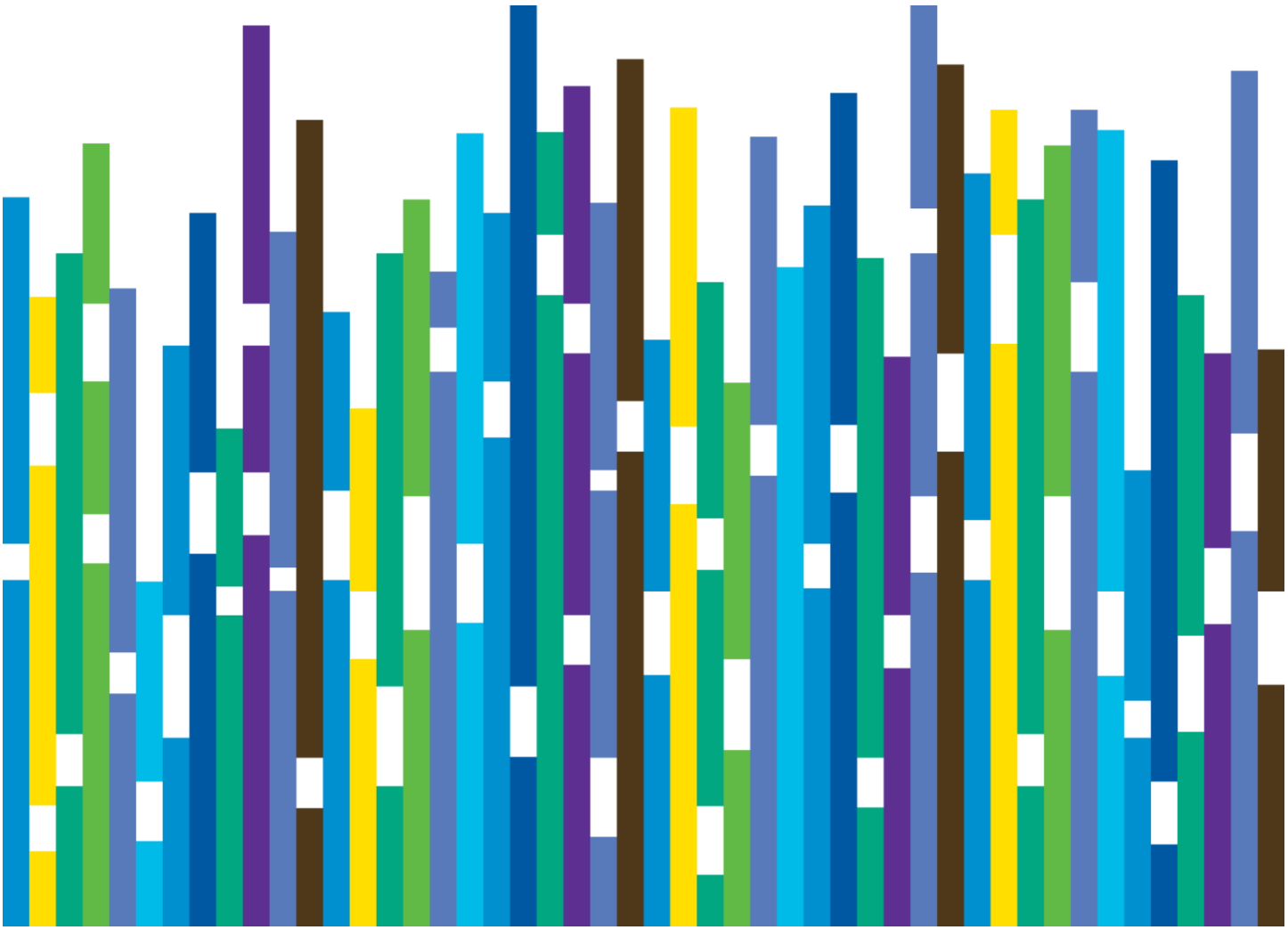
CFA Institute

USER PERSPECTIVES ON FINANCIAL INSTRUMENT RISK DISCLOSURES UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS

Derivatives and Hedging Activities Disclosures (Volume 2)

January 2013



Foreword

CFA Institute[1] has undertaken a study to examine the quality of existing financial instruments risk disclosures. The overall study evaluated credit, liquidity, and market risk disclosures and disclosures for derivatives and hedging activities under International Financial Reporting Standards (IFRS). The study specifically focuses on IFRS Statement No. 7 (IFRS 7), *Financial Instruments: Disclosures*. This report, **Volume 2**, provides a user perspective on the disclosures of derivatives and hedging activities. It is an extension to **Volume 1**, which provided a user perspective on financial instrument credit, liquidity and market risk disclosures.

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[1] CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 115,000 members, who include the world's 109,000 CFA charterholders, in 135 countries and territories, as well as 137 affiliated professional societies in 59 countries and territories. More information may be found at www.cfainstitute.org.

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1 Overview

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1.1 Executive Summary

CFA Institute has undertaken a study to examine the quality of existing financial instruments risk disclosures. This report, **Volume 2**, provides a user perspective on the disclosures of derivatives and hedging activities. It is an extension to **Volume 1** which provided a user perspective on financial instrument credit, liquidity and market risk disclosures. In its approach, the study:

- Reviews relevant literature on derivatives and hedging activities disclosures;
- Obtains user feedback through user surveys and interviews; and
- Reviews the quality of disclosures made in 2011 and 2010 annual reports of 30 IFRS-reporting companies (including a detailed case study review of the disclosures of Lufthansa Airlines). The company review contextualises the user feedback obtained. As a result of reviewing company annual reports, some examples of both useful and less useful disclosures are highlighted.

As discussed in **Section 1.5**, the study triangulates these sources of information in order to recommend derivatives and hedging disclosures which are more useful for users of financial statements.

Key Findings — User Feedback and Existing Literature Reveal That Existing Hedging Disclosures Do Not Fully Inform on Risk Management

The user feedback in **Section 3.1** shows that hedge accounting disclosures are seen as moderately important when compared with the importance assigned to credit, liquidity and market risk disclosures.[2] In addition, there was low user satisfaction with all risk disclosures and with hedge accounting disclosures.

Respondents indicated that hedge accounting and disclosure requirements are complex and confusing for users and they do not readily communicate key economic information (e.g. nature of hedging strategies, hedged versus unhedged exposures and hedge effectiveness). The highly complex and arcane nature of hedge accounting rules, along with the partial information regarding hedging activities addressed by hedge accounting disclosures, does not help users to discern the entirety of risk management practices of reporting companies. This explains the ratings of moderate importance of, and low satisfaction with, hedge accounting disclosures.

[2] Hedge accounting disclosures cover derivatives that qualify for hedge accounting, while disclosures associated with derivatives instruments are included in users' ratings of credit, liquidity and market risk disclosures, which cover all financial instruments.

That said, as discussed in **Section 3.2**, 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; and
- Detect earnings management.

The feedback from users shows that they require multi-dimensional risk management information that is often not currently available, including: disclosure of hedged versus unhedged risk exposures; details of hedging strategies; and the economic effectiveness of the chosen hedging strategies. User comments and an analysis of potential application of these disclosures show that there is an information gap between disclosures that users require for analytical purposes and the disclosures that are provided by companies. We posit that this information gap contributes to the low user satisfaction with existing derivatives and hedging disclosures.

The user feedback was consistent with the literature reviewed in **Section 2**. The literature shows that certain information (e.g. notional amounts, sensitivity analysis) which should be provided through disclosures is value relevant but that there is only partial compliance by companies with the required derivatives and hedging disclosures and limited provision of voluntary disclosures. The literature also emphasises the need for holistic disclosures that are similar to the requirements as articulated by users.

Key Findings – A Review of Annual Reports Shows That the Information Content and Presentation Format of Derivatives and Hedging Disclosures Have Room for Significant Improvement

Several shortcomings with derivatives and hedging activities disclosures were noted through the review of annual reports of IFRS-reporting companies. In general, the information content and presentation format of these disclosures shows room for significant improvement. Moreover, these disclosures tended to be 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 it seemed appropriate to do so. In addition, there was limited voluntary disclosure of useful information across the companies. Specific shortcomings include the following:

- 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. For example, one of the largest banks in the U.K. had significant cash flow hedge deferral to other comprehensive income (OCI) (i.e. >100% of net income from an absolute magnitude perspective) in its 2011 annual report, but we could not readily find any disclosure on whether or not this bank had ineffectiveness on its cash flow hedges.
- Limited scope of disclosure requirements contributes to incomplete reporting of risks and risk management activities.

These shortcomings are discussed further in **Section 4.2.2** and illustrated in the case study on Lufthansa Airlines in the **Appendix, Section 6.1**. The case study shows that even for the analysed company which provided certain disclosures that are better than those provided by most of the companies we reviewed, the information gleaned from the disclosures is often rudimentary, incomplete and not cohesive for purposes of a user fully evaluating risk management practices.

Overarching Recommendations

We make the following overarching recommendations:

- **Holistic Disclosures that Focus on Communication and Not 'Mere Compliance' Should be Provided —** As recommended in **Volume 1**, issuers of financial reports should primarily aim to communicate their risk exposures and risk management rather than preparing these disclosures as a 'tick-the-box' compliance exercise. Clear communication is especially important in relation to derivatives and hedging disclosures. As history has shown, investors can easily be blindsided regarding the purpose and loss potential of derivatives instruments due to uninformative disclosures. Communications regarding the use of corporate derivatives should address the following questions in understandable language and easy-to-access format:

    - What is the extent of application of derivatives for either hedging or trading purposes?
    - How are the derivatives used accounted for?
    - What is the hedging objective when derivatives are used for that purpose?
    - What is the magnitude of the hedged versus unhedged exposure?
    - Are derivatives designated as hedges economically effective?
    - What are the sources of realised hedge ineffectiveness?
    - What are the other associated significant risk exposures from the derivatives?
    - What is the upper bound of potential losses associated with derivatives?

    Companies should go beyond providing the bare minimum of mandated disclosures. As appropriate and where applicable, they should fully comply with mandated disclosures. Companies should also voluntarily disclose all other information necessary for investors to fully comprehend the risk modification arising from the use of derivatives instruments.

- **Materiality Assessment of Derivatives Should Be Based on Loss Potential of Derivatives and Not on Reported Fair Values —** In some cases, firms that use derivatives but provide sparse and inadequate disclosure may assert that derivatives are immaterial for their particular business model. For example, this type of claim could be made by some non-financial companies when the fair values of derivatives reported on their balance sheets are not material relative to the carrying amount of other operating assets. That said, derivatives instruments are inherently risky, highly leveraged financial instruments with significant potential for unexpected losses. Furthermore, derivative fair values represent current market values, not the upper bound of potential losses. Thus, it can be misleading to use the fair value of reported derivatives assets to judge materiality and thereby to reduce the quality of communication made by companies regarding their use of derivatives instruments. Instead, all companies that use derivatives and where there is potential for significant losses beyond the amount depicted by the fair value on the balance sheets should aim to provide holistic disclosures as recommended.

Specific Recommendations

This report's recommendations, as discussed further in **Section 5.1**, are informed by the noted shortcomings of derivatives and hedging disclosures as well as the feedback on useful disclosures from users and available literature. The following improvements are proposed:

- **Improved 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. For example, hedging disclosures should be integrated with disclosures of quantitative risk exposures and market risk sensitivity analyses. In addition, there is scope to improve the integration of disclosures of credit derivatives, credit risk and counterparty credit risk. This latter point is particularly important for banks and non-financial companies where credit risk is a key risk factor. The proposed integration is consistent with the general recommendations made in **Volume 1** of this study.

- **Improved Quantitative Risk Exposure Disclosure —** Comprehensive quantitative risk exposure information is required to assist users in understanding hedged and unhedged 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). We highlight examples of such useful disclosures provided by some of the companies that we reviewed (i.e. Anheuser Busch, a brewing company and Anglo-American, a leading South African mining company). Disclosures should also outline the instrument specific risk exposure (e.g. notional amount, derivatives maturity, counterparty credit risk, and related sensitivity analysis).

- **Improved 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 policies, including the hedging objective and cost of hedging and link their descriptions of risk management to the disclosures of quantitative information. They should shed light on the hedging and risk transformation strategies, including those relating to complex hedging strategies such as: a) macro-hedging; b) synthetic exposures created due to netting or aggregation of hedging instruments and/or hedged items; and c) partial hedging of discrete risk categories.

  It was observed that poor disclosure of hedging strategies is particularly prominent within banks notwithstanding the variety and complexity of hedging strategies that they usually employ. It will be especially concerning for investors if banks were to be in the future, as is currently being considered, be eligible to apply hedge accounting more broadly towards macro-hedges and/or synthetic risk exposures without there being a corresponding significant enhancement in disclosure practices. We further discuss the expanded hedge accounting requirements in **Appendix**, **Section 6.3**. The lack of adequate related disclosures will increase the likelihood of investors not being aware of any risks or potential for losses arising from macro-hedges and/or synthetic exposures. Thus, banks in particular, should improve their qualitative disclosures of macro-hedges and/or synthetic risk exposures regardless of whether hedge accounting is allowed for such hedges.

- **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. The disclosures of both fair value and cash flow hedges should:
    - Outline the nature of the gains or losses, making it clear as to whether they relate to operating, investing, or financing activities;
    - Include a roll forward of balance sheet amounts reflected in the financial statements; and
    - Include an adequate explanation[3] of any sources of ineffectiveness.

  For fair value hedges, the following enhancements should be made either on the face of the financial statements or within the notes:

    - Disaggregation of carrying amounts of hedged items that are part of a hedging relationship (i.e. what is included in and what is excluded from the hedging relationship);
    - Linked presentation that matches risk management pairs (i.e. hedging instrument and hedged item); and
    - Disaggregation of the cumulative fair value adjustments of the hedged item and the hedging instrument.

  As discussed in **Section 4.2.2.4**, cash flow hedge deferrals can be potentially significant in magnitude. In addition, **Section 3.2.5** highlights that cash flow hedges can be used for earnings management. This makes it important to have comprehensive disclosures of cash flow hedges. For cash flow hedges, there is need for companies to better comply with current IFRS 7 disclosure requirements and to disclose the following within the notes:

    - Disaggregation of gains or losses in the income statement clearly differentiating between amounts due to hedge ineffectiveness and amounts due to reclassification to income statement from OCI. Similarly, for OCI gains or losses, there should be clear differentiation between amounts due to termination, selling or voluntary de-designation of hedges.
    - Linked disclosure of gains or losses on hedging instrument and hedged items so as to better inform users about hedge ineffectiveness. This disclosure should include a disaggregation of gains or losses due to different types of hedging strategies.
    - Cash flow hedge forecasts should be accompanied by explanations regarding the nature and amounts underlying the forecasts.

[3] Reval (2011), *Hedge Accounting: Cross Currency Interest Rate Swaps- Minimising P&L Volatility* **—** The importance of disclosing sources of ineffectiveness can be inferred from a white paper by Reval – a boutique management consultancy that specialises in hedge accounting solutions. The white paper reviews the hedging of foreign currency borrowing by corporations, using cross currency interest rate swaps (CCIRS), and the nature of ineffectiveness arising from this hedging strategy. The paper highlights how specific valuation input factors (e.g. coupon reset date and currency basis that reflects cross country credit risk) may have differing impacts on the valuation of the underlying hedged item (i.e. foreign currency debt) and hedging instrument (i.e. CCIRS). It also shows how different elements of the valuation mismatch of hedged item and hedging instrument can translate into sources of reported hedge ineffectiveness. In addition, the paper illustrates that companies can elect a hedge accounting approach (i.e. either fair value or cash flow) for different components of the mentioned hedge so as to influence the reported ineffectiveness. In other words, hedge accounting designation can influence the level of reported hedge ineffectiveness and the same economic hedge but with a different hedge accounting choice can effectively result in different reported ineffectiveness. This example is an illustration of why it is important to disclose to investors the nature of underlying sources of reported hedge ineffectiveness. Such disclosure will help investors to better understand any reported ineffectiveness on the income statement and to discern where seemingly similar economic hedges applied across different companies are comparable in their reported ineffectiveness.

Companies should also provide disclosures of under-hedged[4] amounts arising from cash flow hedges to help users assess whether there is systematic under-hedging. Finally, neither the financial instruments disclosures nor the cash flow statement currently shows the cash flow effects of derivatives. Hence, there should be disclosures that show how derivatives impact the operating, financing and investing cash flows of a company.

- **Extend Scope of Disclosures to Non-Qualifying and Non-Elected Economic Hedges —** The scope of disclosures should be extended to cover economic hedges where derivatives are hedging instruments but hedge accounting is not applied.

IASB's Proposed Improvements to Existing IFRSs Address Some of Our Recommendations but Further Enhancement to Disclosures Is Still Required

We acknowledge that the International Accounting Standards Board (IASB) has made efforts to improve current IFRS 7 hedge accounting disclosures through its recent issuance of the IFRS 9, *Financial Instruments*, Hedge Accounting Staff Draft (Hedge Accounting Staff Draft). The Hedge Accounting Staff Draft was issued after the IASB re-deliberations following the elicitation of stakeholder feedback to the 2010 Hedge Accounting Exposure Draft (Hedge Accounting ED). We further discuss the proposed IFRS updates in **Section 5.3**.

The Hedge Accounting Staff Draft has enhanced disclosure requirements 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 disclosure requirements is limited because rather than explicitly focusing on the disclosure requirements of all derivatives and hedging activities, so as to holistically inform on risk exposures and risk management, the focus of the update is on designated hedge accounting relationships meaning that economic hedges remain out of scope. There also remains an opportunity to enhance derivatives instruments-specific exposures currently not being addressed under general IFRS 7 financial instruments disclosure requirements (e.g. derivatives covenants that impact on liquidity). We posit that the absence of an explicit focus on mandatory derivatives instruments-specific disclosure requirements most likely contributes to the poor quality of disclosures about derivatives instrument risk exposures. Therefore, we recommend that: a) standard-setters consider the enhancement of derivatives instruments disclosures further to current IFRS 7 requirements; and b) reporting entities fully comply with the required IFRS disclosures and such compliance should be based on a mindset of effective communication. They should also voluntarily disclose all information that is useful for investors but not mandated.

In our comment letter response, we highlighted that the expansion and increased complexity of hedge accounting allowed under the updated proposal will increase user interpretation difficulties. We also noted that the expanded eligibility for hedge accounting warranted a significant increase in disclosure requirements around all key judgements regarding eligibility, hedging designation and effectiveness of designated hedge accounting relationships. It remains to be seen whether the updated requirements will result in enhanced communication of risk management practices from companies or, alternatively, whether reporting entities will simply comply with the bare minimum of any disclosure requirement 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 risk management choices and effectiveness.

[4] As discussed in **Section 5.1.4** and the **Appendix, Section 6.3**, for cash flow hedges, only gains or losses from over-hedging are recognised in the income statement as relating to ineffective hedges. Thus, investors need to be aware if there is systematic under-hedging by companies using cash flow hedges. IFRS prohibits systematic under-hedging but disclosures can help investors to monitor if such under-hedging is occurring.

1.2 Objective and Significance of Study

Why Derivatives and Hedging Disclosures Are Important

The use of derivatives for hedging activities is widespread[5] 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 $639 trillion at mid-year 2012 for over-the-counter (OTC) derivatives.

Despite the widespread use of derivatives among large firms, related disclosures are often inadequate, as evidenced by several incidences of derivatives-related corporate losses that surprised investors when hitherto unknown large derivatives-related risk exposures unraveled. The book '*The Big Short*[6]*'* by Michael Lewis provides one example of how investors can be blindsided by derivatives risk exposures even when companies claim to be using derivatives for hedging. The book describes a leading global bank that attempted to hedge its exposure to sub-prime mortgages risk. Because the hedge was expensive (costing several million dollars a year), the bank decided to offset the cost of the hedge by writing a credit default swap contract (i.e. selling protection) and thereby earn premiums from the contract. Unfortunately, this combination of contracts, while seeming to be a hedge, ultimately resulted in greater exposure for the bank and an eventual loss of several billion dollars. The same can be said of the relatively recent and widely reported high-profile JP Morgan derivatives-related losses which varied from an initial estimate of $2 billion when first reported in May 2012 to a later estimate of $5.8 billion. There are several other similar examples[7].

