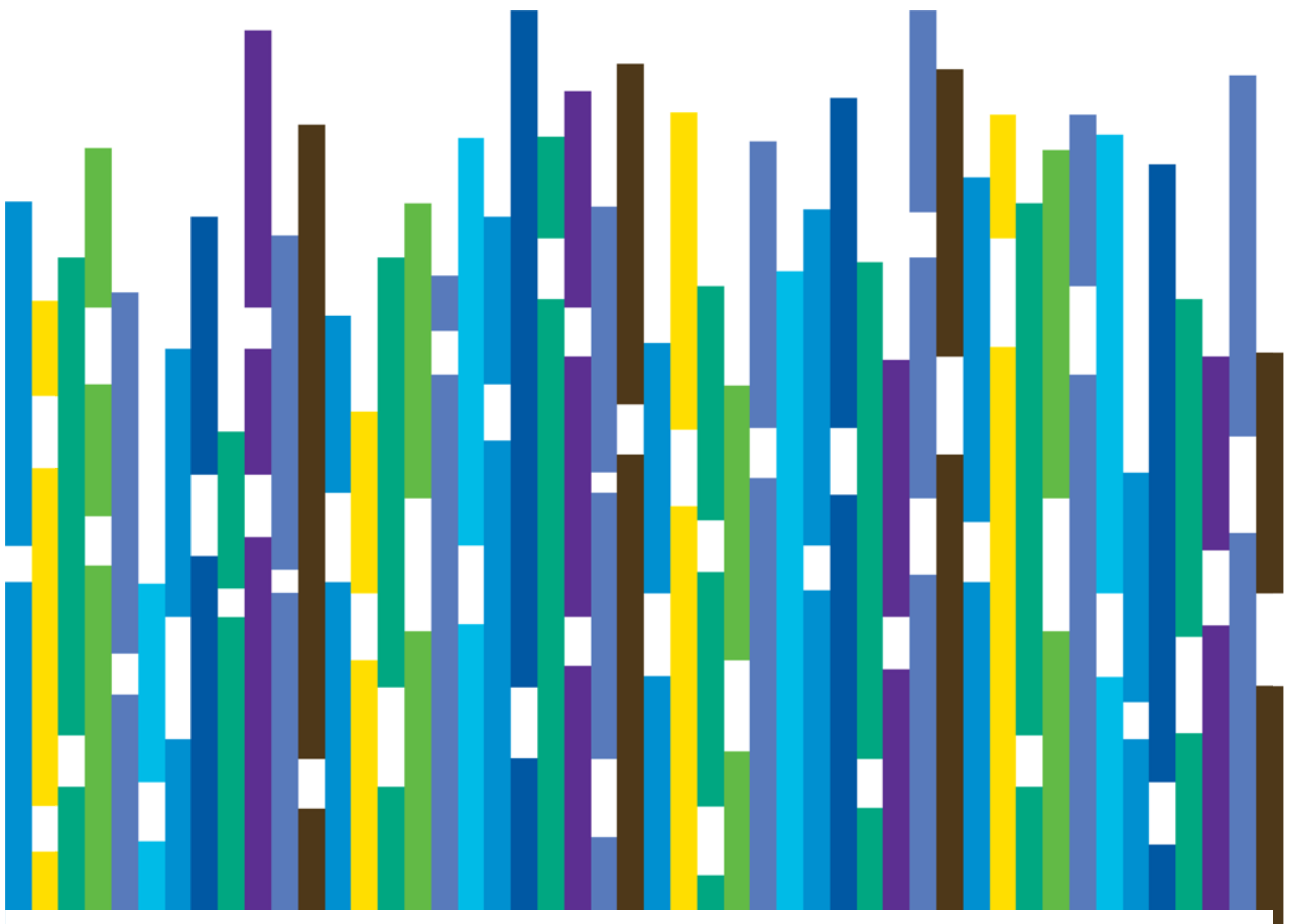
CFA Institute

ISSUE BRIEF: USER PERSPECTIVE ON FINANCIAL INSTRUMENT RISK DISCLOSURES UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS

Volume 2 — Derivatives and Hedging Activities Disclosures



ISSUE BRIEF: USER PERSPECTIVE ON FINANCIAL INSTRUMENT RISK DISCLOSURES UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS

