the entity and making it difficult for them to decipher its risk management policies. Disclosures on 'hedge accounting' are required only by type of hedge. Information on the underlying types of risks being hedged is, however, not required to be disclosed. In contrast, IFRS 9 requires all disclosures about hedge accounting be presented at one place in a tabular format specifying therein the risks being hedged for which hedge accounting is adopted by the reporting entity. Additionally, such entities need to, under IFRS 9, (i) explain their risk management strategy; (ii) elaborate on their derivative positions and the impact of such

positions on future cash flows; and (iii) assess and disclose the impact of 'hedge accounting' on their financial statements.

Risks that are not being hedged by the entity are not required to be disclosed. Similarly, disclosure is not required of risks that are hedged but in respect of which 'hedge accounting' is not opted for by the entity. Nevertheless, some qualitative and quantitative disclosures are required under IFRS 7 of the risks faced by the entity and their management strategies from positions in financial instruments. Standard setters would hope that entities provide information that is useful to their investors in understanding the risks faced by the reporting entities, their risk management strategies, the effectiveness thereof and explanations for the differentials between the economic outcomes of such strategies and their reporting. The absence of alignment of 'hedge accounting' under IAS 39 with the economics of risk management activities and the failure of full reporting and representativeness of such strategies in reported financial statements prepared under IAS 39 contributed to its lack of acceptability with the reporting entities and investors alike. It is hoped that, with its 'macro-hedge' principle based provisions, IFRS 9 would rectify the situation substantially.

A comprehensive illustration explaining the salient provisions of IFRS 9 read with IFRS 7 is included in Appendix A to this article.

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Appendix A - Illustrative disclosure of risk management strategy for commodity price risk

Variations in the price of wheat constitute the primary element of market risk for the ABC Flour Manufacturing Company Inc. (ABC hereinafter). ABC purchases high quality 'A' grade wheat from various suppliers in North America. Contracts of maturities between one and three years are negotiated and settled by ABC with suppliers, identified through a rigorous quality check mechanism. The wheat price is indexed to the USD benchmark price for 'A' grade wheat. The carriage and freight costs therefor are indexed to USD diesel prices. To facilitate adequate and uninterrupted supply of wheat, these supply contracts are entered into a minimum of one year prior to the harvest season of wheat.

ABC usually makes projections for the monthly volumes of its sales and corresponding requirements of raw material (wheat) over a horizon of eighteen months. The market (price) risk exposure due to raw material prices is managed by it on a 12-month rolling basis through the use of futures contracts on the 'A' grade wheat's USD benchmark price.

These futures contracts are designated in cash flow hedges of the 'A' grade wheat's USD benchmark price risk component of its future wheat purchases. Those purchases include committed minimum volumes under the contracts as well as some extremely likely projected transactions (that may involve quantities in excess of the minimum purchases volumes). Purchases may also cover instances relating to periods for which no contract has yet been entered into.

In the present strategy, the risk stimulus that generates the underlying risk of the wheat futures contracts as well as the hedged risk component is the same viz. the 'A' grade wheat's USD benchmark price. Consequently, ABC has adopted a hedge ratio of 1:1 for quantifying the hedge volumes.

Furthermore, since the risk component viz. the 'A' grade wheat's USD benchmark price is contractually specified in ABC's purchase contracts, it (the risk component) is considered to be separately identifiable and reliably measurable by ABC based on the price of wheat futures.

The risk exposure of ABC on account of fluctuations in the purchase price of wheat emanating from indexation of USD diesel price of the carriage and freight costs is integrated with the general logistics costs' risk

management strategy that aggregates exposures arising out of various logistics processes of the company.

The 'A' grade wheat USD benchmark price risk component that ABC designates as the hedged item is determined by it on the basis of the pricing formula in the wheat's supply contracts. This risk component constitutes the largest pricing element for the company.

Comments

IFRS 7 enlists the disclosure requirements for entities adopting hedge accounting. Such entities are required to provide a comprehensive qualitative description of their risk management strategy. The underlying philosophy is to enable the users of financial statements to understand the manner in which such entities are adopting hedge accounting and the impact of hedge accounting on the financial statements. Under IFRS 7, entities implementing hedge accounting are required to disclose information about:

- (i) The risk management strategy and the manner in which it is applied to manage risks;
- (ii) The impact of the risk management activities on the amount, timing and uncertainty of future cash flows;
- (iii) The impact of hedge accounting on the statement of financial position, the statement of comprehensive income and the statement of changes in equity.

While making the aforesaid disclosures, entities need to consider the following:

- (i) The necessary level of detail;
- (ii) The balance between different disclosure requirements;
- (iii) The appropriate level of disaggregation; and
- (iv) Whether additional explanations are necessary to meet the objective.

Furthermore, entities are mandated to make the hedge accounting disclosures in a single note or a separate section of the financial statements. However, cross-referencing to information presented elsewhere is permitted, provided that such information is available on the same terms and at the same time as the financial statements to the users thereof. The risk management activities disclosed should be specific to the entity rather than generic. Entities must describe the risk

management strategy by type of risk. The description of the strategy must provide information on:

- (i) The manner in which each risk arises;
- (ii) The manner and the extent to which such risks are managed;
- (iii) The extent to which, if at all, the entity hedges the risk exposure such as a nominal component or selected contractual cash flows.