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[5] Lins, K.V., Servaes, H. and Tamayo, A. (2011), *Does Derivatives Accounting Affect Risk Management?, International Survey Evidence*, Financial Management, Vol.40, No.3, pp. 525-551. — The study reports the findings of an international survey that had 354 company respondents from 39 countries. The study found that 83% of respondent companies manage foreign exchange risk exposure, 74% manage interest risk and 49% manage commodity risk exposure using derivatives.

[6] Lewis, M. (2010), *The Big Short*, Penguin Books Ltd, London — This book provides a genesis of the sub-prime crisis and includes illustrations of risky strategies applied by key financial institutions using complex financial instruments, including an example of how company claims of hedging can be inaccurate.

[7] The following publications describe significant reported losses as well as potential yet unreported losses arising from the use of derivatives:

a) Partnoy, F. and Eisinger, J. (2013), Atlantic Magazine (January/February), *What's Inside America's Banks?* — The article analyses the financial statements and disclosures of some of the largest US banks (e.g. Wells Fargo and JP Morgan) and shows how losses of financial instruments, including derivatives, are often very well concealed in annual reports. For example, the article observes that Wells Fargo had losses worth $377 million arising from trading derivatives (i.e. collateralized debt obligations) that were buried in the notes to the accounts and that this loss was likely to have escaped the scrutiny of media, investors, and analysts. The authors observe that the opacity of banks has contributed to the loss of investor trust in banks, and they argue for clearer disclosures by banks. Incidentally, the need for enhanced risk disclosures by banks, including their application of derivatives instruments, has also been highlighted through a recently issued (i.e. October 2012) report by the Financial Stability Board (FSB) mandated-Enhanced Disclosure Task Force. The report titled 'Enhancing The Risk Disclosure of Banks' can be accessed through the following FSB website address (www.financial stabilityboard.org/publications).

b) Braithwaite, T., Mackenzie, M., Scannell, K. (December 5 2012), *Financial Times, Deutsche Bank: Show of Strength or a Fiction?* — This article alleges that during the 2007 to 2009 financial crisis, Deutsche Bank may have hidden derivatives-related losses worth billions of dollars. The potential losses would have occurred if a different and possibly more appropriate valuation approach had been applied towards a portfolio of leveraged super senior credit derivatives positions. The article is based on allegations of a Deutsche Bank ex-employee to the effect that, through its applied valuation approach, the bank did not sufficiently reflect the risk exposure arising from the counterparties who had sold credit risk protection to the bank. The specific counterparty risk described is one known as the 'gap option'. The article reports that Deutsche Bank defended the appropriateness of financial reporting and valuation approach applied at the time. Nevertheless, this particular reported episode is indicative of the hidden loss potential of derivatives contracts due to the sensitivity of their reported values to underlying assumptions. This makes it important to have disclosures that can inform investors on the risk of derivatives instruments valuation errors.

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. As shown in **Figure 1-1**, poor derivatives and hedging disclosures can result in investors underestimating the risk exposures of reporting entities.

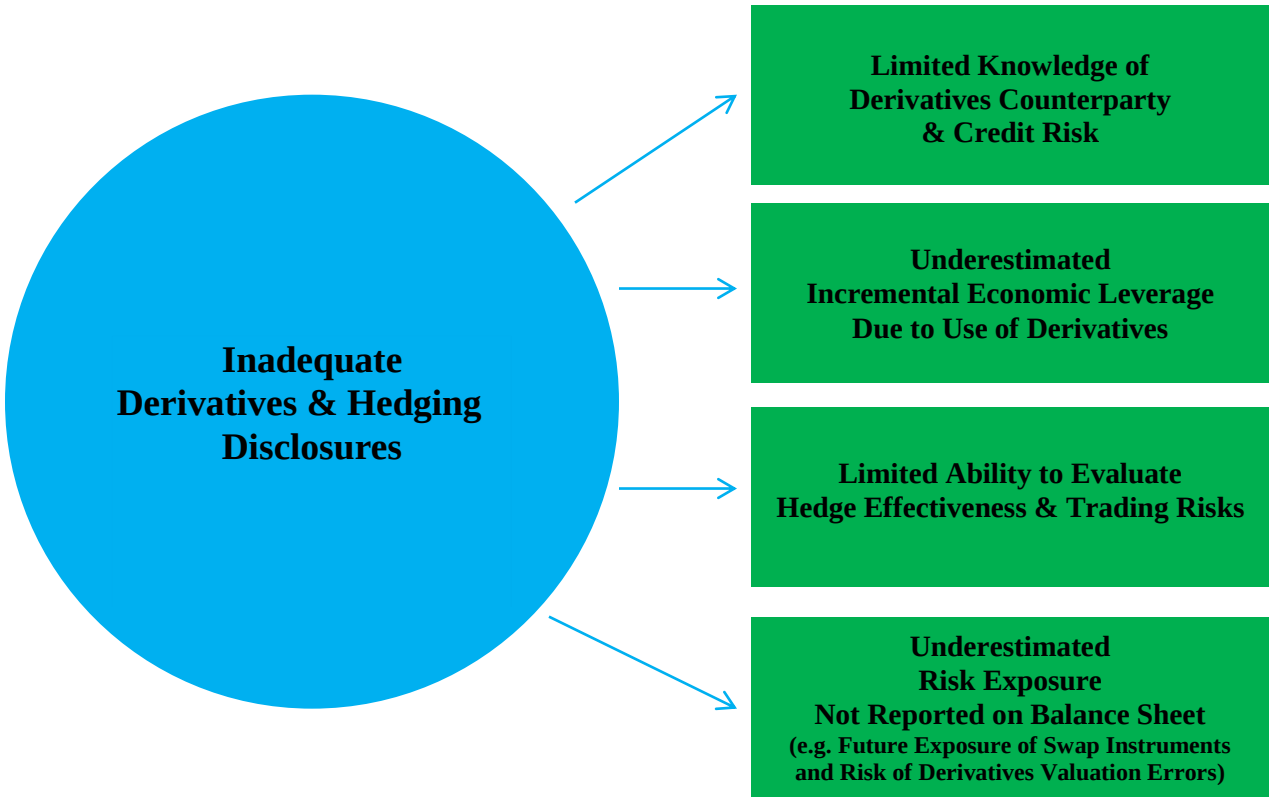
Derivatives can increase a company's risk profile in a manner that is not readily identifiable from the corporate balance sheet. Examples include the following: a) increasing the economic leverage[8] of entities; b) exposures not being recognised or represented in the reported fair values on balance sheet including risk of misstatement arising from derivatives valuation and accounting errors; and c) creating credit and liquidity risk exposures to counterparties. These ways in which derivatives increase a company's risk profile are discussed further in **Section 3.2.1**. In addition, 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.

c) Sanderson, R., Dinmore, G. and Tett, G. (March 8 2010), Financial Times, *An Exposed Position* **—** The article highlighted the situation of Italian municipalities being faced with the prospects of large interest rate swaps derivatives related losses.

d) Geczy, C.C., Minton, B.A., and Schrand, C.M. (2007), *Taking a View: Corporate Speculation, Governance, and Compensation*, The Journal of Finance, Vol. LXII, No.5, pp. 2405-2441. **—** The study pinpoints the following cases of derivatives-related losses: Banc One, Proctor and Gamble, Gibson's Greetings and Barings Bank, Reliant Energy, Encana Corporation, China Aviation Oil and South African Airways.

[8] Chaillet L, 2008, *Financial Leverage* **—** *Lights on an Elusive Concept* – This website article defines economic leverage by highlighting the distinction between balance sheet and economic leverage. Balance sheet leverage relates only to the visible leverage appearing on the balance-sheet as borrowed money. Economic leverage relates to all leverage of an institution including off-balance sheet items. An example of where derivatives result in off-balance sheet debt arises when companies borrow and then enter into swap transactions on their debt. In this instance, the leverage is off-balance sheet because the notional value of the swap instrument is not recognised on the balance sheet; and only the fair value of the swap instrument is shown on the balance sheet. Similarly, a forward contract can be viewed as an irrevocable commitment to purchase or sell some asset on some pre-arranged terms and this is analogous to an off-balance sheet guaranteed future commitment. As we discuss in **Section 3.2.1**, the large loss potential of derivatives instruments compared with their minimal initial investment requirements reflects the economic leverage of these instruments.

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



This Report's Purpose Is to Inform and Recommend Improvements to Derivatives and Hedging Disclosures

The need to improve derivatives and hedge accounting standards including disclosures has been recognised by both the IASB and United States (U.S.) Financial Accounting Standards Board (FASB). These standard setting bodies have in the recent past enacted and proposed additional changes[9] related to derivatives and hedging disclosures.

This report aims to inform the process of reforming derivatives disclosures by highlighting the distinctive perspective of users with regards to these disclosures. The report complements a 2001 study[10] by the predecessor organisation to CFA Institute [Association of Investment Management Research (AIMR)], which analysed derivatives accounting and disclosure requirements as well as the factors that investors consider when reviewing corporate risk management practices. It also complements the principles of good disclosure highlighted by the Comprehensive Business Reporting Model[11] and several CFA Institute comment letters[12] on the subject. The following excerpts from past CFA Institute commentary on the topic emphasise the nature of analyst considerations and the importance of high-quality derivatives and hedging disclosures:

> *Without clear and complete disclosure of a company's risk exposures, its plans and strategies for bearing or mitigating those risks, and the effectiveness of its risk management strategies, investors will be unable to evaluate either of the following: a) company's potential risk and rewards; or b) its future expected outcomes.* — Comprehensive Business Reporting Model

> *Analysts evaluating the statements and related notes with the goal of understanding the firm's risk positions, derivative use, management strategies, and the implications for the firm's future risk profiles and profitability will have to look well beyond the specific accounting method chosen to the apparent economics underlying the transactions. This assessment will be critically dependent on both the quantity and quality of disclosure that management chooses to provide.* — AIMR 2001 Study

The latter comment highlights the importance to investors of disclosures that go beyond explaining the accounting for derivatives to also illuminate the economic risk exposures and risk management of reporting entities.

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9 Under IFRS, derivatives disclosure is mandated by:
a) IFRS 7, *Financial Instrument: Disclosures*; and
b) International Accounting Standard Statement No. 39 (IAS 39), *Financial Instruments Recognition and Measurement*.
In 2008, IFRS 7 was updated to require liquidity risk maturity analysis for derivatives liabilities. Further, there are proposed updates to hedge accounting and disclosure requirements under the IASB's Hedge Accounting Staff Draft.

Under U.S. GAAP, derivatives disclosure is mandated by SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities — An Amendment of FASB Statement No. 133*, which was issued in 2008 and is now part of Codification Topic 815. Codification Topic 815 also encompasses the accounting for derivatives established under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. The FASB is currently considering modifications/amendments to derivatives accounting, albeit to a substantially lesser degree than under the IASB Hedge Accounting Staff Draft.

10 Gastineau, G.L., Smith, D.J., and Todd, R. (2001), *Risk Management, Derivatives, and Financial Analysis Under SFAS 133*, The Research Foundation of AIMR and Blackwell Series in Finance.

11 CFA Institute (2007), *A Comprehensive Business Reporting Model.*

12 Recent CFA Institute comment letters on hedging accounting include:
a) CFA Institute April 25, 2011 comment letter to IASB and FASB on IASB Exposure Draft, *Hedge Accountin*g, and FASB, *Selected Issues About Hedge Accounting*.
b) CFA Institute September 30, 2010 comment letter to FASB on Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities.*
c) CFA Institute August 15, 2008 comment letter to FASB on Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities — An Amendment of FASB Statement No.133, Accounting for Derivative Instruments and Hedging Activities.*

1.3 Background Information on Derivatives and Hedge Accounting and Disclosures

Under IFRS, derivatives disclosure is set out in a) IFRS 7, *Financial Instruments: Disclosures* and b) International Accounting Standard Statement No. 39 (IAS 39), *Financial Instruments Recognition and Measurement*. Further, there are proposed updates to hedge accounting and disclosure requirements under the Hedge Accounting Staff Draft.

Recognition and Measurement of Derivatives and Hedging Activities

As a general rule, derivatives are accounted for on a fair value basis, with the fair value of the derivatives instrument recorded on the balance sheet and the gains/losses on the derivatives instrument recognised in the income statement. Further to the general rule, hedge accounting is permitted for qualifying derivatives used for hedging purposes. Hedge accounting is permitted for qualifying derivatives (hedging instruments) and hedged items in order to reduce net income volatility. Net income volatility arises when derivatives used as hedging instruments are measured at fair value with their gains and losses reflected in the income statement without corresponding fair value recognition of the hedged item in the income statement. In effect, hedge accounting reduces the potential of artificial accounting volatility that may arise from inconsistencies in either the recognition or measurement between the hedging instrument and hedged items.

Hedge accounting rules provide for three types of hedges: a) fair value, b) cash flow, and c) net investment hedges. The principal difference among these three types of hedges is their impact on the timing of recognised fair value gains or losses on the hedging instrument and hedged item through the income statement. Fair value hedge accounting addresses measurement inconsistency[13] between the hedged item and hedging instrument. This is done by measuring the hedged item on a fair value basis so as to match the measurement of the hedging instrument. Fair value hedges result in the recognition of derivatives gains or losses and changes in the fair value of hedged items in the current-period income statement. Fair value hedges relate to hedging of recognised assets and liabilities (e.g. borrowings, loans held) and previously unrecognised firm commitments.

Cash flow and net investment hedge accounting addresses the recognition inconsistency between the hedging instrument and hedged item. This is done by ensuring the recognition of gains or losses of hedging pairs occurs in the income statement during the same period. For cash flow hedges, current-period derivatives gains or losses, when they relate to effective hedges, are deferred through OCI while gains or losses from ineffectiveness of the hedging instrument are recognised in the income statement during the period that they occur. The hedged items are not adjusted to be measured at fair value under cash flow hedges. Cash flow hedges relate to hedging of forecast, future highly probable transactions and firm commitments (e.g. exports/ imports, interest payments/receipts, future capital commitments). Net investment hedges relate to hedging of foreign operations and have similar recognition mechanics as cash flow hedges. The **Appendix, Section 6.3,** provides an outline of the characteristics and examples of the hedge accounting approaches and describes the modification (i.e. mainly expansion) of hedge accounting as proposed by the Hedge Accounting Staff Draft.

[13] Measurement inconsistency arises if the hedged item is measured on an amortised cost basis while the hedging derivatives instrument is measured on a fair value basis.

Disclosure of Derivatives and Hedging Activities
IFRS 7 mandates disclosures for financial instruments including derivatives (i.e. credit, liquidity, and market risk and fair value disclosures). In addition, IFRS 7 specifies hedge accounting related disclosures with a primary focus on financial statement (i.e. income statement and balance sheet) effects of hedge accounting.

The Hedge Accounting Staff Draft requirements propose various disclosures to help provide information about risk management strategies where a hedge accounting election is made. The proposals are described by the IASB as disclosures that aim to provide a top-down portrayal of risk management. The proposed disclosures are discussed further in **Section 5.2** and the **Appendix, Section 6-3**.

1.4 Scope

This report, **Volume 2**, focuses on derivatives and hedging activities disclosures under IFRS. The report is the by-product of a broader study conducted on financial risk disclosures under IFRS 7. **Volume 1** of this study reports the user perspective on credit, liquidity and market risk disclosures. The purpose of this study is to:

- Assess the usefulness of disclosures related to derivatives and hedging activities currently made in compliance with IFRS 7. IFRS 7 disclosures primarily focus on financial instruments including derivatives that have been designated in hedging relationships. However, IFRS 7 also prescribes disclosures of risks associated with financial instruments in general (e.g. sensitivity analysis, credit and liquidity risk disclosures of derivatives).

- Assess the extent to which the Hedge Accounting Staff Draft enhances IFRS 7 disclosures.

- Analyse how existing and proposed disclosures could be improved.

Although the scope of this study is limited to derivatives and hedging activity disclosures under IFRS, the recommendations made can be extended to disclosures of this nature included in country-specific accounting standards. Also, as the focus is only on derivatives and hedging disclosures, this study does not evaluate the derivatives and hedge accounting recognition and measurement requirements. The investor perspectives regarding hedging recognition and measurement requirements have been comprehensively articulated by CFA Institute through its comment letters[14] to the IASB and FASB.

[14] Ibid 12.

1.5 Methodology

As illustrated in **Figure 1-2**, this study was conducted through a combination of reviewing literature related to disclosures of derivatives and hedging activities; obtaining user feedback through interview and survey techniques; and performing detailed analyses of company derivatives and hedging risk disclosures. The methodology is elaborated upon further below:

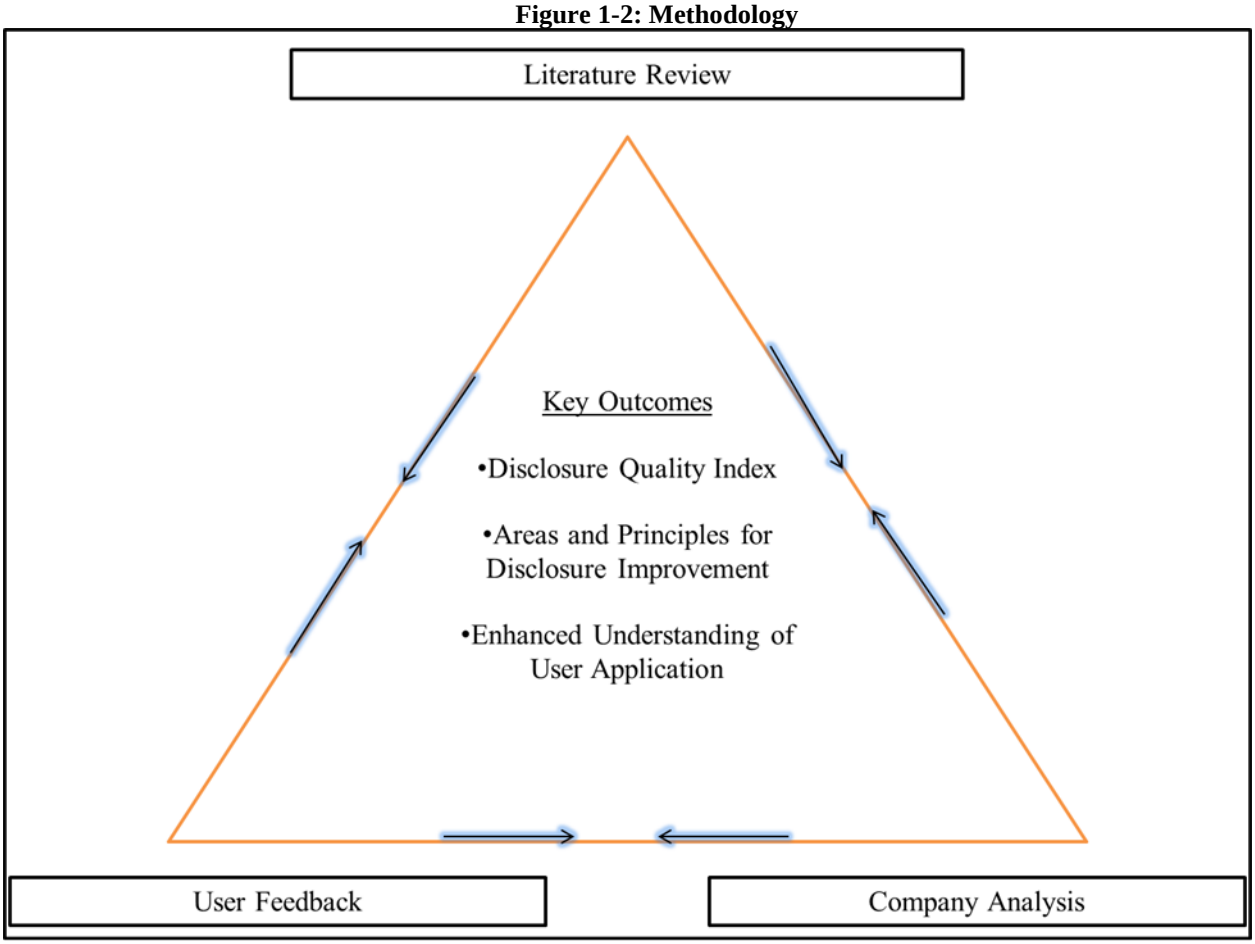
- **Derivatives and Hedging Disclosure Literature Review —** The framework used to analyse the usefulness of derivatives and hedge accounting disclosures is derived from various sources of literature including academic, other related studies and standard-setter comment letters (e.g. user comment letters).
- **User Feedback —** Direct user feedback was gathered through a combination of an abridged and a comprehensive survey of 133 users. Respondents included 83 CFA Institute members who are users of financial statements and 50 external sell-side analysts[15] who were not CFA Institute members. A detailed description of the survey design is included in the **Appendix**, **Section 6.2**. Through these surveys, respondent users were queried on the:
  - General usefulness of IFRS 7 disclosures;
  - Relative usefulness of different components of IFRS 7 disclosures;
  - Relative rating of the importance of, and satisfaction with, specific categories of risk disclosures (i.e. credit, liquidity, market and derivative and hedging); and
  - Specific use and application of information from different disclosures by analysts and investors in the performance of security selection, valuation and risk analysis.