Derivatives and Hedging Activities Disclosures

Introduction

CFA Institute recently issued a report, *User Perspective of Financial Instrument Risk Disclosures Under IFRS (Volume 2)*, that focuses on the disclosures of derivatives and hedging activities of financial and non-financial institutions. The report is timely as it addresses one of the top concerns for CFA Institute members around the globe in the coming year, as highlighted by the recently released Global Market Sentiment Survey 2013 (GMSS). The GMSS showed that alongside the transparency of financial reporting, disclosure of derivatives was one of the key areas that needs to be addressed to restore trust in the integrity of capital markets.

The report is an extension of *User Perspective of Financial Instrument Risk Disclosures Under IFRS (Volume 1)*, which focused on credit, liquidity, and market risk disclosures. Volume 2 reviewed relevant literature on derivatives and hedging activities disclosures; obtained user feedback through user surveys and interviews; and reviewed the quality of disclosures made in annual reports of 30 IFRS-reporting companies (including a detailed case study of Lufthansa Airlines disclosures) to place the user feedback in the appropriate context. We also highlight some examples of both useful and less useful disclosures.

This report aims to inform the ongoing process of reforming derivatives disclosures by highlighting the distinctive perspective of users with regards to these disclosures. The need to improve transparency around derivatives and hedging activities has also been recognized by both the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB), which recently enacted and proposed additional changes related to derivatives and hedging accounting and disclosures. The report also aims to encourage companies to voluntarily disclose information known to be useful for investors.

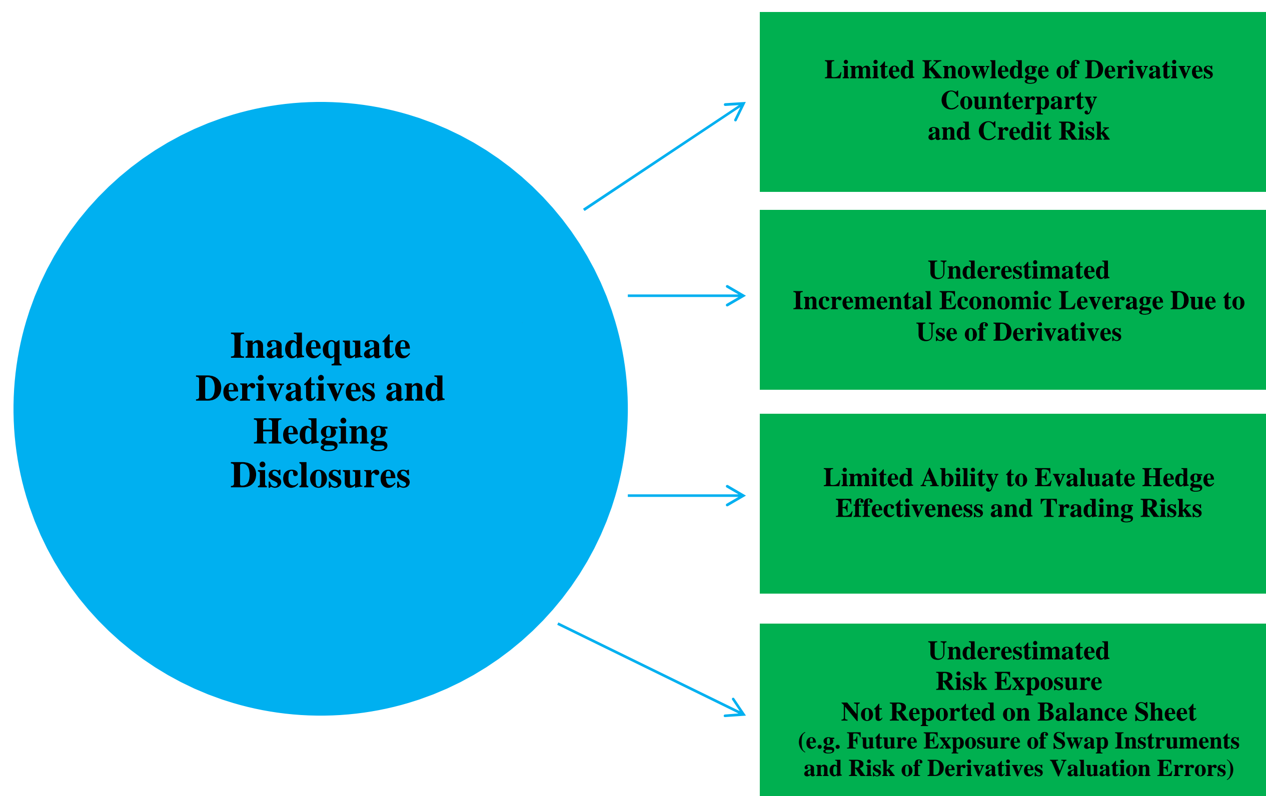
Why Improving Transparency of Derivatives and Hedging Activities Is Necessary