Specific disclosures are mandated, for the purposes of the above, on:

- (i) The hedging instruments used by the entity and the manner in which they are used to hedge the various risk exposures;
- (ii) Justification for the economic relationship, if any, perceived to exist between the hedged item and the hedging instrument, by the entity;
- (iii) The method adopted for determination of hedge ratio;
- (iv) The expected sources of ineffectiveness.

In instances, where an entity hedges only a component of a risk exposure, it is required to disclose the manner in which such component is determined and how the

component, so hedged, relates to the item in its entirety. It is emphasized that entities need to classify disclosures by the type of risk, rather than the type of hedging relationship (e.g., cash flow hedge or fair value hedge).

As mentioned above, the underlying philosophy of these disclosure requirements is to enable the users to understand the link between an entity's risk management activities and their impact on the financial statements. It is, thus, desirable that entities make full disclosures, particularly in relation to key issues that involve exercise of judgement in applying the new hedge accounting model e.g. in assessing the existence of economic relationship between the hedged and hedging items, calculating the hedge ratio, identifying risk components etc.

Illustrative disclosure of timing, amount and average price of wheat futures contracts

The following wheat futures contracts are held by ABC Flour Manufacturing Company Inc. as at the closing of December 31, 20XX, for the purpose of hedging the exposure on its wheat purchases over the next twelve months:

| | Month of maturity | | | | | | Total |
|-------------------------------------|-------------------|------|------|------|-----------|------|-------|
| | Jan | Feb | Mar | Apr | May | Dec | |
| Notional amount (in thousand kgs) | 275 | 425 | 350 | 310 | 350 | 200 | 4,275 |
| Average hedged rate (in USD per kg) | 1.21 | 1.23 | 1.24 | 1.26 | 1.26 | 1.45 | 1.33 |

Comments

In addition to the risk management strategy, the 'terms and conditions' of the hedging instruments together with the manner and extent to which they affect the amount, timing and uncertainty of future cash flows need to be disclosed by entities adopting hedge accounting. This disclosure requirement embraces the following (to be disclosed for each category of risk):

- (i) A profile of the timing of the nominal amount of the hedging instrument;
- (ii) The average price or rate of the hedging instrument, if applicable.

If and when an entity applies a dynamic hedging process, it may so happen that there occur frequent changes in both, the amount of hedged item and

hedging instrument. In such instances, the aforesaid disclosures may not be very informative. As such, exemption is provided from such disclosures to entities using a dynamic hedging process. Instead, such entities are required to disclose:

- (i) The ultimate risk management strategy in relation to those dynamic hedging relationships;
- (ii) The manner in which the entity reflects this risk management strategy by using hedge accounting and designating those particular hedging relationships;
- (iii) The frequency with which the hedging relationships are terminated and recommenced as part of the dynamic hedging strategy in relation to those hedging relationships.

Illustrative disclosure of the effects of hedge accounting on the financial position and performance

The following enlists the impact of hedging instruments designated in hedging relationships on the statement of financial position of ABC Ltd. as of 31 December 20XX:

| Cash flow hedges | Notional amount | Carrying amount | Line item in the statement of financial position | Change in fair value used for measuring ineffectiveness for the period |
|--|--------------------------|-----------------|--|--|
| Wheat price risk 'A' grade wheat futures | 4,275 kgs (in thousands) | (2.5) | Short-term derivative financial liabilities | (1.0) |
| | | | | |
| Fair value hedges | Notional amount | Carrying amount | Line item in the statement of financial position | Change in fair value used for measuring ineffectiveness for the period |
| | | | | |

The following enlists the impact of hedged items designated in hedging relationships on the

statement of financial position of ABC Ltd. as of 31 December 20XX:

| Cash flow hedges | Change in value used for measuring ineffectiveness | | | Cash flow hedge reserve | |
|----------------------------------|--|--|--|--|--|
| Wheat price risk Wheat purchases | 1.0 | | | 2.5 | |
| | | | | | |
| Fair value hedges | Carrying amount | Thereof accumulated fair value adjustments | Line item in the statement of financial position | Change in fair value used for measuring ineffectiveness for the period | |
| | | | | | |

The following enlists the impact of the above hedging relationships on the profit (loss) and other

comprehensive income:

| Cash flow hedges | Hedging gain or loss recognized in OCI | Ineffectiveness recognized in profit or loss | Line item in the statement of profit or loss | Amount reclassified from OCI to profit or loss | Line item in the statement of profit or loss |
|--|--|--|--|--|--|
| Wheat price risk Hedges of projected wheat purchases | (1.0) | - | - | - | - |
| | | | | | |
| Fair value hedges | Ineffectiveness recognized in profit or loss | | Line item in the statement of profit or loss | | |
| | | | | | |

Comments

Disclosure under IFRS 7 is required of the impact of hedge accounting, by the type of risk, on the entity's financial position and performance in a tabular

format. Additionally, a reconciliation of the components in equity that arise in connection with hedge accounting and an analysis of OCI is also prescribed under IFRS 7.