  In addition to the survey feedback, various insights were also distilled from discussions held by the Corporate Disclosure Policy Council (CDPC)[16] with standard-setters on derivatives and hedging disclosures.
- **Company Analysis —** The company analysis was carried out by reviewing disclosures from the 2011 and 2010 financial statements of 30 IFRS reporting financial and non-financial institutions. The companies whose disclosures were analysed were large-capitalisation companies across a range of industries and were selected due to their significant exposure to derivatives instruments. The review of company financial statement disclosures resulted in the construction of a disclosure quality index (also referred to as a DQI). Both prescribed disclosures as well as voluntary disclosures deemed beneficial for users were included in the DQI. We also made a detailed case study review of the disclosures of Lufthansa Airlines as reported in **Appendix**, **Section 6-1**. The company analysis provided a context to corroborate and evaluate user comments.

[15] The sell-side analysts were identified from research reports of large-capitalisation IFRS-reporting companies. These sell-side research reports were downloaded from the Thomson Research Investext database.

[16] The CDPC is the policy advisory committee to the Financial Reporting Policy Group of the SFMI division of CFA Institute. The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosures worldwide. The CDPC comprises investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioner's perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Figure 1-2: Methodology



1.6 Organisation of Document

The rest of the report reviews in more detail other related studies, and the user feedback and application of derivatives and hedging disclosures. This is coupled with an analysis of these disclosures by IFRS reporting companies and a detailed case study review of Lufthansa airlines. On the basis of the above, recommendations are made to improve these disclosures. The rest of the document is organised as follows:

- Analytical framework and review of related studies (**Section 2**);
- User feedback and application of derivatives and hedging disclosures (**Section 3**);
- Review of annual report disclosures of derivatives and hedging activities (**Section 4**);
- Recommendations (**Section 5**); and
- Appendix — Case Study, Survey Design and Hedge Accounting Requirements (**Section 6**).

2 Analytical Framework and Review of Related Studies

This section consists of a review of the literature regarding useful derivatives and hedging activities financial reporting information. Through the literature review, we identify a framework for developing useful derivatives and hedging disclosures in financial reports. In addition, we review related studies of derivatives and hedging disclosures which verify the usefulness of these disclosures.

2.1 Analytical Framework — Useful Derivatives and Hedging Activities Financial Reporting Information

2.1.1 Defining Comprehensive Disclosures

To identify useful derivatives and hedging activities disclosures, reference is made to other analytical frameworks articulated in existing literature. For example, Stephen Ryan in his textbook[17] on financial instrument accounting proposes the following framework of questions that can help guide the development of useful derivatives and hedging disclosures:

- What are the aggregate exposures?
  - What are the magnitude and nature (including sensitivity) of reporting firms' aggregate exposure to changes in market prices?
  - What are the remaining lives of these exposures?
- What derivatives does a company use to modify the risk of its aggregate exposures?
  - Is it economically hedging or speculating?
  - Is any hedge or speculation one sided or two sided?
  - Is it attempting to modify fair value or cash flow variability?
  - If cash flow variability, does this make sense?
  - Are the amounts, sensitivities, and maturities of its derivatives reasonable given its risk exposure?
- What are the threats to hedge effectiveness?
  - Non-linearity?
  - Basis risk?
  - Unknown exposure?
- How does the entity account for its derivatives and hedging?
  - Do its derivatives qualify as accounting hedges?
  - If so, are they fair value hedges or cash flow hedges?
  - What are the limitations of the accounting?

[17] Ryan, S.G. (2007), *Financial Instruments & Institutions: Accounting and Disclosure Rules*, Second Edition, Hoboken, NJ: John Wiley & Sons, Ltd.

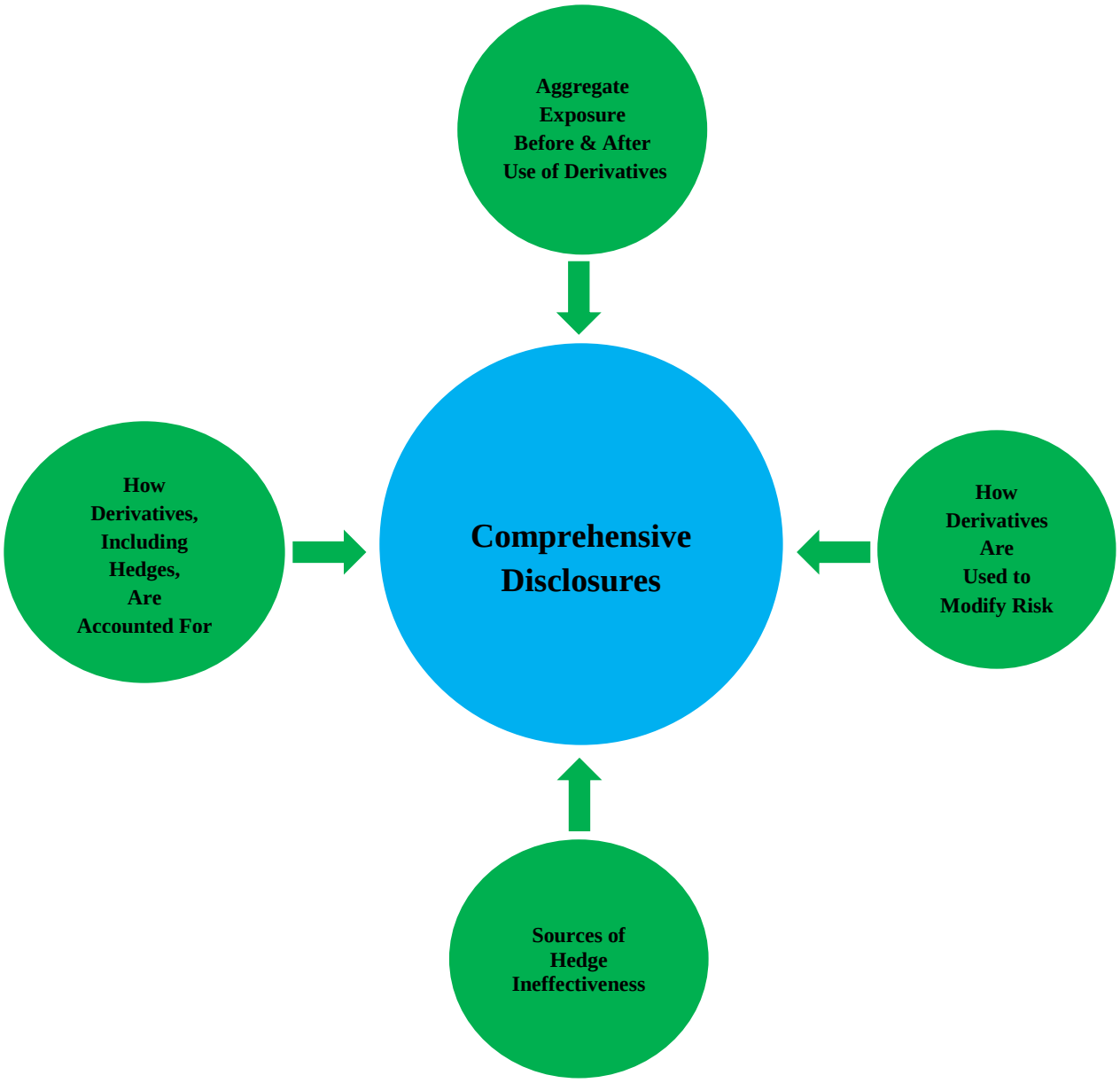
The appropriateness of the analytical elements identified through the above questions has been affirmed in other literature[18] with the following being identified as the key elements of useful information for readers of financial statements:

- Economic exposure to financial risk by type of risk (e.g. foreign currency, interest rate, commodity, credit, and equity).
- Derivatives instrument risk exposure, including: counterparty risk; instrument type; linearity of instrument; notional amount; maturity of derivatives; and valuation sensitivity analysis.
- Derivatives instrument application, including distinction between speculative trading and economic hedging activities. This should outline the respective accounting choices made (i.e. derivatives eligible for hedge accounting and distinction among fair value, cash flow, and net investment hedge accounting).
- Hedging objectives and practices used to manage financial risk and distinguishing between hedged and unhedged economic exposures.
- Effectiveness of hedging activities in neutralising exposure to risk. This includes describing the effects of derivatives activity on current and future income. Further, an important factor influencing readers' ability to evaluate a company's financial effectiveness of its risk management strategies is the degree to which the risk management effects on the financial statements can be separated from the effects of the company's other operating, financing, or investment activities on financial statements.
- Sources of hedge ineffectiveness (e.g. non-linearity of instruments, basis risk).

Figure 2-1 summarises the combination of information required to comprehensively provide information about derivatives and hedging activities. The above analytical elements taken together with user feedback in **Section 3** form the basis of evaluating the quality of mandatory and voluntary disclosures of derivatives and hedging activities as discussed in **Section 4**.

[18] Hamlen, S. and Largay, J. (2005), *Has SFAS 133 Made Derivatives Reporting More Transparent? — A Look at the Dow Jones 30*, Journal of Derivatives Accounting, Vol. 2, Issue 2, pp. 215-230. — The journal paper highlights the need for holistic disclosures that are prepared considering the needs of users of financial statements.

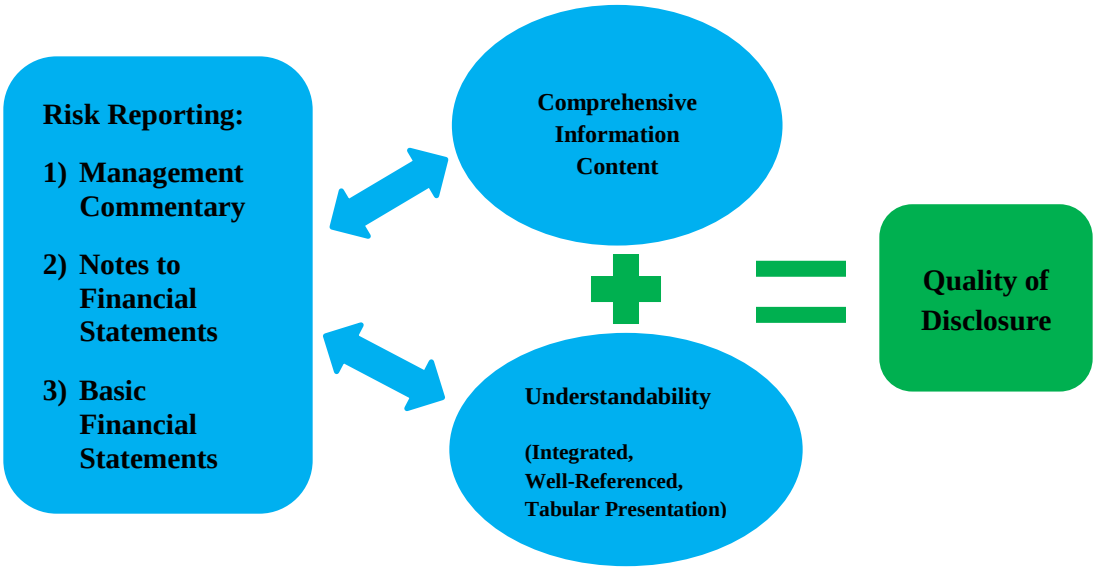
Figure 2-1: Comprehensive Disclosures on Derivatives and Hedging Activities



2.1.2 Understandability Contributes to Quality of Disclosures

The quality of disclosures is also considered in the context of attributes which enhance the understandability of disclosures as proposed by the IASB Conceptual Framework[19]. As discussed in **Volume 1** of this report, the attributes that enhance understandability of disclosures include the use of tabular formats and having centralised and well-referenced disclosures. The importance of effective presentation of comprehensive information content is reflected in **Figure 2-2**. The figure depicts that integrated presentation (i.e. well located and sufficiently cross-referenced) improves the overall quality of disclosures.

Figure 2-2: Quality of Disclosures Regarding Derivatives and Hedging Activities



[19] Botosan, C. (2004), *Discussion of a Framework for the Analysis of Firm Risk Communication*, The International Journal of Accounting, Vol. 39, pp. 289-295. — The author emphasises the need to anchor the analysis of usefulness of risk disclosures to the IASB Conceptual Framework because the framework reflects the collective wisdom garnered over the years by standard setting authorities regarding how to identify useful financial reporting information. The IASB Conceptual Framework expounds on the attributes of financial reporting information that can result in decision-useful information. These attributes include: a) relevance; b) reliability; c) comparability; and d) understandability.

2.2 Review of Related Studies – Verifying the Usefulness of Derivatives and Hedge Accounting Disclosures

There has been an emergent stream of studies that verify the usefulness of current financial reporting of derivatives, including the recognition and measurement and disclosures requirements. These studies, in many cases, either implicitly or explicitly cover hedging derivatives that apply the hedge accounting approach. However, most of these studies have been predominantly focused on U.S. GAAP (i.e. SFAS 133, now part of Topic 815). In contrast, this report expands available evidence by verifying the usefulness of IFRS disclosures. An IFRS focused study can reinforce the understanding of how derivatives and hedging activities disclosures can be improved across global jurisdictions, including major economies such as the U.S. and Japan, which have yet to adopt IFRS.

Studies which examine the usefulness of disclosures predominantly focus on:

- Value relevance of components of derivatives-related information, including hedging, and
- Assessing the extent of compliance with mandatory disclosures and provision of other useful voluntary disclosures. Compliance with mandatory requirements and provision of voluntary disclosures are both indicators of quality.

These studies are elaborated upon further in the following sections.

2.2.1 Value Relevance of Derivatives and Hedge Accounting Financial Reporting Information

Studies reviewing the value relevance[20] of derivatives including hedging derivatives-related financial reporting information tend to encompass information reported on the balance sheet and income statement as well as disclosed through the financial footnotes and management commentary. Value relevance studies are typically based on historical data from recorded financial statements of multiple reporting periods.

[20] Value relevance empirical studies ascertain whether there is an association between the information contained in annual reports and the stock price. They are often applied as a means of inferring the usefulness of financial reporting information. In effect, these studies have tended to focus on the impact of specifically mandated accounting standard requirements, by analysing the value relevance of information as a result of the adoption of the mandatory reporting requirements.

Earlier value relevance studies (i.e. related to periods before the required recognition of derivatives fair values on balance sheets) tended to focus on disclosures in the footnotes and management commentary. These studies[21] provided evidence regarding the value relevance of derivatives' notional amount and fair value information disclosed in the notes to the accounts and generally show that these components are value relevant.

More recent studies[22] provide evidence of the value and risk relevance of derivatives fair values recognised and reported in the basic financial statements rather than simply disclosed in the notes to the financial statements. These studies do not make a distinction between the value relevance of fair values related to hedge accounting derivatives versus fair values related to non-designated derivatives. Effectively, they cover the value relevance of fair value measurement for both designated hedging and non-designated derivatives (i.e. economic hedges and trading derivatives).

[21] Several studies show the value relevance of disclosures of derivatives-related information contained in notes to financial statements. They include the following:

a) Aggarwal, R. and Simkins, B.J. (2004), *Evidence on Voluntary Disclosures of Derivatives Usage by Large US Companies*, Journal of Derivatives Accounting, Vol. 1, No.1. — The authors find that market to book ratios have a positive association with derivatives disclosure of fair values in the notes.

b) Wong, M. (2000), *The Association Between SFAS No. 119 Derivatives Disclosures and the Foreign Exchange Risk Exposure of Manufacturing Firms*, Journal of Accounting Research, Vol. 38 (No.2), pp. 387-418. — The author finds that quantitative disclosures about notional amounts of foreign currency derivatives are associated with the information used by equity investors to assess risk exposures.

c) Venkatachalam, M. (1996), *Value Relevance of Banks' Derivatives Disclosures*, Journal of Accounting and Economics, Vol.22 (Aug-Dec), pp. 327-355. — The author finds there to be a significant association between the disclosure of notional derivatives amounts and the observed stock price.

[22] Studies supporting the value relevance of fair values in the main financial statements (i.e. balance sheet and income statement) include:

a) Ahmed, A.S., Kilic, E. and Lobo, G. (2011), *Effects of SFAS 133 on the Risk Relevance of Accounting Measures of Banks' Derivatives Exposures*, The Accounting Review, Vol. 86 (No.3), pp. 769-804. — This study provides evidence of risk relevance of accounting measures of bank derivatives exposures to bond markets.

b) Ahmed, A.S., Kilic, E. and Lobo, G. (2006), *Does Recognition versus Disclosure Matter? Evidence from Value Relevance of Banks Recognised and Disclosed Derivatives Financial Instruments*, The Accounting Review, Vol. 81 (No.3), pp. 567-588. — This study used separate samples of pre-SFAS 133 (146 banks) and post-SFAS 133 data (82 banks that were a sub-sample of the pre-SFAS 133 data). The pre-SFAS 133 data was from 1995-2000 and post-SFAS 133 data from 2001-2004. In these samples, they distinguished between recognised and disclosed amounts. The study finds that SFAS 133 recognition and measurement requirements have significant incremental impact on firm value.

c) Zhou, H. (2009), *Does Fair Value Accounting for Derivatives Improve Earnings Quality?* Working Paper, University of Illinois at Urbana Champaign. — The study reviewed U.S. bank holding companies from 1995 to 2005, and finds that the inclusion of derivatives fair value gains or losses in the income statement, as required under SFAS 133, increases the information content of the core earnings. The study also provides evidence showing that cash flow hedges are used for earnings management through deferrals of losses such that reported net income losses are transformed into net income gains.

In addition to empirical value relevance studies that are based on recorded financial statements data, there are other studies that are not based on actual company data but instead use mathematical modelling to simulate how different agents in a simulated capital market economy would respond to accounting information from companies. These other studies can be described as theoretical model studies. Theoretical model studies contrast with value relevance studies, where conclusions are derived from 'real world' data drawn from recorded financial statements or from interviewing market participants. In theoretical model studies, conclusions about company choices on risk management (i.e. whether to truly hedge or use derivatives speculatively) and investor judgements on the riskiness of reporting firms are derived from hypothetical settings and models. For example, one such study [23] simulated how investors would perceive the riskiness of firms when these firms comply with mandated hedge accounting requirements. That said, these theoretical model studies are few in number, and they usually do not provide clear-cut evidence on the usefulness of derivatives and hedging activities disclosures.