The use of derivatives for hedging activities is widespread among both financial and non-financial institutions. In addition, derivatives are widely used for active trading positions in banking and other financial institutions and, to a lesser extent, by some non-financial companies. Indeed, the Bank of International Settlements website reported aggregate outstanding notional amounts of US$639 trillion at mid-year 2012 for over-the-counter (OTC) derivatives.

Given the widespread use of derivatives, the quality of financial reporting for derivatives and hedging activities is very important as it can impact investor understanding of risk exposure and risk management activities undertaken by corporations. Poor derivatives and hedging disclosures can result in investors underestimating the risk exposures of reporting entities. Derivatives can increase a company's risk profile in a manner that is not readily identifiable from the main financial statements. In turn, inadequate disclosure of derivatives and hedging activities results in limited transparency for users regarding a) the aggregate impact of using derivatives instruments on the overall risk profile of companies including counterparty risk and b) the effectiveness of risk management.

In addition, inadequate disclosures can result in surprised investors when previously unknown, large derivatives-related risk exposures have unraveled. Recent high profile losses show how claims of undertaking hedging can be misleading and that a 'hedge is not always a true hedge'. One example is the relatively recent and widely reported high profile JPMorgan derivatives-related losses from what seemed to be an economic hedging position.

Figure 1-1: Impact on Investors of Inadequate Derivatives and Hedging Disclosures



Key Finding: Derivatives and Hedging Disclosures Do Not Fully Inform Investors about Risk Management Practices

We asked users to rate the importance of different categories of disclosures including hedge accounting disclosures. Hedge accounting is only applicable for financial instruments including derivatives that are designated as hedges for accounting purposes; it does not apply to all hedging relationships. Hedge accounting minimises net income volatility.

User feedback showed that hedge accounting disclosures are seen as moderately important when compared to the importance assigned to credit, liquidity, and market risk disclosures. In addition, there was low user satisfaction with all of these disclosures.

Respondents indicated that hedge accounting and disclosure requirements are complex and confusing for users and do not readily communicate key economic information (e.g., the nature of hedging strategies, hedged versus un-hedged exposures, and hedge effectiveness). The highly complex nature of hedge accounting rules, along with only partial information regarding hedging activities addressed by hedge accounting disclosures, does not help users have a complete understanding of a reporting company's risk management practices. This explains the ratings of moderate importance of, and low satisfaction with, hedge accounting disclosures. Several respondents indicated that they entirely ignore hedge accounting disclosures due to their limited usefulness when the objective is to understand the full range of entity-wide economic risk management practices.

Notwithstanding the views on limited usefulness of existing hedge accounting disclosures, user comments show that high quality derivatives and hedging activity disclosures, if provided by companies, can potentially assist users to:

- Assess derivatives instruments use and risk exposure
- Assess extent of hedging activities
- Differentiate impact of core business activities from hedging activities on reported performance
- Assess economic hedging effectiveness of designated hedge accounting relationships
- Detect earnings management

Room for Significant Improvement

In our review of the annual reports of 30 IFRS-reporting companies, we noted several shortcomings with derivatives and hedging activities disclosures. In general, the information content and presentation format of these disclosures have room for significant improvement. Moreover, these disclosures were often inconsistent across the companies we reviewed — and this can make it challenging for readers of financial reports to compare derivatives use, risk exposure, and risk management practices across companies. Some of the reviewed companies did not fully comply with mandated disclosures even when these seemed appropriate. In addition, there was limited voluntary disclosure of useful information across the companies. More specific shortcomings include:

- Derivatives and hedging disclosures could be better presented and more effectively integrated with other risk category disclosures
- Inadequate disclosure of underlying aggregate quantitative risk exposure and derivatives instruments
- Insufficient disclosure of derivatives use and hedging strategies
- Insufficient information related to the effects of hedging activities on the financial statements. This inadequacy was particularly pronounced with cash flow hedges
- Limited scope of disclosure requirements contributes to incomplete reporting of risks and risk management activities

Report Recommendations

The report's recommendations are informed by the noted shortcomings. Our general recommendation is that issuers should aim to effectively communicate their risk exposure and risk management practices rather than merely complying with existing accounting standards requirements. We also propose the following improvements:

- ***Improve Presentation, Location, and Integration of Derivatives and Hedging Disclosures with Other Key Risk Disclosures —*** Centralised and tabular risk disclosures should be provided. In addition, derivatives and hedging disclosures should always be integrated with other risk disclosures in management's discussion of use of derivatives.

- ***Improve Quantitative Risk Exposure Disclosure —*** Comprehensive quantitative risk exposure information is required to assist users in understanding hedged and un-hedged exposures. This disclosure should include an outline of both the economic exposure (e.g., foreign currency, interest rate, or commodity) both before and after hedging (e.g., effective post-hedging currency exposure). It should also outline the instrument-specific risk exposure (e.g., notional amount, derivatives maturity, counterparty credit risk, and related sensitivity analysis).
- ***Improve Communication of Derivatives Use and Hedging Strategies —*** Companies should adequately explain the nature and purpose of derivatives instruments used, making a clear distinction between accounting hedges, economic hedges, and trading derivatives. When hedging, they should also explain their risk management policy, including the hedging objective and cost of hedging, and link their descriptions of risk management to the disclosures of quantitative information.
- ***Enhancement of Disclosures Related to Effects of Hedge Activities on Financial Statements —*** Disclosures related to the impact of both fair value and cash flow hedges on the financial statements need improvement to better illustrate the impacts of hedging activities on the balance sheet, income statement, and cash flow statement.
- ***Extend Scope of Disclosures to Economic Hedges Not Treated as Accounting Hedges —*** Communication of risk management through disclosures should not be restricted by whether a company qualifies for, or has elected to apply, the hedge accounting approach.

Proposed Update to IFRS Hedging Disclosures Useful but Further Enhancement Still Required

We acknowledge that the IASB has made efforts to improve current IFRS hedging disclosures through its recent issuance of the IFRS 9, *Financial Instruments*, Hedge Accounting Staff Draft. The Hedge Accounting Staff Draft has enhanced disclosures so that they can contribute towards a top-down portrayal of risk management, and it has included a number of our proposed recommendations (e.g., better disaggregation of financial statement effects of hedge accounting and disclosures on sources of ineffectiveness). However, the usefulness of the additional proposed disclosures is limited because they only focuses on designated hedge accounting relationships. For example, economic hedges that do not qualify for hedge accounting remain out of scope. There also remains an opportunity to enhance derivatives instruments specific exposures not currently addressed under general IFRS financial instruments disclosure requirements (e.g., derivatives covenants that impact liquidity). Therefore, we recommend that: a) standard setters consider further enhancing derivatives instruments disclosures in addition to current IFRS 7 requirements; and b) reporting entities should fully comply with the required IFRS disclosures, and this should be based on a mindset of effective communication. They should also voluntarily disclose all information that is useful for investors but not mandated.

Despite IASB proposals to improve hedging disclosures, it remains to be seen whether the updated requirements will yield enhanced communication of risk management practices from companies alongside the proposed significant expansion of their eligibility for hedge accounting treatment. Or alternatively, whether companies will simply comply with the bare minimum of proposed disclosure requirements and continue to treat hedge accounting as primarily a vehicle for minimising accounting earnings' volatility while failing to provide all information that investors would need to fully understand corporate risk management. Thus, it is important to emphasize that companies should prioritise effective and complete communication, as articulated through the recommendations in our report, with the aim of fully informing investors about risk exposures and risk management practices.