Overall, all of the aforementioned studies partially contribute to the mosaic of evidence on the usefulness of derivatives-related information within financial reports. However, the usefulness of these studies tends to be limited due to the following reasons. They do not:

- *Test the Impact of Disaggregated Hedge Accounting Presentation and Disclosure* — We are not aware of any studies that explicitly focus on ascertaining the value relevance of sufficiently disaggregated fair value and cash flow hedges information.
- *Address the Impact of Disclosures Location* — We are not aware of any studies that adequately test whether the location of derivatives-related information impacts its usefulness for example, studies evaluating whether the proximity of related derivatives and hedging disclosures is beneficial for users.
- *Consider the Impact of Whether Interrelated Information Is Available* — Empirical tests of the value relevance of single components of information (e.g. notional amount) can also overlook situations where the individual components of the information being tested can become more useful if other related information were provided. For example, disclosing the fair value of derivatives would be more useful if such disclosure were accompanied by the disclosure of a roll forward of derivatives assets and liabilities. Similarly, reported notional amounts would be more useful if accompanied by a breakdown of long versus short positions.
- *Cover Potentially Useful Voluntary Disclosures*—The ability of researchers to empirically demonstrate the usefulness of disclosures is constrained by the limited availability of disclosures which are not specifically required by standard-setters[24] and which may be useful to investors and other users of the financial statements. As mentioned earlier, value relevance studies are usually conducted based on available historical data and the absence of data constrains this type of study.

Effectively, there is scope for future studies to enhance the evidence regarding the usefulness of derivatives and hedging related disclosures.

[23] Gigler, F., Kanodia, C., and Venugopalan, R. (2007), *Assessing the Information Content of Mark-to-Market Accounting With Mixed Attributes: The Case of Cash Flow Hedges*, Journal of Accounting Research, Vol. 45 (No. 2), pp. 257-276. — This paper highlights that users are likely to misinterpret and underestimate the risk profile of companies that have reported derivatives losses related to cash flow hedges. The risk of misinterpretation is exacerbated under a mixed attribute recognition and measurement regime.

[24] Examples of potentially useful disclosures (e.g. credit risk contingent commitments) are discussed in **Section 3.2**.

2.2.2 Extent of Compliance with Mandatory Disclosures and Provision of Voluntary Disclosures

The extent to which companies comply with mandatory accounting standards is one indicator of overall reporting quality. Similarly, the extent to which companies provide useful voluntary disclosures contributes to reporting quality. That said, several studies have tended to show a pattern of companies being only partially compliant with the mandatory disclosure requirements for derivatives and hedging activities. We further discuss the related studies below.

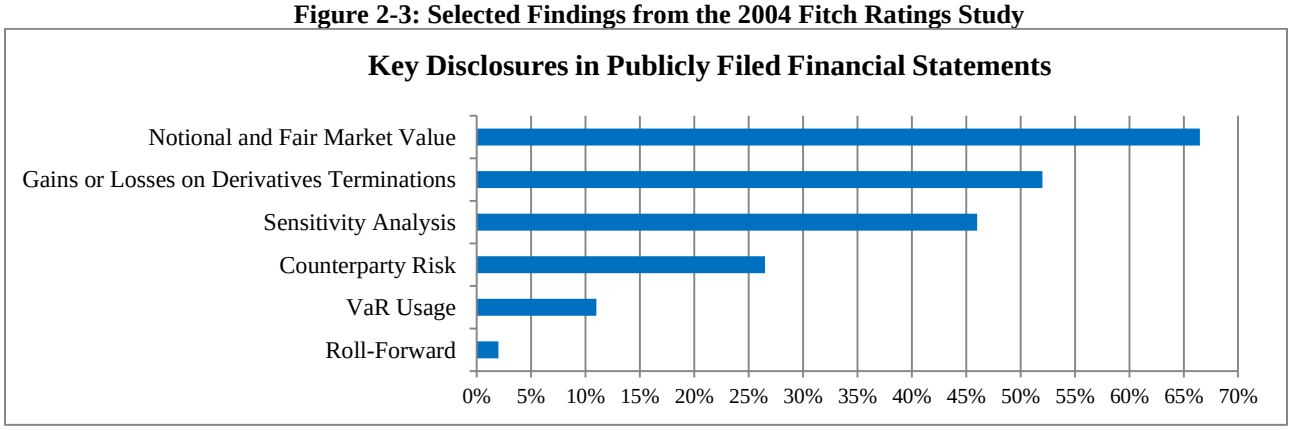
Fitch Ratings Study of Derivatives and Hedging Disclosures

Company disclosure practices in the U.S. after adoption of SFAS 133 (i.e. now Topic 815) were found to be incomplete and inconsistent during a Fitch Ratings study[25] conducted in 2004, as reflected in the following excerpt:

> *Fitch found wide disparities in disclosure across companies and industries. This is true for even the most generic instruments, such as interest rate and currency hedges. Similarly, lack of any requirements to disclose valuation adjustments, much less the sources from which they were derived, raises concerns of possible inconsistency and lack of comparability. For example, there is no requirement for disclosure of income derived from mark-to-market or mark-to-model valuation adjustments.*

The aforementioned Fitch Ratings study showed partial compliance with several key components of required disclosure and limited provision of voluntary disclosure, as shown in the graph in **Figure 2-3**. Key disclosures, such as notional amounts and fair values, were not provided by all the companies assessed in the Fitch Ratings study. Only 67% of the companies assessed provided notional and fair market values, while only 46% of companies provided sensitivity analysis information.

Figure 2-3: Selected Findings from the 2004 Fitch Ratings Study



Source: 2004 Fitch Ratings study.

[25] Studies on level of compliance with mandatory and voluntary derivatives disclosures:

a) Fitch Ratings Credit Policy Special Report: July 22, 2009: *Derivatives: A Close Look at What New Disclosures in the US Reveal.* — The study was based on a survey of derivatives disclosures of 100 global corporations after the SFAS 161 disclosure requirements. The study found that 58% of companies reviewed disclosed their credit risk contingent commitments. The study also found that derivatives valuation is often model based and that analysis would be enhanced if issuers provided additional disclosure of sensitivity of derivative valuations to major assumptions.

b) Fitch Ratings Credit Policy Special Report: November 9, 2004: *Hedge Accounting and Derivatives Study for Corporates: Disclosure, Hedge Accounting and Restatement Risk.* — The study was based on a survey of 57 global corporations and focused on assessing derivatives used, hedge accounting, financial reporting, valuation and disclosure practices. Hedge accounting was applicable by 96% of the 57 companies surveyed.

The aforementioned Fitch Ratings study also highlights several examples of the inadequacies of hedge accounting disclosures for companies reviewed at the time. Examples of inadequacies included the following:

- *Underreporting on Usage of Shortcut Method for Hedge Effectiveness Testing* — Under U.S. GAAP, the shortcut method was allowed for determining the hedge effectiveness when the hedging strategy involved plain-vanilla swap instruments. The study found that only 32% of companies reviewed specifically disclosed that they used the shortcut method, although 60% used some form of plain-vanilla swap and this was indicative of underreporting of the use of the shortcut method.
- *Likely Underreporting on Fair Value Hedge Gains or Losses on Debt That Is Associated with Receive-Fixed Swaps* — Of the companies reviewed, 54% reported the use of receive-fixed swaps and these swaps were mainly used as hedges to fixed-rate debt. That said, not all these companies reported the upward or downward adjustments to the underlying debt, and this was indicative of undisclosed fair value hedge gains or losses.

Academic Studies of Derivatives and Hedging Disclosures

In addition to the Fitch Ratings study, there are academic studies[26] based on data from different jurisdictions (e.g. SFAS 133 in the U.S., FRS 13 in the U.K.) that also assess the adequacy of mandatory and voluntary derivatives disclosures. One of these studies (Hamlen and Largay) also evaluated disclosures regarding the financial statement effects of hedging activities (e.g. hedge accounting-related disclosures) after the adoption of SFAS 133 in the U.S. and found that, although the introduction of SFAS 133 improved disclosures, they remained inadequate. This study found that there was improvement in the disclosure of: a) income effects of effective and discontinued hedges and b) hedges of net investment in foreign operations. However, Hamlen and Largay described the overall state of derivatives and hedging disclosures as being incomplete, complex, and difficult to compare across firms and recommended a greater effort by the standard-setting bodies to provide user-oriented disclosures that focus on overall risk and hedging impact. To this effect, the FASB subsequently issued SFAS 161 (Topic 815) that specifically aimed to improve derivatives disclosures.

Summary of Studies

The aforementioned studies which assess the adequacy of both derivatives and hedging activities disclosures provide useful evidence regarding where inadequacies may exist. In the same vein this study, as described in **Section 4**, reviews the extent to which companies comply with related IFRS 7 disclosure requirements and provide other useful voluntary disclosures. This assessment is thereafter used to identify deficiencies and make enhancement recommendations for these disclosures.

[26] Studies on level of compliance with mandatory disclosures and voluntary derivatives disclosures:

a) Dunne, T., Helliar, C., Power, D., Mallin, C., Ow-Yong, K. and Moir, L. (2004), *The Introduction of Derivatives Reporting in the UK: A Content Analysis of FRS 13 Disclosures*, Journal of Derivatives Accounting, Vol.1 (No.2), pp. 205-219. — This paper shows that there was an improvement in disclosure levels in the UK after the adoption of FRS 13. This improvement was most prominent for FTSE 100 companies and non-cyclical services industries.

b) Ibid 18 — The study by Hamlen and Largay showed that, although Dow Jones companies had an overall improvement in the level of disclosures (e.g. financial statement effects of hedging) after the adoption of SFAS 133 in the US, there was incomplete and inconsistent compliance with SFAS 133 requirements. This study found that there was improvement in the disclosure of a) income effects of effective and discontinued hedges and b) hedges of net investment in foreign operations after the adoption of SFAS 133 in the U.S.

2.3 Conclusion

The literature shows that certain information (e.g. notional amounts, sensitivity analysis) which should be provided through disclosures is value relevant but that there is only partial compliance with required derivatives disclosures and limited provision of voluntary disclosures. Furthermore, the adequacy of derivatives and hedging disclosures must be measured not only against what is currently required by accounting standards but also against a framework of disclosure usefulness which addresses the following elements of a company's profile:

- Overall economic exposure;
- Derivatives instruments risk exposure;
- Use of derivatives for either speculative or hedging purposes;
- Hedging objectives and practices, including a discussion of hedged versus unhedged exposures;
- Effectiveness of its hedging activities in neutralising exposure to risk; and
- Degree to which the risk management effects on the financial statements can be separated from the company's other operating, financing, and investing activities.

3 User Feedback on and Application of Derivatives and Hedge Accounting Disclosures

This section comprises an analysis of the following:

- User feedback on derivatives and hedging disclosures (**Section 3.1**); and
- Potential user application of derivatives and hedging disclosures (**Section 3.2**).

3.1 User Feedback on Derivatives and Hedge Accounting Disclosures

3.1.1 User Rating — Importance of, and Satisfaction with, Derivatives and Hedging Disclosures

Ratings Show High Importance Assigned to Risk Disclosures of Financial Instruments (Including Derivatives) and Moderate Importance to Hedge Accounting Disclosures

Figure 3-1 shows the survey respondents' rating[27] of the importance of specific risk disclosure categories. The proportion of respondents that considered disclosures to be important, per risk disclosure category, is as follows:

- 82.4% for Credit Risk,
- 80.3% for Liquidity Risk,
- 70.5% for Market Risk, and
- 59.5% for Hedge Accounting.

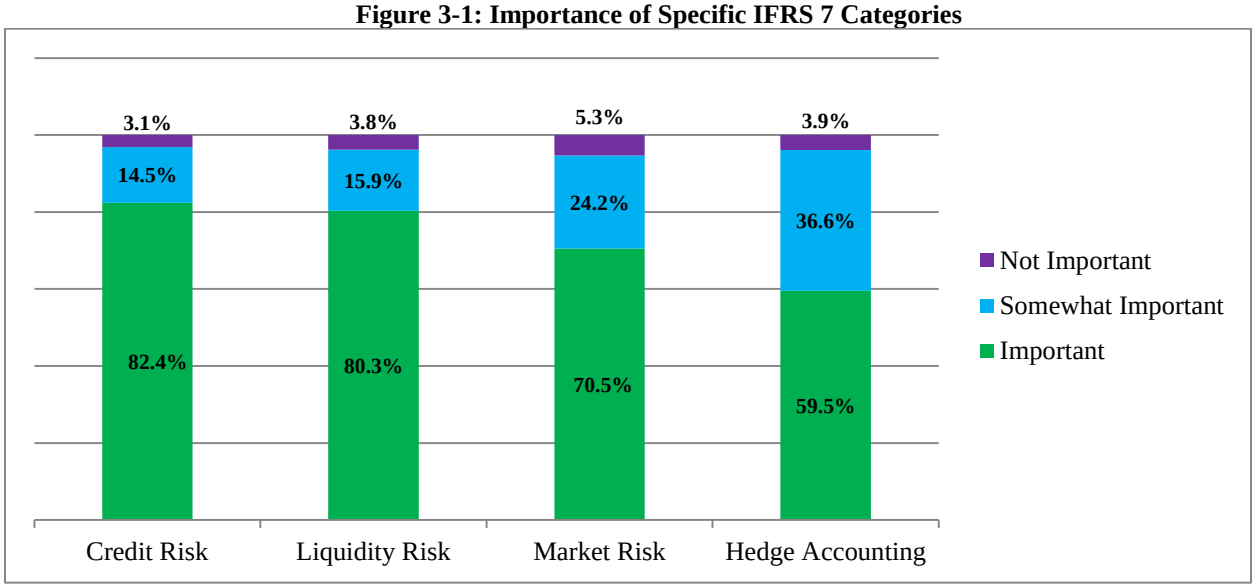
Effectively, the user feedback on hedge accounting disclosures pertains only to qualifying hedging derivatives. All derivatives, regardless of whether they qualify for hedge accounting are included in the user assessment of credit, liquidity, and market risk disclosures. For example, the maturity analysis of derivatives liabilities is included under liquidity risk and sensitivity analysis of derivatives is included under market risk.

Only 59.5%[28] of respondents consider hedge accounting disclosures to be important. These findings show that respondents consider hedge accounting disclosures to be relatively less important than other categories of risk disclosures. The lower importance assigned is likely to be due to the narrower focus of hedge accounting disclosures on derivatives that are hedge accounting designated and the potential lack of usefulness of current disclosure requirements.

[27] The users' ratings of importance of, and satisfaction with, different risk disclosure categories were obtained through the feedback from 133 respondents to both the comprehensive and abridged surveys. Both these surveys asked users to rate importance of and satisfaction with credit risk, liquidity risk, market risk and hedge accounting disclosures.

[28] The profile of the 59.5% of respondents who consider hedge accounting disclosures to be important could be further broken down into: a) 62.2% of CFA Institute member respondents; and b) 55.1% of non-member sell-side equity analyst respondents. That said, the inference that hedge accounting disclosures are only moderately important is consistent across both CFA Institute members and non-members.

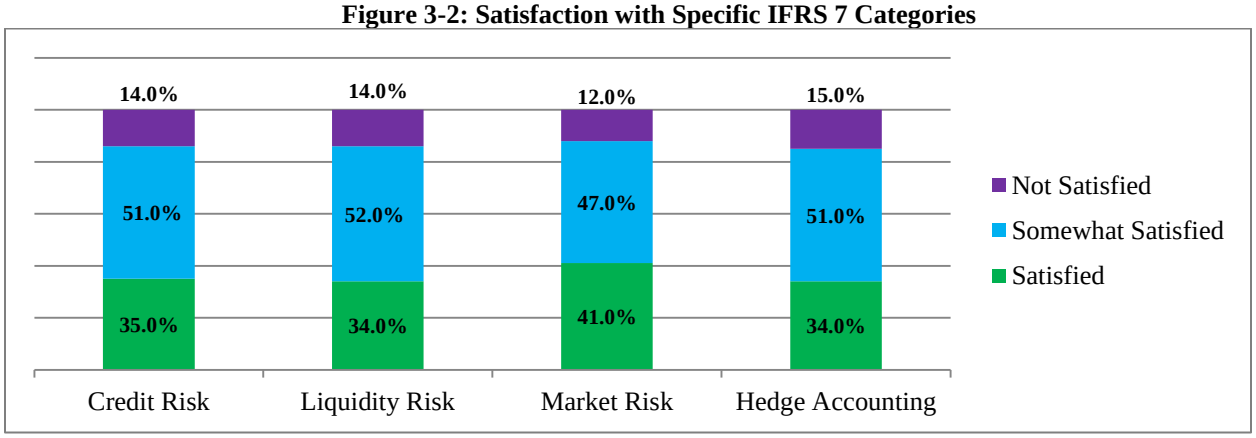
Figure 3-1: Importance of Specific IFRS 7 Categories



Ratings Show Low Satisfaction with Both Risk Disclosures of Financial Instruments (Including Derivatives) and Hedge Accounting Disclosures

The findings in **Figure 3-2** also show that, similar to other risk disclosures, there are low levels of full satisfaction with hedge accounting disclosures (i.e. 34% for hedge accounting and liquidity risk, 35% for credit risk, and 41% for market risk). The analysis in the sections which follow (i.e. **Sections 3.2 and 4**) helps to explain the low level of satisfaction. These sections outline user expectations of high-quality derivatives and hedging disclosures as well as provide a review of the state of disclosures.

Figure 3-2: Satisfaction with Specific IFRS 7 Categories



User Rating of Derivatives and Hedging Disclosures Are Consistent with Previous Survey Findings

The importance of, and need to improve, derivatives and hedging disclosures was also highlighted through a 2007 CFA Institute member survey[29]. It should be noted that that the past survey solicited user feedback on a global basis (e.g. including U.S. GAAP) and not only on IFRS-based disclosures.

The 2007 survey results showed a higher importance score (67.5%) for derivatives and hedging than the 59.5% assigned importance for hedge accounting from this study. The higher 2007 survey score may be explained by the different framing of the 2007 survey, which asked users to jointly rate 'derivative and hedging' disclosures as compared with this study, which focused on 'hedge accounting' disclosures separately from credit, liquidity, and market risk disclosures. As noted earlier, for this study, since derivatives are financial instruments, their disclosures are included in the assessment of credit, liquidity and market risk disclosures. On the other hand, hedge accounting disclosures only include derivatives that qualify for hedge accounting.

That said, the overall results of the 2007 survey are consistent with this study as they show that a high proportion (67.5%) of respondents consider derivatives and hedging disclosures as important, but very few (27.7%) consider these disclosures to be of good quality and 40.5% consider these disclosure to be of poor quality. Effectively, there is a gap between users' view of the importance of derivatives and hedging disclosures and their satisfaction with such disclosures.

[29] The 2007 survey, which had 680 respondents, asked members to rate the importance and quality of various disclosures on a scale of 1 to 5 (i.e. 5 = very important and 1 = not important). The survey showed that 67.5% of respondents considered derivatives and hedging disclosures to be important (i.e. 4 or 5) while 40.5% rated the quality of these disclosures as poor quality (i.e. 1 or 2) and only 27.7% rated these as good quality (i.e. 4 or 5).

3.1.2 User Feedback Shows That Complexity of Hedge Accounting and Partial Information Lowers Usefulness of Hedge Accounting Disclosures

The respondent comments help to further explain why only 59.5% considered hedge accounting disclosures to be important and only 34% were satisfied with disclosures. Respondents indicated that hedge accounting and disclosure requirements are complex and confusing for users and they do not readily communicate key economic information (e.g. nature of hedging strategies, hedged versus unhedged exposures, and hedge effectiveness). The comments show that the low understandability, incomplete nature, and high complexity of hedge accounting disclosures are influencing the relatively lower level of importance assigned to them. Hedge accounting is viewed by some users as a mere accounting construct. This view is reflected in the comment below:

> *Hedge accounting is simply an accounting notion or construct and I do not find it particularly useful.* — Structurer

The respondent comments also reveal a varied level of understanding regarding the purpose and usefulness of hedge accounting-related information because hedge accounting is an accounting construct. As discussed in **Section 3.2**, several respondents conveyed how they use this information. However, several others 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.

The limited usefulness of hedge accounting disclosures arises in part due to: a) the optional application of hedge accounting regardless of eligibility and b) the ineligibility or difficulties in qualifying for hedge accounting for some economic risk factors (e.g. credit risk and inflation risk). Said differently, because hedge accounting information only reports a subset of economic risk management practices undertaken, users do not necessarily place reliance on hedge accounting information to understand corporate risk management.

3.2 Potential User Application of Derivatives and Hedging Disclosures

Section 2.2 outlined a framework for determining useful derivatives and hedging disclosures. Building on this earlier discussion, this study obtained feedback from users on how they could apply high-quality derivatives and hedging disclosures if provided by reporting companies. User expectations of how high-quality disclosures could be applied was also helpful in understanding the user feedback regarding the importance of, and satisfaction with, existing hedge accounting disclosures. The comprehensive survey respondents indicated that derivatives and hedging disclosures could potentially be useful to users by enabling:

- Assessment of derivatives instrument use and risk exposure (**Section 3.2.1**);
- Assessment of the extent of hedging activities (**Section 3.2.2**);
- Differentiating the impact of core business activities from the impact of hedging activities on reported performance (**Section 3.2.3**);
- Assessment of economic hedging effectiveness of designated hedge accounting relationships (**Section 3.2.4**); and
- Detection of earnings management (**Section 3.2.5**).

These user applications of disclosures are consistent with what is described in the literature as discussed in **Section 2.2**. A further discussion of these means of utilising derivatives and hedging disclosure follows.

3.2.1 Assessment of Derivatives Instruments Use and Risk Exposure

As discussed in **Section 1.2**, derivatives can increase enterprise risk when used as trading instruments or even when used for hedging purposes. For this reason, it is important for users to understand the extent to which derivatives are used, whether they are used for hedging or trading, and the underlying instrument-specific risk exposure.

The need for greater explanation of derivatives use and associated exposure is reflected in the following user comments:

> *I would have the following questions: Are the derivatives buried in other transactions that are not being reported? Is every derivative being disclosed?* — Portfolio Manager, Buy-Side

> *The company should state whether or not it takes speculative bets. If it does, it should disclose the maximum possible exposure of its speculative activities.* — Portfolio Manager, Buy-Side

> *It is important to understand the source of risks, how the company manifests the risks and whether the risks are real rather than synthetic.* — Structurer

In the section below, we further expound on different characteristics of derivatives instruments that have a bearing on their risk profile and underlying loss potential and correspondingly on the need for disclosures that minimise the likelihood of investors underestimating risk exposures of derivatives instruments. The outlined characteristics apply to both designated hedging and non-designated derivatives:

- *Complex Economic Features, Valuation, and Accounting Requirements and Associated Risk* — Derivatives instruments have inherently complex economic characteristics (i.e. contingent pay-off and complex contractual features including embedded optional features). In addition, as is widely recognised, these instruments have highly complex valuation and accounting requirements. The varied forms of complexity associated with derivatives use increase the likelihood of their misapplication by preparers as highlighted by high-profile derivatives failures and incidences of accounting restatements[30]. The misapplication includes a) undertaking ineffective and loss making hedges and b) valuation and accounting errors whilst recording the use of derivatives instruments. Correspondingly, in the absence of informative and clear disclosures, there is an increased likelihood of investors failing to anticipate the hidden loss potential of these instruments.

- *Exposure Not Fully Captured on Balance Sheet* — Derivatives result in exposure that is not represented in the reported fair values. Unlike the measurement of cash financial instruments (i.e. non-derivatives) such as debt securities, the fair value of derivatives instruments reported on the balance sheet does not represent the known upper bound of potential future losses. Under current reporting, where only fair values of derivatives are reported, there is the risk that investors can misinterpret the reported balance sheet and income statement values. This is because the fair value of a derivative instrument reported on the balance sheet does not convey the upper limit of the potential loss associated with such instruments. For example, for swap derivatives instruments, the fair value will be closer to zero at inception and will fluctuate through the holding period of the swap instrument. For such a swap instrument, the future exposure would more effectively reflect the upper limit of possible losses.

- *Economic Leverage* — Derivatives increase the economic leverage[31] of entities as they create unfunded risk exposures. Derivatives create risk exposures that do not arise when balance sheet assets are funded by either debt and/or equity. Cash inflows from debt funding are usually invested in either balance sheet assets or in cash flow-generating operating capacity, in a manner where the magnitude of assets held would be of a similar order to the magnitude of liabilities. In other words, even if the assets bought using financing cash flows may have differing current market values and maturities from the debt obligations, it is often expected that the liquidation of assets, if required, should sufficiently cover the debt obligations. In contrast, derivatives typically require minimal initial cash investment but can result in exposures that are of a much higher magnitude relative to either the cash inflows or outflows related to the derivatives. Effectively, the use of derivatives contributes to the economic leverage of a company, which is greater than the accounting leverage that is reported, and the use of derivatives lowers the loss absorption capacity of reporting entities. For this reason, having a sense of the effective economic leverage is important for investors.

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30 Katz, D.M. (July 5 2011), CFO.com (www.cfo.com/article.cfm/14585872), *You Make Me Feel Like a Natural Hedge* — The article highlights the significant risk of accounting restatements due to hedge accounting. The author observes that hedge accounting restatement risk has left many companies opting for natural hedges (i.e. economic hedges); with some companies choosing to altogether avoid hedge accounting. Furthermore, the publications cited earlier (i.e. Ibid 7) have highlighted several incidences of derivatives-related losses.

31 Ibid 8 provides a definition of economic leverage.

- *Counterparty Credit Risk* — Derivatives use can result in increased credit risk exposures to counterparties. Derivatives counterparty credit risk emerged as a key risk category during the financial crisis. Counterparty credit risk pertains to derivatives assets, and it arises when the derivatives position held by a company is 'in the money' and there is the risk of non-payment from the associated counterparty. Counterparty credit risk is often evidenced by the recognition of credit valuation adjustment (CVA) losses due to the increased credit risk of a counterparty. Conversely, reporting entities' increased exposure to counterparties (e.g. due to the ratings downgrade and increase in its own credit risk) can be evidenced by debit valuation adjustment (DVA) gains. The desire by users for greater understanding of overall counterparty risk is reflected in the following survey respondent comment:

  There is very little discussion of counterparty risk in management's view of hedging.
  — Portfolio Manager

- *Funding Liquidity Risk Due to Derivatives Contractual Features Including Covenants* — Derivatives may also pose funding liquidity risk. This risk arises from derivatives instruments containing covenants that permit counterparties to make margin calls of the reporting company in the event that it has a ratings downgrade. In essence, these covenants give rise to contingent commitments. Similarly, in addition to covenant-triggered funding requirements, there is liquidity risk if derivatives instruments have time puts or mutual termination options[32] that are exercisable when a ratings downgrade of the reporting company occurs. Because of this, the aforementioned Fitch Ratings study[33] noted the necessity of monitoring derivatives instruments of investment-grade companies and to anticipate the impact of a downgrade on a company's liquidity risk profile.

- *Financial Instrument Product Liquidity Risk* — Unlike funding liquidity risk, financial instrument product liquidity risk[34] is the risk that a position cannot easily be unwound or offset at short notice without significantly influencing the market price, because of inadequate market depth or market disruption. A key indicator of this type of liquidity risk is the absence of observable market prices/trades. As has been evident during various junctures of the ongoing economic crisis, market liquidity risk has a bearing on valuation practices of financial instruments (including derivatives) and illiquid markets increase the likelihood of subjective valuations that are based on in-house pricing models.

  In the context of derivatives, illiquid markets are likely to arise in relation to OTC derivatives (which are often customised) and tend to be less of an issue for exchange-traded instruments (standardised). Another consequence of financial instrument product liquidity risk is that it could influence the choice of hedging instrument in a manner that contributes to imperfect hedges. For example, airline companies are likely to use crude oil or kerosene derivatives rather than jet fuel derivatives — irrespective of the underlying basis risk that arises due a mismatch of the underlying risk factor of the hedging instrument and the hedged item. Airlines make this choice because jet fuel derivatives are illiquid relative to crude oil or kerosene derivatives. Conversely, if the airlines were able to enter into OTC jet fuel derivatives contracts, they would likely have to use internal valuation models and such

[32] Jorion, P. (2011), *Financial Risk Manager Handbook-FRM Part I/Part II,* Hoboken, NJ: John Wiley & Sons, Ltd. — The handbook outlines that time puts or mutual termination options, permit either counterparty to terminate the transaction unconditionally on one or more dates in the contract. This feature decreases both the default risk and the exposure. It allows one counterparty to terminate the contract if the exposure is large and the other party's rating starts to slip.

[33] Ibid 25.

[34] Ibid 32 — FRM Handbook defines market risk.

models are subject to valuation error (i.e. model risk comes into play). Due to the impact of market liquidity risk on valuation error and, thereafter, on the accuracy of the hedge effectiveness assessment, it is important for investors to be able to monitor any such risk in relation to derivatives instruments.

We emphasise the need for disclosures around the above characteristics of derivatives instruments irrespective of whether they are designated hedging or non-designated instruments. As discussed in **Sections 4.2.2.5**, **5.1.5** and **5.2**, existing and proposed IFRS requirements only explicitly focus on designated hedge accounting derivatives. Other derivatives instruments are subsumed under general financial instruments disclosure requirements. We posit that the absence of an explicit focus on derivatives instrument-specific disclosure requirements contributes to lower quality of information. The low quality of derivatives instrument-specific risk exposure is evident through the review of annual reports in **Section 4.2.2.2**. Further, in **Section 5.1.2**, we propose disclosures that can help investors to understand the aforementioned derivatives instrument risk exposures.

3.2.2 Assessment of Extent of Hedging Activities

Derivatives and hedging disclosures have the potential to inform investors regarding the extent of hedging. The potential use of disclosures to provide information about the extent of hedging is reflected in the comment below:

> *I would like to see a more thorough discussion of hedging activities and use of derivatives including strategy behind their use. What is the level of expertise the company has in using said instruments? What is the company's history and success in using said instruments?*
>
> — Portfolio Manager

Furthermore, in situations where companies are hedging discrete risk categories, disclosures can potentially help identify which portion of reported balance sheet amounts have not been hedged. The following user comment emphasises the need for disclosures that distinguish between hedged and unhedged balance sheet amounts as a basis of understanding hedging activities:

> *Disclosures regarding fair value hedge accounting are important so as to know which on-balance sheet exposures are or are not being hedged.* — Sell-Side Analyst

To illustrate the point being made in the above user comment, consider a situation where a company has foreign currency borrowing but is only hedging the interest rate risk and not the associated foreign currency risk of the debt. In such a case, a determination of the extent of hedging is only possible if there are adequate disclosures of the carrying amounts of the hedged item with a disaggregated breakdown of the hedged portions (i.e. fair value changes due to interest rate changes) and unhedged portions (i.e. fair value changes due to changes in exchange rate) of the debt.

We discuss in more detail the required disclosures around hedging activities in **Sections 4.2.2.3**, **4.2.2.4**, **5.1.3** and **5.1.4**.

3.2.3 Differentiating the Impact of Core Business Activities from the Impact of Hedging Activities on Reported Performance

As highlighted in a study[35]of derivatives disclosures, an important factor influencing readers' ability to evaluate the financial effectiveness of a company's risk management strategies is the degree to which the risk management effects on the financial statements can be separated from the effects of the company's other operating, financing, or investing activities. In other words, users would like to be able to perform a comparative analysis of the 'before and after' effects of hedging on reported earnings and cash flows.

The importance of an analysis of the impact of derivatives on reported performance is reflected in the following user comments:

> *In some cases, users want to know the entity's risk profile when stripped of hedging activities, so as to assess the underlying business risk profile and thereafter the impacts of any risk transformation activities. For example, for an airline company, it is useful for investors to have an understanding of the income volatility associated with fluctuations in the price of jet fuel (i.e. what would an unhedged airline performance look like across multiple periods). Hence, emphasis should not be on single period risk management alone. Investors also want to know how both the hedged and unhedged risk profile of the entity changes over time*.
>
> — Accounting and Valuation Analyst

> *Fair value hedge is important because my baseline EBITDA needs to exclude such profit or loss volatility (especially where there's basis or mismatch risk)*. — Buy-Side Analyst

> *I may need to recalculate underlying earnings, as gains or losses on hedging instruments may not be recurring in future years.* — Investment Banking Analyst

The Fitch Ratings study[36], as reflected in the excerpt below, came to similar conclusions on the need for investors to strip out hedge accounting effects while comparing core performance ratios of reporting companies.

> *Hedge accounting can alter important debt and equity ratios, making period to period and company-to-company comparisons tricky. While hedge accounting may dampen income statement volatility, there are balance sheet consequences that should be recognised by investors and analysts.*
>
> *Moreover, there may be disparities in income statement effects. Fitch believes it is often appropriate, for analytical purposes, to consider the core ratios it uses in its analysis with and without the effects of hedge accounting adjustments if the adjustments are material and provided there is adequate disclosure.*

The above comments demonstrate that users need to understand the core business performance prior to any hedging activity and therefore they require sufficiently disaggregated disclosures related to reported derivatives gains or losses.

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35 Ibid 18.

36 Ibid 25(b).

The need for users to have greater visibility of the impact of derivatives on cash flow is supported by a past survey[37] conducted by CFA Institute. Respondents were asked to rate the importance of different components of cash flow from operations if a direct cash flow statement format was provided. The mentioned survey showed that 65% of respondents considered as important a disaggregated presentation of operating cash flow outlining cash flows from derivatives used to hedge forecast sales or purchases.

Despite user requirements, the disclosure and presentation of cash flow effects of hedging derivatives in financial reports is virtually non-existent. We further discuss the shortcomings of cash flow disclosures in **Section 4.2.2.4**. In addition to the non-existent disclosure of cash flow effects, the disclosures do not always sufficiently disaggregate the derivatives gains or losses to allow users to identify whether they relate to operating, investing, or financing activities.

[37] The 2009 survey sent to 12,050 CFA Institute members had a response from 541 members (i.e. 4.5%). There is a confidence interval of 4.1%, at 95% confidence. The purpose of this survey was to obtain CFA Institute member feedback on issues related to cash flows from operating activities and their presentation in the direct and indirect methods of cash flow statements.

3.2.4 Assess Economic Hedging Effectiveness of Designated Hedge Accounting Relationships

The reporting of income statement and balance sheet effects of hedge accounting can contribute to investors' understanding of the economic effectiveness of designated hedging strategies. Fair value hedge accounting results in the contemporaneous recognition of gains or losses on the hedging instrument and the hedged item in the income statement. Offsetting the gains or losses of hedging instruments against those of hedged items results in a net amount, which is indicative of the hedge ineffectiveness during a particular reporting period. Similar to fair value hedges, cash flow hedge ineffectiveness can be identified through the amounts recognised in the income statement and disclosed in the notes.

Respondents indicated that they use hedging disclosures to assess the overall hedge effectiveness of designated hedge accounting items, as reflected in the comments below:

> *I would thoroughly review the effectiveness of the hedge from the description i.e. the rationale of the particular hedge. The movements in the fair value of the hedge in relation to the hedged assets would also assist in determining the effectiveness of the hedges. I would incorporate my analysis of the effectiveness of the hedges into my review of the entity's sensitivity to risk factors e.g. market risks.* — Accounting and Financial Analyst

> *Cash flow hedge related gains or losses give a picture of ineffectiveness. However, the current profile of disclosures only gives a partial picture of hedge ineffectiveness.*
>
> — Sell-Side Analyst

Review and analysis of derivatives and hedging disclosures in annual reports as discussed in **Section 4.2.2.4** reinforces the respondent's comment above with respect to existing disclosures only giving a partial picture of hedge ineffectiveness. Review of disclosures shows that there is often a failure to meaningfully disaggregate the amounts recognised in the income statement arising from cash flow hedge accounting. For example, some companies report cash flow hedge accounting gains or losses that were recycled from OCI to the income statement. However, these disclosures are often not sufficiently disaggregated so as to allow users to assess the extent to which recycled items are due to: hedge ineffectiveness, termination, or voluntary de-designation of hedges. Further, there is usually no description of the source of hedge ineffectiveness.

The fragmentary nature of disclosures related to the impact of hedge accounting on financial statements often constrains the ability of users' to assess which portion of reported gains or losses can be attributed to economic hedge ineffectiveness. This, in turn, negates the principal objective of hedge accounting which is to eliminate recognition and measurement inconsistencies between hedging instruments and hedged items. If users cannot precisely discern the nature of gains or losses that are reported in the income statement, they face a significant risk of misinterpreting such numbers and, correspondingly, making erroneous analytical assessments or adjustments. This issue is discussed further through the analysis of an airline company case study in the **Appendix**, **Section 6.1**.

3.2.5 Detection of Earnings Management

One respondent's comments alluded to disclosures being used to detect earnings management that could have occurred through hedge accounting. The potential use of disclosures to detect earnings management is reflected in the following comment:

> *Designating derivatives as cash flow hedges is potentially a profit manipulation tool for management, so I want greater disclosure there.* — Portfolio Manager

Hedge accounting, such as cash flow hedge accounting, can be used for earnings management because it allows for the deferral of gains or losses on the hedging instrument. The possibility for earnings management through the use of hedge accounting is supported by empirical evidence. An academic study[38] showed that cash flow hedge accounting deferrals were used for the purpose of earnings management across a sample of firms. This study was based on 434 bank holding companies using data from 1995 to 2005. The study found that, after adjusting reported income by reversing cash flow hedge accounting deferrals, a statistically significant number of reported earnings increases were effectively transformed into earnings decreases. However, there was no corresponding statistically significant evidence of adjusted reported earnings decreases being transformed into effective earnings increases. The study interprets this finding as being evidence of systematic, unidirectional earnings management where cash flow hedge accounting deferrals were used to reverse and mask earnings declines.

By using methods similar to those used in the study cited above, investors can monitor the potential for earnings management by conducting trend analysis of deferred and recycled gains or losses over multiple reporting periods.

3.3 Conclusion

User survey results indicate that relative to hedge accounting disclosures, a higher importance is assigned to risk disclosures that cover all financial instruments, including all derivatives instruments. This is because hedge accounting disclosures only cover derivatives designated for hedge accounting treatment. The survey results indicate a low level of satisfaction with current financial instruments, including derivatives risk and hedge accounting, disclosures.

User feedback shows that hedge accounting is considered an accounting construct that reports only a subset of economic risk management practices and, as a result, hedge accounting disclosures are considered to have limited usefulness. Survey and interview feedback also indicate that derivatives and hedging disclosures could be much more useful in helping users:

- Assess risk exposure arising from derivatives instruments;
- Assess the extent of hedging activities;
- Differentiating the impact of core business activities from hedging activities on reported performance;
- Assess economic hedging effectiveness of designated hedge accounting relationships; and
- Detect earnings management.

Overall, the analysis of the potential application of these disclosures shows that there is an information gap between disclosures that users require for analytical purposes and the disclosures that are provided by companies. We posit that this information gap contributes to the low user satisfaction with these disclosures.

[38] Ibid 22(c).

4 Review of Annual Reports' Derivatives and Hedging Activities Disclosures

To further identify areas of improvement, this study undertook a review of derivatives and hedging activities disclosures contained in financial statements prepared under IFRS. The review was based on a combination of the elements of the analytical framework outlined in **Section 2** and the user feedback on how these disclosures could be used in **Section 3**. The review of disclosures focused on the 2011 and 2010 annual reports of 30 IFRS-reporting companies. We reviewed a larger number of banks than non-financial companies (i.e. 20 banks versus 10 non-financial companies) because derivatives tend to be used more extensively by banks. We also reviewed 2009 annual reports of 25 IFRS-reporting companies. The selected companies were large-capitalisation companies known to have significant financial risk exposure and thus likely users of derivatives instruments.

From the review of the sample annual reports, a disclosure quality index (also referred to as the DQI) was constructed. The analysis in **Sections 4.1** and **4.2** below is based on the DQI derived from reviewing 2011 annual reports. Only the 2011 results are reported below because they represent the most recent data reviewed and also because the analysis of 2010 and 2009 annual reports was generally consistent with that of the 2011 annual reports.

The analysis of disclosures in annual reports provides further context for evaluating the user feedback regarding these disclosures. It also provides an objective basis for identifying the areas for improvement as discussed in **Section 5**. The sections below describe:

- Construction of the DQI (**Section 4.1**); and
- Key findings (**Section 4.2**).

4.1 Construction of the Disclosure Quality Index (DQI)

4.1.1 Inputs into DQI

The following disclosure evaluation dimensions were included in the construction of the DQI:

- **Desirable Presentation of Disclosures —** Attributes that improve understandability of disclosures (e.g. tabular presentation and centralised disclosures). As discussed in **Volume 1** of this report and in **Section 2.1.2**, the attributes that enhance understandability of disclosures include the use of tabular formats, centralised and well-referenced disclosures. Two of the 22 dimensions (i.e. dimensions 1 and 2 on **Table 4-1**) pertain to the desirable presentation of disclosures.

- **Mandatory Disclosures —** Prescribed IFRS 7 disclosure requirements (e.g. balances, gains or losses of fair value and cash flow hedges, quantitative risk exposure). Net investment hedges were excluded because they tend to be used to a lesser extent than fair value and cash flow hedges and are similar in accounting approach to cash flow hedges. Nine of the 22 dimensions pertain to mandatory disclosures. These are dimensions 5, 6, 9, 10, 12, 17, 19, 20 and 21 on **Table 4-1** and can be identified by the '*' marker next to the dimension.

- **Voluntary Disclosures —** Voluntary disclosures (e.g. hedging ratio, covenants on credit risk contingent commitments) were included based on having been identified as useful derivatives and hedging disclosures in **Sections 2.2** and **3**. 11 of the 22 dimensions pertain to voluntary disclosures. These are dimensions 3, 4, 7, 8, 11, 13, 14, 15, 16, 18 and 22 on **Table 4-1**.

4.1.2 Determining DQI Score

Table 4-1 reports DQI scores across 22 disclosure dimensions comprising desirable presentation attributes of disclosures and mandatory and voluntary disclosures. Using 2010 annual reports, 30 IFRS compliant companies (i.e. 20 banks and 10 non-financial companies) were individually assessed for compliance with each disclosure dimension and a score was assigned as follows:

- 100% = Full compliance
- 50% = Partial compliance
- 0% = No compliance

Thereafter, an average DQI score was determined for each of the 22 dimensions based on the average score for all the eligible companies. Hence, if all 30 companies were expected to conform to a particular dimension and they each scored 100% for that particular dimension, the DQI score would be 100%. If for another dimension, 10 companies scored 100%, 10 scored 50%, and 10 companies scored 0%, the average DQI score would be 50% for that other dimension. In similar fashion, separate DQI scores were determined and reported for all the assessed dimensions as outlined in **Table 4-1**. As discussed in the **Appendix**, **Section 6.2**, this scoring system sufficiently informs on the extent to which the selected companies complied with the assessed disclosure dimensions.

4.1.3 DQI Score Adjustment for Applicability of Disclosures to Companies

As noted, the DQI score for each dimension is based on the compliance with the dimension by eligible companies. Adjustments to the number of eligible companies were considered as follows:

- **Mandatory Disclosures —** Adjustments were made to eligible companies when mandatory disclosures, as required by IFRS 7 (e.g. effects and details of different types of hedge accounting), were not applicable. It was possible to determine whether companies were applying either fair value or cash flow hedges by reviewing balance sheet and income statement disclosures and OCI statement. In cases where either fair value or cash flow hedges were not applicable, the DQI score was correspondingly adjusted by excluding the company from the DQI score determination.

- **Voluntary Disclosures —** With regards to the voluntary disclosure DQI, we adjusted the number of eligible companies included in the DQI for two of the 11 voluntary disclosures. These two dimensions were related to fair value hedges (i.e. cumulative gains or losses, and details of hedged item on balance sheet). As noted above, it was possible to determine applicability of fair value hedges to the companies we reviewed, enabling companies to be excluded where the disclosure was not applicable.

  For seven of 11 voluntary disclosures dimensions (i.e. dimensions 3, 4, 7, 13, 14, 15 and 22), we assumed it was not appropriate to make any company eligibility adjustments to the DQI, as these disclosures (e.g. notional amount, credit rating and risk of derivatives, effects of derivatives on cash flow statements) ought to be applicable to all companies with derivatives being used for either hedging or trading.

  The remaining two voluntary disclosures (i.e. dimension 8 for covenants on credit risk contingent commitments, and dimension 11 for unqualified economic hedges) may not have been applicable to all companies. However, it was not possible to determine applicability and to correspondingly adjust the number of eligible companies whilst determining the DQI score related to these particular two disclosures. This was because the companies we reviewed often did not have any communication that could allow ready judgement on whether these other voluntary disclosures were applicable. That said, it is unlikely that a low DQI score for any of the voluntary disclosure dimensions can simply be explained by these disclosures not being applicable for most companies. For example, the Fitch

Ratings study[39] determined that there was a pattern of poor disclosure of credit risk contingent commitments even when these were applicable. In the same vein, it is likely that for most, if not all, of the companies we reviewed, these two mentioned voluntary disclosures would be applicable. Thus, a low DQI for all the voluntary disclosures would be more likely indicative of failure to communicate the underlying information than it would be of non-applicability.

4.2 Key Findings

4.2.1 DQI Findings

Table 4-1, which follows, reports the findings from the aforementioned review of the annual report disclosures of derivatives and hedging activities of the 30 IFRS reporting companies and the construction of a DQI across 22 dimensions. **Table 4-1** also distinguishes the DQI scores of banking and non-financial companies.

[39] Ibid 25(b) — As discussed earlier in **Section 3.2.1**, the Fitch Ratings study highlights the importance of credit risk contingent commitments (i.e. where companies may face margin calls should their credit rating be downgraded).

Table 4-1: Derivatives and Hedge Accounting Disclosure Quality Index

DISCLOSURE DIMENSION (22 DIMENSIONS) [Items with asterisk (*) are required or mandatory IFRS disclosures]	Average DQI Score Banks[40]	Average DQI Score Non-Banks[41]	Average DQI Score All
DISCLOSURE UNDERSTANDABILITY — DESIRABLE PRESENTATION OF DISCLOSURES			
1) Sufficient use of tabular presentation	80%	90%	83%
2) Ease of use (i.e. related disclosures mostly in one location or adequately cross-referenced)	58%	70%	62%
DISCLOSURES OF AGGREGATE RISK EXPOSURES			
3) Notional amount of derivatives	90%	40%	73%
4) Notional amount disaggregated by risk type and by use (i.e. hedging versus trading)	83%	30%	65%
5) Adequately disaggregated quantitative risk exposure (e.g. disaggregate assets or liabilities by foreign currency type, proportion of fixed versus floating-rate debt, exposure to commodities)*	53%	45%	50%
DISCLOSURES OF DERIVATIVES INSTRUMENT SPECIFIC RISK EXPOSURE			
6) Market risk — sensitivity analysis of derivatives*	53%	45%	50%
7) Credit risk of derivatives counterparties [e.g. disaggregation into credit rating buckets of derivatives assets and provision of details of underlying credit quality of each bucket (e.g. probability of default)]	35%	20%	30%
8) Funding liquidity risk — derivatives-related covenants (e.g. credit risk contingent commitments)	8%	0%	5%
9) Financial instrument liquidity risk — fair value hierarchy* (i.e. helpful to assess derivatives instrument liquidity risk)	93%	100%	95%

[40] Banks include: ABSA, Barclays, BNP Paribas, BBVA, Commerzbank, Credit Agricole, Deutsche Bank, Dexia, Erste, HSBC, ING, Investec, Lloyds Banking Group, Millenium BCP, Nordea, Royal Bank of Scotland, Société Générale, Standard Chartered, UBS and Unicredit.

[41] Non-banks include: Anglo-American, Anheuser Busch, British Airways, BMW, BP, BHP Billiton, EADS, EDF Group, GSK and Lufthansa.

Table 4-1: Derivatives and Hedge Accounting Disclosure Quality Index

DISCLOSURE DIMENSION (22 DIMENSIONS) **[Items with asterisk (*) are required or mandatory IFRS disclosures]**	**Average DQI Score Banks**	**Average DQI Score Non-Banks**	**Average DQI Score All**
DISCLOSURES OF HEDGING ACTIVITIES			
10) Disaggregation of derivatives assets and liabilities by hedge accounting category* (i.e. cash flow, fair value and net investment hedge accounting)	85%	85%	85%
11) Non-designated derivatives — disaggregation between trading derivatives and derivatives that are economic hedges (i.e. they do not qualify as accounting hedges)	15%	15%	15%
12) Breakdown of derivatives by instrument type* (e.g. futures, forwards, swaps, options, synthetic and exotic instruments)	80%	80%	80%
13) Qualitative and quantitative disclosures adequately describe hedging strategies (e.g. describing items being hedged and explaining related quantitative disclosures)	28%	60%	38%
14) Quantitative amount of hedging ratio (i.e. describes expected change in value of hedged instrument/expected change in value of hedged item. Hedging ratio can be in expressed in terms of a quantity of risk factor or monetary terms)	0%	15%	5%
15) Disclosure of sources of ineffectiveness (e.g. basis risk due to the mismatch of maturity or underlying risk factor, time value of options)	0%	0%	0%

Table 4-1: Derivatives and Hedge Accounting Disclosure Quality Index

DISCLOSURE DIMENSION (22 DIMENSIONS) **[Items with asterisk (*) are required or mandatory IFRS disclosures]**	**Average DQI Score Banks**	**Average DQI Score Non-Banks**	**Average DQI Score All**
DISCLOSURE OF EFFECTS OF HEDGING ACTIVITIES ON FINANCIAL STATEMENTS			
16) Fair value hedges — breakdown of hedged item including amount hedged versus amount unhedged and balance sheet item categorisation	18%	28%	21%
17) Fair value hedges — details of gains or losses of hedged item and hedging instrument presented jointly in the disclosures*	75%	78%	76%
18) Fair value hedges — disclosure of cumulative gains or losses of hedging instrument and hedged item for fair value hedging relationships	13%	0%	9%
19) Cash flow hedges — companies with cash flow hedges provide sufficient income statement disclosures of cash flow hedge ineffectiveness*	45%	39%	43%
20) Cash flow hedges — sufficient disclosure of items reclassified from OCI to income statement* (i.e. differentiating between hedges discontinued due to de-designation, realised hedges, and ineffective hedges)	20%	61%	33%
21) Cash flow hedges — the periods in which the cash flows hedges are expected to be reflected in the profit or loss*	65%	50%	60%
22) Disclosure of the impacts of hedges on cash flows (e.g. within operating, investment or financing categories of the cash flow statement)	0%	0%	0%

4.2.2 Discussion of DQI Findings

In general, the information content and presentation format of these disclosures have room for significant improvement. Moreover, these disclosures tended to be 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. The construction of the DQI showed that some of the companies we reviewed did not fully comply with mandated disclosures even when these seemed appropriate. In addition, there was limited voluntary disclosure of useful information across companies. The following specific shortcomings were highlighted:

- Derivatives and hedging disclosures could be better presented and more effectively integrated with other risk category disclosures (**Section 4.2.2.1**);
- Disclosure of quantitative risk exposures is inadequate (**Section 4.2.2.2**);
- Disclosure of derivatives use and hedging strategies is insufficient (**Section 4.2.2.3**);
- Disclosure of the effects of hedging activities on financial statements is inadequate (**Section 4.2.2.4**); and
- Incomplete risk management disclosure due to limited scope of disclosures (**Section 4.2.2.5**).

A more detailed discussion of the findings is provided in the sections which follow.

4.2.2.1 Derivatives and Hedging Disclosures Could Be Better Presented and More Effectively Integrated with Other Risk Category Disclosures

Well-presented, well-located, and integrated disclosures contribute to the overall understandability of the disclosures. There is room to improve the location and presentation of derivatives and hedging disclosures. There is also room for companies to improve the integration of derivatives and hedging disclosures with those of other key risk categories, such as market risk, liquidity, and credit risk. This latter point was raised in **Volume 1** in respect of credit, liquidity, and market risk disclosures.

Scope to Improve Tabular Presentation and Location of Related Disclosures

The DQI score of 83% (Dimension 1) shows that although many of the companies provided derivatives and hedging disclosures in tabular format, there were still some companies which had room for major improvement in their use of tabular presentation. Even when companies used tabular presentations, it was not unusual to find that they also had some key information buried in the descriptive text and not presented in tables. For example, the absence of helpful tabular disclosures of OCI reclassification adjustment to income statement is highlighted in **Section 4.2.2.4** and in the Lufthansa Airlines case study in the **Appendix**, **Section 6.1.2.3**. Thus, there is scope for several companies to improve the presentation of derivatives and hedging disclosures via tabular presentation of all key quantitative information and centrally located disclosures.

There are also several instances where companies have dispersed the location of related disclosures, as shown by the DQI score of 62% (Dimension 2) for centrally located or adequately referenced related disclosures. The dispersed location of related disclosures was particularly a problem for a number of the banks reviewed where information tended to be spread in a fragmentary fashion across the risk reporting sections within the management commentary and financial footnotes.

Inadequate Integration of Derivatives, Hedging and Market Risk Disclosures

There is scope to better integrate and map information on derivatives use to underlying risk exposure and sensitivity analysis information. The inadequate integration of derivatives use and market risk disclosures is expounded upon below:

- *Inadequate Integration of Derivatives, Hedging and Quantitative Risk Exposures Disclosures —* As discussed in **Section 4.2.2.2** below, disclosures of quantitative risk exposures can be significantly

improved. One possible improvement could be the delineation of pre-hedging and post-hedging exposures (e.g. effective currency exposure or effective interest rate after hedging). Only a few of the reviewed companies (e.g. Anheuser Busch and Anglo-American) provided the pre- and post-hedging breakdown of aggregate risk exposures.

- *Inadequate Integration of Derivatives, Hedging and Sensitivity Analysis Disclosures* — The DQI score for sensitivity analysis of derivatives instruments was 50% (Dimension 6). The 2004 Fitch Ratings study[42] also showed that only 46% of evaluated companies provided sensitivity analysis. Even when sensitivity analysis information was available, it appears that such information was not designed to provide information regarding hedge effectiveness. In addition, although not included as one of the DQI dimensions, the potential future exposure (PFE),[43] which is a form of sensitivity analysis of derivatives similar to Value at Risk (VAR), was not reported by many of the evaluated IFRS reporting companies, including those that would be expected to report it, such as the banks.

The poor quality of integration of quantitative risk exposure and sensitivity analysis information likely reflects a preparer mindset of mere compliance with what the preparer believes to be stipulated requirements as opposed to making an effort to communicate risk exposures and the effects of risk management. The observed poor quality and quantity of sensitivity analysis information exacerbates the difficulties that investors face in anticipating losses that could arise from derivatives instruments and/or allowing them to judge how effectively these instruments modify a reporting entity's risk profile.

Credit Derivatives, Credit Risk Management and Counterparty Credit Risk Disclosures Should Be More Effectively Integrated

Companies can use credit derivatives to either hedge their credit risk exposure (i.e. buy protection) or to assume credit risk by undertaking to fulfil payment obligations when external reference entities are unable to meet their payment obligations (i.e. sell protection). For the banking industry, credit risk is a key risk and the use of credit derivatives is pervasive. In this respect, although a detailed evaluation of credit derivatives disclosures was not part of the DQI scoring, a general observation from the review of bank disclosures (i.e. 20 IFRS-reporting banks reviewed in this study) is that there is room to improve the integration of disclosures in relation to credit derivatives and credit risk. Improvements in integration of disclosures could occur in the following areas:

- *Difficult to Determine Aggregate Derivatives Counterparty Exposure Due to Fragmentary and Incomplete Related Disclosures —* There are concerns about counterparty risk as described below:
  - *Fragmentary Credit Derivatives Counterparty Related Information —* As pointed out in an ECB paper[44], it is often difficult to discern whether reporting entities are net buyers or sellers of credit risk protection due to incomplete and fragmentary disclosures. Even where there is counterparty risk (e.g. from buying protection for credit risk using credit derivatives), the related information, such as CVA or DVA adjustments related to the counterparty, is often provided in fragmentary fashion. The aforementioned Fitch Ratings study[45] also observed that derivatives counterparty risk

[42] Ibid 25(b).

[43] Ibid 32 — The FRM Handbook defines PFE as the credit exposure at a future date. PFE relates to gains (i.e. positive fair values) and is modeled with a specific confidence interval (e.g. 95% confidence). While it is a form of sensitivity analysis, it differs from VAR. VAR is an exposure due to market loss; in contrast, PFE is a credit exposure due to gain. In addition, while VAR typically refers to a short horizon (one or ten days), PFE looks into longer time horizons. For example, if a bank has a swap instrument with a maturity period of five years, the PFE for up to year four or five will be useful information for investors.

[44] European Central Bank, August 2009, *Credit Default Swaps and Counterparty Risk*.

[45] Ibid 25(b).

is reported on a fragmentary and incomplete basis. The discussion on incomplete information in counterparty risk disclosures is extended in **Section 4.2.2.2**.

- *Incomplete Information on Counterparty Credit Risk Management* — Banks are increasingly hedging[46] their CVA exposures. However, disclosures of whether and how much of CVA is being hedged are virtually non-existent. If applicable, information regarding the hedging of CVA should be presented in a manner that allows investors to easily discern if/how the aggregate counterparty exposure is reduced through hedging.

- *Disclosure of Credit Risk Mitigation through Credit Derivatives* — Credit risk mitigation can occur through several mechanisms, including the following: netting of derivatives contracts between bilateral counterparties; the receipt of collateral from counterparties; and the use of credit derivatives when companies buy credit risk protection. However, the reporting of credit derivatives is rarely linked to the reporting of underlying credit risk exposure. The opacity of credit derivatives as hedging instruments is compounded because they tend not to be reported as part of hedge accounting disclosures, as it is often difficult for credit derivatives to qualify for hedge accounting under IAS 39 requirements.

4.2.2.2 Disclosure of Quantitative Risk Exposures Is Inadequate

As discussed in **Sections 2.1**, **2.2 and 3.2**, readers of financial statements require full transparency regarding the underlying risks to which companies are exposed. This includes transparency about the hedged and the unhedged risk exposures as well as risks arising from the use of derivatives instruments (e.g. counterparty and liquidity risks). Additional information could be provided on all of the following areas:

- Aggregate risk exposure, by type of risk, on both a pre- and post-hedging basis;
- Notional amount of derivatives;
- Credit risk of derivatives counterparties;
- Funding liquidity risk that could arise in the event of a ratings downgrade of the reporting company;
- Maturity analysis of both derivatives assets and liabilities; and
- Financial instrument liquidity risk, as evidenced by a fair value hierarchy that allows an investor to determine the extent to which derivatives valuations are based on observable market inputs.

[46] Ernst & Young (2012), *Reflecting Credit and Funding Adjustments in Fair Value — Insight into Practices: A Survey.* — Ernst and Young conducted a survey of 19 of the largest global banking financial institutions covering both IFRS and U.S. GAAP reporters. The survey results show that a) 14 of the 19 bank respondents hedged their CVA exposure and b) 5 of the 19 hedged their DVA exposure.

These inadequacies are discussed in further detail below:

- *Disclosures of Quantitative Aggregate Pre-Hedging and Post-Hedging Risk Exposure Requires Improvement* — Users can only meaningfully judge hedging objectives and how derivatives hedging instruments are applied if they have knowledge of the aggregate risk exposure[47] that arises from different risk factors. As discussed earlier in **Section 2.2**, users need to know the aggregate risk exposure both pre-hedging and post-hedging. That said, we observed poor reporting of aggregate risk exposure by many of the companies we reviewed. The DQI score was 50% (Dimension 5) for adequate quantitative risk exposure for all key financial risk factors (e.g. foreign currency exposure, proportion of fixed- versus floating-rate debt). Inadequate risk exposure disclosures were also noted in the **Volume 1** report, where there was a DQI score[48] of 47.5% for companies providing quantitative market risk exposure information.

- *Notional Amount of Derivatives Not Always Provided* — Notional amount is a useful indicator of overall risk exposure and the volume of derivatives used. However, this information is not always provided by reporting companies. The DQI score for disclosure of notional amount was 73% (Dimension 3). Non-financial companies reported notional amounts less frequently than did banks. Further, only some companies provided a disaggregation of notional amount by risk type, use and hedge accounting category. This is shown in the DQI score of 65% (Dimension 4) for disaggregating the notional amount by risk type and by use (i.e. hedging versus trading).

  As highlighted by one of the academic papers (Wong[49]) reviewed in **Section 2.1**, there is empirical evidence that the notional amount of derivatives is directly associated with stock price. That said, it is important to point out the need for careful interpretation of any reported notional amount. The need for careful interpretation arises because:

  - Notional amount is often mainly a reference amount for derivatives instruments and does not necessarily represent the exposure or upper bound of possible losses. For example, for a swap derivatives instrument, the maximum possible loss will be higher than reported fair value but lower than the notional amount. This is unlike for a loan or bond held on the balance sheet, where the notional amount is the amount lent or invested and representative of the maximum loss that can be incurred.

  - Derivatives contracts are often bilateral contracts between counterparties where netting of exposures would represent the effective exposure. Therefore, any reported gross notional amounts would, if considered alone, likely overstate the exposure.

  - Notional amounts reported across risk categories (i.e. interest rate, foreign currency, credit, commodity, and equity) could provide clues on the existence of counterparty risk. However, there is need for caution in linking the likelihood of counterparty exposure across different risk categories to the notional amount. For example, while the notional amounts of interest rate derivatives tend to be most significant for banks, credit derivatives with much lower notional

[47] Common examples of exposure include: a) foreign currency exposure could arise from foreign currency receivables, payables, investments and borrowings; it could also arise from highly probable forecast sales or purchases in a foreign currency; b) interest rate exposure could arise from fixed or floating-rate borrowings; and c) commodity price exposure could arise from highly probable forecast purchase or sale of commodities; this type of risk normally relates to non-financial assets.

[48] As noted earlier, the determination of DQI in **Volume 1** was based on the 2009 reports of 20 financial and non-financial companies.

[49] Ibid 21(b).

amounts are likely to have significant counterparty wrong-way risk. [50] Therefore, comparing interest rate derivatives to credit derivatives notional amounts will not give a sense of comparative counterparty risk exposures. (This latter point was raised in a paper by Algorithmics[51]).

Notwithstanding the need for careful interpretation of notional amounts, it is a necessary disclosure as it is an indicator of risk exposure. Further, as highlighted in the academic paper[52] authored by Wong, the notional amount is most useful when evaluated in conjunction with other, related derivatives and risk disclosures. The academic paper proposes that alongside the notional amount, there is need for disclosures of inherent business risk as well as disaggregated disclosures of risk exposure, including: the sign of the position (i.e. long versus short), classes of instruments, time to maturity, degree of leverage, level of complexity, and type of currency to which the derivatives relate. The usefulness of notional amounts and maximum exposure information is also reflected in the following respondent comment:

> *The disclosures could be improved by providing more information about maximum risk exposure of derivatives including notional value*. ― Valuation Consultant

- *Disclosures of Derivatives Counterparty Credit Risk Are Inadequate* ― As mentioned earlier, there is inadequate reporting of derivatives counterparties. The ECB paper[53] raised the inadequacy of counterparty risk disclosures in the context of credit default swaps, noting that limited information is provided on counterparties. Similarly, a recently published KPMG report[54] which reviewed the 2011 annual reports of the 16 largest European banks observed that there are difficulties in discerning counterparty risk through financial statements' information:

> *Net derivative positions continued to be relatively small with derivative assets being largely offset by derivative liabilities. However, this gives only a broad indication of risk exposure and it is important to consider the underlying counterparty risk, the impact of unfunded derivative asset positions and wrong-way risk exposures. This information is difficult to assess and compare from the banks' financial statement disclosures*. ―KPMG

Among the sample companies reviewed, the credit ratings of derivatives (i.e. one measure of counterparty credit quality) were hardly ever disclosed, as shown by the DQI score of 30% (Dimension 7). Credit ratings of derivatives assets can inform investors regarding the credit risk of the related counterparties and as discussed in **Section 3.2.1**, counterparty credit risk has emerged as a key risk category during the financial crisis.

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50 Algorithmics (2009), *Credit Value Adjustment: And the Changing Environment for Pricing and Managing Counterparty Risk.* ― The paper notes that an effective hedge is likely to be in place whenever losses incurred by a reporting entity can be offset by receivables from the hedging counterparty. Right-way risk connotes situations where the reporting entity incurs losses and at the same time credit quality and financial strength of the hedging counterparty is high. In such situations, the hedging counterparty is well placed to fulfil its payment obligation to the reporting entity. Appropriate hedges should be based on right-way risk with a hedging counterparty. On the other hand, wrong-way risk occurs when the credit quality of the hedging counterparty deteriorates at the same time as the reporting entity incurs hedged item losses. An example of wrong-way risk during the financial crisis was when mono-line insurers that sold credit risk protection to banks experienced credit ratings downgrades at the time banks were writing off loan losses and seeking recovery under contracts.

51 Ibid 50.

52 Ibid 21(b).

53 Ibid 44.

54 KPMG (2012), *Focus on Transparency: Financial Reporting of European Banks in 2011 ― Surviving the Storm.*

- *Limited Information on Funding Liquidity Risk Related to Derivatives Covenants* — The DQI score for disclosure of derivatives-related covenants (e.g. credit risk contingent commitments) was 5% (Dimension 8). As discussed in **Section 3.2**, the disclosure of credit risk contingent commitments can help to highlight funding liquidity risk in the event of rating downgrades of the reporting company. This disclosure is not required under IFRS but is required under U.S. GAAP under Topic 815 (formerly referred to as SFAS 161). The low DQI score for derivatives credit risk contingent commitments shows that most IFRS reporting companies could improve their reporting of funding liquidity risk arising due to covenants related to a rating downgrade.

- *Required Maturity Analysis of Derivatives Only Gives Partial View of Related Funding Liquidity Risk* — IFRS 7 requires the disclosure of maturity analysis of derivatives liabilities. The findings in **Volume 1** showed a DQI of 95% for maturity analysis of derivatives liabilities based on the 2009 annual reports of 20 financial and non-financial companies. However, the DQI score for maturity analysis of financial assets was 75%. The poorer disclosure of maturity analysis of financial assets when compared with that of financial liabilities, including derivative liabilities, could be because it is not mandated by IFRS 7. That said, disclosure of maturity analysis for both derivatives assets and liabilities is useful for investors. Especially given that unlike other funded financial assets (e.g. loans and debt securities), some derivatives can, over time, fluctuate from an asset to a liability position. The general importance of the disclosure of maturity analysis of financial assets is reflected in the following comment (also reported in **Volume 1**):

  > *Maturity analysis of financial assets should be mandatory. It helps users to see the duration relationship and compare the asset duration to liability duration.*
  >
  > — Mergers and Acquisition Advisory Analyst

- *Financial Instrument Liquidity Risk Disclosures Should Always Be Provided* — The main assessment of liquidity risk was done by way of the assessment of required fair value related disclosures. Specifically, we examined whether the evaluated companies provided a fair value hierarchy that allowed investors to assess the extent to which the valuation of a reporting entity's derivatives was based on observable market inputs. The DQI score of 95% (Dimension 9) shows that, although this disclosure is provided by most of the companies analysed, there are some companies that do not provide the information. As discussed in **Section 3.2,** investors need to be aware of market liquidity risk as this factor could contribute to valuation subjectivity and errors (e.g. if valuation is based on internal models). The valuation of derivatives also impacts the assessment of hedge effectiveness. In other words, a flawed valuation of derivatives used for hedging purposes leads to erroneous judgements of effectiveness, and consequently to inaccurate recognition of related gains or losses.

The findings of other studies,[55] although focused on U.S. companies and U.S. GAAP and based on relatively older data (i.e. pre-2006), are consistent with the above reported IFRS-focused DQI scores. These other studies showed a pattern of partial compliance by companies in the reporting of notional amount, risk exposure and derivatives instrument-specific risk such as counterparty risk and details of covenants. From these findings,

[55] 1) Ibid 25(b) — The 2004 Fitch Ratings study based on a review of 57 U.S. companies found the following: a) 67% of companies provided notional amounts; b) 36% reported foreign currency risk; c) 46% reported sensitivity analysis; d) reporting of counterparty risk was generally poor with only 26% reporting some form of counterparty information; and e) disclosure of credit risk contingent commitments was generally poor. This latter finding of poor disclosure of credit risk contingent commitments was confirmed by the 2009 Fitch Ratings study cited in Ibid 25(a). The study found that only 58% of the US companies reviewed made this disclosure.

2) Ibid 18 — The journal paper reviewed the disclosures of 30 Dow Jones Industrial Average (DJIA) companies and found that only 10 of 30 DJIA companies reported notional amounts after the introduction of SFAS 133.

there is clearly an opportunity for companies to improve upon disclosure of general quantitative risk exposure including the derivatives instrument-specific risk exposure.

4.2.2.3 Disclosure of Derivatives Use and Hedging Strategies is Insufficient

Information on Use of Derivatives Requires Improvement

As discussed in **Section 3.2**, users require companies to disclose the use of derivatives. However, the review of disclosures shows that there is room for improvement in the details and explanations of the derivatives' use.

Insufficient Distinction between Accounting versus Economic Hedges or Trading Derivatives — In many cases, the reporting did not adequately distinguish the nature of amounts not designated for hedge accounting (i.e. derivatives used for active trading purposes versus those used for economic hedges). Even when companies indicated that they use economic hedges, they did not provide sufficient disaggregation of details related to these economic hedges. In addition, in a few cases, even where appropriate, there wasn't sufficient granularity related to the application of hedge accounting (i.e. clear distinction between cash flow versus fair value versus net investment hedges). The following DQI score findings elaborate on the aforementioned shortcomings associated with the disclosure of how derivatives are used:

- DQI score of 85% (Dimension 10) for disaggregation of derivatives assets and liabilities by designated hedge accounting versus non-designated categories. This shows that there are a number of companies that do not provide details of which hedge accounting method is applied. One would expect there to be 100% compliance by all companies with this particular disclosure.

- DQI score of 15% (Dimension 11) for disaggregation of non-designated derivatives, distinguishing between unqualified economic hedges and trading derivatives.

Inadequate Disclosure of 'Own-Use' Exception Derivatives — IAS 39 exempts some commodity derivatives contracts (i.e. executory contracts when not classified as financial instruments[56]) from the general requirement to be recognised at fair value on the balance sheet and are described as 'Own-Use' derivatives. Effectively these contracts are off-balance sheet. They are also described as 'normal purchases or sales'. The off-balance sheet treatment of these executory contracts may change in the future under IFRS, because the IFRS 9 Hedge Accounting Staff Draft proposes to modify requirements such that there are circumstances when the fair value amounts of such contracts may be recognised on the balance sheet. For example, these contracts would be recognised on the balance sheet when they are hedged items, in which case, they would be eligible for consideration as qualifying hedged items. Under both current and proposed requirements, it is, and will be, important for users to be aware of whether these contracts exist and their magnitude.

Current reporting of these contracts is opaque, and as a result, users are unlikely to be aware of the existence and degree of these contracts. Although this study did not include an evaluation of the quality of disclosures

[56] Under IAS 39, a commodity contract is treated as a financial instrument and is thereafter eligible for the fair value recognition as all other derivatives if any of the following three conditions are met:

1) The entity has a practice of settling similar contracts net in cash, or by entering in offsetting contracts, or by selling the contracts; or

2) The entity has a practice of taking delivery and selling shortly after so as to profit from fluctuations in price or dealer's margin; or

3) Where the contract permits either party to settle net in cash or another financial instrument, or by exchanging financial instruments, or by selling the contracts, or where the non-financial item that is the subject of the contract is readily convertible to cash, unless the contract was entered into, and continues to be held, for the purpose of receipt or delivery in accordance with the entity's normal purchase, sale or usage requirements.

associated with these types of derivatives as a DQI dimension, it was observed that hardly any company reported or provided any meaningful details related to these types of derivatives contracts. For example, one of South Africa's major mining conglomerates (i.e. Anglo American) provided a detailed breakdown in its 2011 Annual Report of its derivatives and hedge accounting application but merely stated the use of the 'normal purchases or sales' exception without providing any details of related amounts.

Better Explanation of Hedging Strategies Needed

Companies deploy a wide range of hedging strategies. Examples of these strategies include:

- Macro-hedging[57] by financial institutions;
- Use of exotic instruments;
- Netting and aggregating financial instruments to create synthetic risk exposures for purposes of hedging; and
- Hedging discrete risk categories (e.g. only hedging the interest rate risk and not the credit risk for a bond investment).

Although many companies provide a breakdown of the type of derivatives instruments they use (e.g. forwards, options), most companies fail to adequately explain their hedging strategies. Poor explanation of hedging strategies is particularly pronounced within banks, notwithstanding the variety and complexity of hedging strategies that they usually employ (e.g. macro-hedging).

It will be especially concerning for investors if banks are allowed in the future, as is currently being considered, to apply hedge accounting more broadly[58] without there being a corresponding significant enhancement in disclosure practices. The heightened concern for investors arises because the lack of adequate related disclosures will increase the likelihood of investors not being aware of any risks or potential for losses arising from macro-hedges and/or synthetic exposures.

A common justification by financial statement preparers for failing to disclose hedging strategies is that they consider their hedging strategies to be proprietary and that disclosure of hedging strategies would compromise any competitive advantages they enjoy. That said, the failure to communicate the nature of hedging strategies limits investor understanding of the risk profile and risk management of companies. The need by users to understand hedging strategies is reflected in the following comment from one of the survey respondents:

> *The line between hedging and speculating can sometimes be very thin. Furthermore, companies may try to camouflage active positions as hedging transactions. This makes it particularly difficult to distinguish between the hedging and active position.* — Credit Analyst

The above comment highlights that derivatives' risk exposures can be overlooked by users when not articulated by companies. Even when companies claim to be hedging, they may in fact have increased their potential risk exposure by constructing opaque hedging strategies with embedded risk. For example, the case study cited earlier [59] illustrates this point by showing that, even when reporting entities claim to be hedging

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[57] Ramirez, J. (2007), *Accounting for Derivatives, Advanced Hedging under IFRS*, Hoboken, NJ: John Wiley & Sons, Ltd. — This textbook notes that IAS 39 allows the fair value hedge of the interest rate exposure of a portfolio of financial assets and/or financial liabilities. By designating the hedged items in terms of an amount of assets or liabilities in a maturity time period, rather than as individual assets or liabilities, hedge accounting can be attained.

[58] The need for significant disclosure enhancement to match any expanded hedge accounting requirements is discussed further in **Section 5.2**.

[59] Ibid 6 — The *'Big Short'* by Michael Lewis discusses how a bank that was buying credit risk protection for its structured asset portfolio included an additional short credit default swap contract so as to minimise the cost of the hedge. This 'hedging' structure ultimately resulted in a couple of billion dollars' worth of losses.

they can in fact increase risk exposure in a manner that is difficult for investors to discern. The same can be said of the relatively recent and widely reported high-profile JP Morgan derivatives-related losses, which varied from an initial estimate of $2 billion when first reported in May 2012 to a later estimate of $5.8 billion. The need to clarify the line between hedging activities and speculation will become increasingly important for banks if and when the so-called Volcker Rule goes into effect, which will require banks to make this distinction. The risk of investors overlooking risk exposures is heightened when there is limited transparency about the following:

- Objectives and costs of entering into different hedging strategies;
- The loss potential of constructed hedging strategies. Due to loss potential, it is worth re-emphasising the importance of the sensitivity analysis, which we discussed earlier; and
- Sources of reported hedging gains or losses. To this effect, it is necessary to provide information that will help users understand how hedge effectiveness or ineffectiveness is determined for purposes of either income statement recognition or deferral of gains or losses.

The following DQI score findings elaborate on the aforementioned shortcomings of current hedging strategy disclosures:

- DQI score of 38% (Dimension 13) for the qualitative disclosure of hedging strategies including a description of company-specific risk management policy and adequate explanation of reported hedging amounts. For the sample companies analysed, banks were markedly worse in their disclosure of hedging strategies. As noted earlier, the poorer description of risk management by banks occurs although they apply relatively more complex hedging strategies (e.g. macro-hedging) than most non-financial companies. The DQI score was 28% (Dimension 13) for the bank group and 60% for the non-financial group.

- DQI score of 80% (Dimension 12) for providing a breakdown of derivatives instruments by instrument type. This shows that companies do not always provide details of hedging instruments applied.

- DQI score of 5% (Dimension 14) for companies disclosing their hedging ratio. This shows that it is rare for companies to provide details of their hedging ratio so as to help users get a sense of the extent of hedging that is occurring.

- DQI score of zero (Dimension 15) related to sources of ineffectiveness shows that companies do not provide disclosures on the sources of ineffectiveness and the methods used to determine hedge effectiveness. To assess the economic hedge effectiveness, as well as the effectiveness of risk management strategies, users need to be aware of the sources of hedging ineffectiveness (e.g. basis risk).

- The DQI did not include an evaluation of disclosure on the cost of hedging strategies. However, we observed that this disclosure generally was not provided.

4.2.2.4 Disclosure of the Effects of Hedging Activities on Financial Statements Is Inadequate

A sufficiently detailed breakdown of the effects of hedging activities on the financial statements (i.e. balance sheet, income statement and cash flow statement) can help users to assess the effectiveness of hedging strategies employed by companies. This viewpoint is reflected in the following survey respondent comment*:*

> *Companies are terrible at disclosing the real meaning of gains/losses on derivatives. Many say it's just an accounting entry, but they do not explain why the entry really isn't important. I want to know what portion of derivatives gains/losses relate to current items versus long term items.* — Sell-Side Analyst

Our review of annual reports shows that disclosures related to the effects of hedge accounting on financial statements (i.e. income statement and balance sheet) are inadequate. The inadequate disclosure of financial statement effects is evident in the reporting of both cash flow and fair value hedges as reflected in the DQI scores[60] and explained in the sections which follow.

Roll forward Information Required

Balance sheets alone do not explain the changes in derivative fair values from one period to the next. Accordingly, one potentially useful disclosure that can allow users to understand the reported fair value is the roll forward reconciliation. A roll forward, as proposed by the 2004 Fitch Ratings study[61], that shows the fair value gains or losses on additions, maturity, terminations, and settlements, would meet investor information requirements. The DQI did not include the roll forward as a dimension, but there is clearly need for companies to include this disclosure. The Fitch Ratings study showed that fewer than 5% of evaluated companies provided a roll forward reconciliation. Although not included in the DQI assessment, roll forwards were virtually non-existent in the reviewed IFRS reporting companies.

Disclosures of Fair Value Hedges Need Improvement

The analysis of annual report disclosures shows that the disclosure of fair value hedged items is often inadequate. This is evident through the following DQI scores:

- DQI score of 21% (Dimension 16) for the disclosure of the classification of the hedged item on the balance sheet (i.e. nature of asset or liability). The low DQI score reflects the finding that, with a few exceptions (e.g. Millenium BCP, Unicredit), disclosures of balance sheet hedged items were rare.
- DQI score of 76% (Dimension 17) for the disclosure of both gains and losses of the hedged item and hedging instrument. This disclosure is required under IFRS 7 and it helps users to better understand fair value hedge ineffectiveness. One would expect 100% compliance by all companies that have fair value hedges. However, the DQI score shows that some companies failed to provide this disclosure.
- DQI score of 9% (Dimension 18) for disclosure of cumulative gains or losses of the hedged item and hedging instrument. The low DQI score reflects the finding that, with a few exceptions (e.g. Investec), disclosures of cumulative gains or losses of the hedged item and hedging instrument was rare.

In addition, there is usually insufficient disaggregation of gains or losses among operating, investing, and financing activities on the cash flow statement and income statement. Inadequate disclosure of fair value hedge

[60] As noted earlier, the construction of the DQI was adjusted for instances where disclosures were known not to be applicable. In particular, the DQI score for cash flow and fair value hedges was determined after taking into account instances where companies disclose that either of these disclosures was not applicable. In such cases, these companies were excluded from the DQI score determination. In our sample of 30 IFRS-reporting companies, fair value and cash flow hedge accounting was respectively applicable to 29 companies.

[61] Ibid 25(b).

accounting-related items limits users' ability to assess: the extent of the hedging of balance sheet items and the effectiveness of fair value hedging over multiple reporting periods.

Disclosures of Cash Flow Hedges Need Improvement

As described in **Section 1.4** and the **Appendix, Section 6.3**, cash flow hedges result in the deferral of effective portions of the change in fair value of hedging instruments. At the same time, recycling of cash flow hedge-related amounts from other comprehensive income to the income statement can occur due to hedge ineffectiveness, termination, selling, or voluntary de-designation of derivative contracts by corporate managers.

Table 4-2 highlights the cash flow hedging OCI amounts for a selected number (i.e. eight of the 20 sample banks) of IFRS-reporting banks for some of their reporting periods. We reviewed these amounts from the 2009, 2010 and 2011 annual reports of the highlighted banks and only include in **Table 4-2** the reporting period/s where the deferral seems to be significant. The aforementioned table highlights: a) the pre-tax cash flow hedge deferrals and b) OCI reclassification to net income, as a percentage of net income. Compared with pre-tax amounts, calculating after-tax cash flow hedge deferrals would have been more precisely indicative of the percentage change of net income if the deferrals had not occurred. However, there wasn't always clear disclosure of the tax amount attributable to cash flow hedge deferral, and for this reason, we analyse the pre-tax cash flow hedge deferral. Besides, an analysis of pre-tax deferral as a percentage of net income is appropriate as it is simply meant to illustrate that the magnitude of OCI deferrals can be significant notwithstanding that cash flow hedge derivatives are typically a very small proportion of a bank's balance sheet derivatives as can be seen with the examples in **Table 4-3**.

In addition to being potentially significant in magnitude, as discussed in **Section 3.2.5**, there is empirical evidence[62] based on a study of U.S. banks showing that cash flow hedge deferrals can be used to manage earnings. Thus, comprehensive disclosures regarding the nature of cash flow hedge deferrals, gains or losses are important for investors. The importance of cash flow hedge disclosures is also reflected in the below user comment:

> *Generally I would want as much disclosure as possible for cash flow hedge accounting, as that is the one I would want to make adjustments to.* — Buy-Side Analyst

[62] Ibid 22(c).

Table 4-2: Illustrative OCI Cash Flow Hedge Deferrals and Reclassification to Income Statement

Company	Year End	|OCI Cash Flow Hedge Deferral|/ |Net Income or Loss|	|OCI Cash Flow Hedge Reclassified to Net Income|/ |Net Income or Loss|
ABSA	2011	19.4%	22.6%
	2010	39.8%	21.2%
Barclays	2011	60.9%	19.1%
	2010	13.2%	15.0%
BNP Paribas	2011	9.3%	0.5%
HSBC	2011	3.2%	4.4%
	2010	1.3%	1.2%
	2009	7.2%	12.1%
	2008	26.5%	27.0%
ING	2011	19.2%	0.0%
	2010	16.3%	0.0%
	2009	71.6%	0.0%
Lloyds TSB	2011	33.8%	0.0%
	2010	406.2%	361.2%
	2009	17.9%	4.1%
Royal Bank of Scotland	2011	122.8%	89.8%
	2010	10.8%	10.7%
	2009	16.6%	0.6%
UBS	2011	69.9%	25.8%
	2010	11.8%	14.1%

Source: Annual Reports **— Table 4.2** displays examples of significant cash flow hedge gross deferrals through OCI (i.e. unrealised gains or losses of effective hedges) and reclassification from OCI to income statement. OCI cash flow hedge deferral, OCI reclassification to income statement and net income are, respectively, measured in absolute terms (i.e. only magnitude of amounts is considered). **Table 4-2** simply means to illustrate the occurrence of significant gains and losses through OCI due to cash flow hedges.

Notwithstanding the importance of cash flow hedge disclosures, our review of annual reports shows that there is poor disclosure of income statement and OCI effects related to cash flow hedges. The shortcomings of cash flow hedge disclosures include the following:

- *Limited Information Regarding the Nature of Cash Flow Hedge Gains or Losses on Income Statement and OCI* **—** The poor disclosure of cash flow hedges gains or losses is evident through the following DQI scores:

    - A DQI score of 43% (Dimension 19) for cash flow hedging ineffectiveness reported on the income statement represents low-quality compliance. Of the 29 eligible companies that we reviewed, 23 had at least some level of disclosure on ineffectiveness including stating whether there was no ineffectiveness. That said, the information disclosed was often either of limited use or difficult to access due to its presentation in non-tabular format. The information was of limited use because reporting entities often failed to disclose either the risk being hedged or the associated income statement line item. For example, the Lufthansa Airlines case study analysed in the **Appendix**, **Section 6.1**, shows how reported cash flow hedge gains or losses recognised in the income statement often do not provide information to enable users to make a link between the reported ineffectiveness and various underlying hedging strategies.

Lufthansa Airlines applies cash flow hedge accounting towards its fuel price and currency hedging strategies. However, its reported cash flow hedge gain or loss on the income statement was not disaggregated to show the separate hedging ineffectiveness arising from hedging fuel prices (i.e. operating expense) and currency exposures due to purchases of airline fleet (i.e. investing expense).

In many cases, it was also not possible to know whether there were underlying offsetting cash flow hedge ineffectiveness gains or losses, whenever ineffectiveness was disclosed through a single amount on a net basis. In addition, for some companies, which had significant cash flow hedge OCI deferrals in recent reporting periods (e.g. Royal Bank of Scotland with a deferral >100% of net profit from an absolute magnitude perspective for the year 2011), we could not readily find any disclosure on whether or not these companies had hedge ineffectiveness.

- A DQI score of 33% (Dimension 20) for adequate disaggregation regarding the nature of amounts reclassified from OCI to the income statement reflects low-quality disclosure. Only 15 of 29 eligible companies had some level of disclosure on amounts reclassified from OCI to the income statement. Notwithstanding that the banks could have significant amounts of OCI cash flow hedge-related reclassifications to the income statement, as shown on **Table 4-2**, the banks were notably poor in their disclosures, with only 6 of the 20 eligible banks providing some level of disclosure. In contrast, all the nine eligible non-financial companies provided some level of disclosure. The low DQI score reflects the finding that with a few exceptions (e.g. Dexia Bank), even when they provided disclosures, the reporting entities did not disaggregate the amount being recycled to allow users to discern what portion of recycled gains or losses related to hedge ineffectiveness, termination, selling or exercising or voluntary de-designation of hedges by corporate managers.

  In addition, these disclosures were often presented in non-tabular format and in a manner that made it difficult to reconcile them to the reported reclassification of cash flow hedge amounts from OCI to the income statement as reported in the comprehensive income statement. For example, this was the case with the OCI reclassification disclosure in the 2011 Annual Report of Barclays Bank (Note 17, page 223). This mentioned disclosure shows the following amounts denominated in pound sterling (GBP), being reclassified from OCI to income statement:

  - Interest income gain of 86 million (gain of 88 million in 2010);
  - Interest expense gain of 732 million (gain of 515 million in 2010);
  - Net trading loss of 157 million (loss of 148 million in 2010); and
  - Administrative and general expense gain of 2 million (gain of 99 million in 2010).

  These different reclassification adjustments effectively add up to gains of GBP 663 and GBP 554 million respectively for the years 2011 and 2010. However, the comprehensive income statement (Page 198) shows that the net gains of cash flow hedges transferred from OCI to the income statement were GBP 753 and GBP 684 million, respectively, for the years 2011 and 2010. In other words, the disclosed amounts appear not to reconcile to the comprehensive income statement amounts. These non-reconciling disclosures can be confusing for users, as users are bound to have questions about the nature of the amounts not being disclosed and why it was not necessary to disclose these omitted amounts. Thus, providing a tabular presentation of recycled cash flow hedges that can be reconciled to all reported amounts in the main financial statements would be a lot more useful to investors and other readers of financial reports.

The observed pattern of poor disclosures regarding the effects of cash flow hedges on financial statements is backed by other studies. One such study[63] looked at 67 Swedish OMX companies and found that only 42% disclosed the amount of ineffectiveness from cash flow hedges that was recognised in profit or loss. An earlier cited study[64] looked at Dow Jones Industrial Average companies between 2002 and 2005 and showed that only 69% disclosed the ineffectiveness posted to the income statement for cash flow hedges. The shortcoming of cash flow hedge accounting disclosures was also highlighted by a user respondent as noted below:

> *The hedge ineffectiveness disclosure in the case of cash flow hedge accounting can be made more useful.* — Sell-Side Analyst

- *Cash Flow Hedges Forecast Needs Improvement* — The DQI scores for the anticipated impact of cash flow hedges on future periods (Dimension 21) was 60%. The maturity forecast of cash flow hedges could provide information regarding the derivatives maturity and impact on reported performance and balance sheet items. That said, this disclosure, as currently provided, has limited usefulness. Companies typically provide maturity analysis of cash flow hedges at an aggregate level, but they do not disaggregate the information related to the underlying hedging instruments and the hedged items (e.g. highly probable forecast transaction, such as foreign currency sales or purchases and future purchase commitments). In addition, companies do not communicate on whether previous-period forecasts for current reporting were realised. Without knowledge of the underlying hedged item and hedging instrument, this disclosure has limited usefulness for investors as a basis of predicting the future impact of hedging on performance. Further, the absence of a comparison between forecast and realised impacts of cash flow hedges on net income and the balance sheet makes it difficult for users to judge how reliable these forecasts are.

No Existing Communication on Cash Flow Effects of Derivatives

There are no requirements under IFRS 7 for financial statement preparers to provide disclosures of the impact of derivatives on the cash flow statement. As a result, none of the companies analysed provided any such details as reflected by a zero DQI score (Dimension 22). In addition, a general observation is that there are no meaningful disclosures of cash flow impacts of both hedging and trading derivatives.

The required derivatives liability maturity analysis and the anticipated cash flow hedge forecast could potentially provide information about likely future cash flow impacts. However, as discussed above, in relation to anticipated cash flow hedge forecast disclosure, maturity disclosures can only be meaningful if they are adequately disaggregated by the characteristics of hedging instruments (e.g. risk factor and type of instrument) and are accompanied by explanatory notes that highlight key contractual terms or any economic compulsion such as the need to rollover particular derivatives contracts.

[63] Hausin, M., Hemmingson, C., and Johansson, J. (2008), *How to Hedge Disclosures? — IFRS 7 and Hedge Accounting — A First Stock Take*, MBA thesis. School of Economics and Business — Gothenburg University.

[64] Ibid 18.

4.2.2.5 Incomplete Risk Management Disclosure Due to Limited Scope of Disclosures

As shown in **Table 4-3** below, the proportion of derivatives not designated as hedges for accounting purposes can be significant for both banks and non-financial companies. Nevertheless, it is difficult for users to distinguish between derivatives used as economic hedges and those used for trading because companies rarely provide sufficient information to allow users to make this distinction. The inadequate disclosure and disaggregation of non-designated derivatives was evident through the DQI score of 15% (Dimension 11). Only a few of the companies we reviewed (e.g. Anheuser Busch), had any disclosure on economic hedges. Anheuser Busch did disclose the nature and amounts on the balance sheet of economic hedges as well as their associated income statement gains or losses. But this type of disclosure is not common.

Despite poor disclosure, it is likely that economic hedges are part of the non-designated derivatives for both financial and non-financial companies and companies fail to disclose these economic hedges simply because the accounting standards do not require them to do so. For example, this is the case for banks which have risk exposures that they hedge (e.g. credit and inflation risk) using derivatives. But because these derivatives generally do not qualify for hedge accounting, we observed that there was hardly any available or useful disclosures on economic hedges made by the banks we reviewed.

Table 4-3: Illustrative Balance Sheet Classification of Derivatives Assets[65]

Company	Cash Flow	Fair Value	Net Investment	Non-Designated
Anglo–American	0.7%	64.0%	0.0%	35.3%
Barclays	0.3%	0.4%	0.7%	98.6%
BMW	11.9%	52.2%	0.0%	35.9%
BP	0.3%	18.9%	0.0%	80.8%
Deutsche Bank	0.0%	0.9%	0.0%	99.1%
EADS	26.2%	28.9%	0.0%	44.9%
Glaxo SmithKline	0.0%	54.2%	14.8%	31.0%
HSBC	0.5%	0.1%	0.0%	99.4%
Lufthansa*	45.9%	17.6%	0.0%	36.5%
Standard Chartered	0.1%	2.8%	0.1%	97.0%

Source: Annual Reports (2011). (*) means that the breakdown of net derivatives assets by accounting method is highlighted for Lufthansa. The other companies in **Table 4-3** have a breakdown of gross derivatives assets by accounting method.

As noted above, the limited reporting of economic hedges that do not qualify for hedge accounting arises, in part, due to the fact that IFRS 7 only requires disclosures of derivatives that qualify for hedge accounting. As shown in the **Appendix**, **Section 6.3**, the IFRS 9 Hedge Accounting Staff Draft proposes to retain this narrow scope of disclosure requirements. Such a narrow scope limits the usefulness of current and prospective hedge accounting information, because the election of hedge accounting by companies does not necessarily represent their full spectrum of risk management activities.

[65] Percentage is determined by taking fair value of derivatives assets reported under each category as a proportion of the sum of the fair value of all recorded derivatives assets on balance sheet. This data was based on derivatives assets recorded on balance sheet as at year end 2011.

4.3 Conclusion

The review of disclosures of derivatives and hedging activities in annual reports found that there is room for improvement in a number of areas. Presentation of information is fragmentary, dispersed throughout the reports, and in several cases, could be improved by more use of tables. Disclosure of hedged and unhedged risks as well as risks arising from the use of derivatives is insufficient, reflected in inadequate disclosures of notional amounts, quantitative market risks, sensitivity analyses, and credit-related risks. Companies also tend to provide a poor explanation of hedging strategies. Explanations of the impact of hedging strategies on the financial statements could also be improved so that users could better understand the effectiveness of a company's hedging activities. Finally, the focus on disclosing information only related to hedge accounting activity, as opposed to a more robust discussion of the full range of economic hedging activities, provides users with only a limited understanding of a company's overall risk management activities.

5 Recommendations

5.1 Summary of Recommendations

The preceding sections have laid the foundation for establishing ways to improve disclosures of derivatives and hedging activities. The analytical framework, user feedback, and annual report disclosure review have resulted in the following recommendations:

- Improved presentation, location, and integration of derivatives and hedging with other risk disclosures is required (**Section 5.1.1**);
- Comprehensive quantitative risk exposure information is required (**Section 5.1.2**);
- Improved communication of overall derivatives use and hedging strategies is necessary (**Section 5.1.3**);
- Enhanced disclosures related to the effects of hedging activities on financial statements is required (**Section 5.1.4**); and
- The scope of disclosures should be extended to non-qualifying and non-elected economic hedges (**Section 5.1.5**).

5.1.1 Improved Presentation, Location, and Integration of Derivatives and Hedging Disclosures with Other Risk Disclosures Is Required

Tabular Presentation of all Key Quantitative Risk Exposures Should Always Be Provided

As discussed in **Section 4.2.2.1**, there is scope for some companies to improve the extent to which they use tabular format presentation when presenting derivatives and hedging information. All key quantitative disclosures should always be in tabular format.

Integrated Derivatives, Hedging and Risk Disclosures Should Be Provided

As discussed in **Section 4.2.2.1**, integrated risk disclosures should be provided. For example, there should be disclosure of the integration of risk exposure and risk management information. As reported in **Volume 1**, the user appetite for integrated disclosures is reflected in the following comment:

> *I would favour summary quantitative data about exposures to risk as contained in internal reports to management. This should explain VAR calculations by type of risk, the gross and net after hedging risks, the time trend of risk exposures and the asset/liability management expectation.*
>
> — Industry Consultant

These principles can be extended to the disclosures of derivatives instruments and hedging activities. We recommend the integration of the following disclosures:

- *Hedging Disclosures and Quantitative Risk Exposure Should Be Integrated* — We recommend that companies provide a breakdown of the pre-hedging and post-hedging exposures for their key risk categories. For example, banks should provide this information in respect of credit and interest rate risk exposures. Similarly, both financial and non-financial companies with subsidiaries and operating entities across multiple jurisdictions should report their structural foreign currency exposures on a pre-hedging and post-hedging basis. The **Appendix, Section 6.1.2.1**, outlines an example of the desirable pre-hedging and post-hedging disclosure extracted from the annual report of Anglo-American. Similarly, the 2011 Annual Report of Anheuser Busch provided several useful disclosures of pre-hedge and post-hedge exposures and these should also be provided by other reporting entities.

Anheuser Busch 2011 Annual Report disclosures (Note 28) highlight the following:

- *Foreign currency operations exposure* — A breakdown of firm commitments and forecast transactions showing the following items in separate columns: total exposure of firm commitments and forecast transactions by multiple currency pairs (e.g. USD/EUR etc.) before hedging; total derivatives used for hedging the exposure; and open position or exposure after the application of derivatives (Note 28, Page 121).
- *Foreign currency borrowing exposure* — Financial liabilities split by currency and distinguishing the effective interest rate and amount of financial liabilities on a pre-hedging and post-hedging basis (Note 28, Page 125).

- *Derivatives and Hedging Disclosures and Sensitivity Analysis Should Be Integrated* — Based on the shortcomings of the sensitivity analysis of derivatives discussed in **Section 4.2.2.1**, we reiterate the recommendation also made in **Volume 1** to improve the sensitivity analysis of financial instruments, including derivatives. For example, **Volume 1** recommended that the disclosure of VAR measures in relation to both the pre-hedging and post-hedging exposures can be used to supplement hedge accounting disclosures in informing users regarding economic hedge effectiveness.[66]

- *Integration of Credit Derivatives, Credit Risk Management and Counterparty Credit Risk Information* — As discussed in **Section 4.2.2.1**, credit derivatives can increase or decrease the aggregate credit exposure of the entity, and they can also result in wrong-way risk associated with counterparties. Therefore, all risk exposures and risk management choices related to credit derivatives should be presented in a comprehensive and integrated fashion. Credit derivatives disclosures should be presented such that they:
  - Allow users to discriminate between credit derivatives that are used to hedge credit risk and those that are used for active trading;
  - Make it clear as to whether reporting entities are net buyers or net sellers of credit protection;
  - Provide clarity on the source and nature of any recognised counterparty valuation adjustments; and
  - Communicate regarding any hedging strategies on CVA exposures.

[66] If the hedged item is a financial instrument with VAR data, the VAR of the derivatives and VAR of the hedged item can provide information regarding hedge effectiveness.

5.1.2 Comprehensive Quantitative Risk Exposure Information Required

We reiterate the recommendations made in **Volume 1** regarding risk exposure information. Specifically, companies should provide comprehensive quantitative economic risk exposure disclosures across all key risk factors. In addition, based on the shortcomings of risk exposure disclosures noted in **Section 4.2.2.2**, the following risk exposure information should be required:

Aggregate Risk Exposure

- *Comprehensive Aggregate Pre-Hedge and Post-Hedge Risk Exposure Is Required* — As discussed above, companies should provide a breakdown of key aggregate risk exposures on a pre-hedging and post-hedging basis. This should include a breakdown, by key currency type, of assets, liabilities, future purchase commitments and future sales commitments, the amount of floating-rate assets or liabilities held, and exposure to commodity risk.

- *Commodity Risk Exposure Should Be Reported in Currency Units and by Volume of Commodities (i.e. Nominal Amounts)* — Reporting the risk exposure being hedged in volumes of commodities provides investors with useful information about the underlying risk exposure. That said, the quantitative risk exposure information should also be reported in currency units in addition to other units of account (e.g. volumes/quantity of commodities, such as ounces of gold). Reporting in currency units allows users to make meaningful comparisons of the risk exposure across different companies, and such reporting is complementary to reporting by other units of account.

Derivatives Specific Risk Exposure

- *The Notional Amount of Derivatives Should Always be Provided* — As noted in **Section 4.2.2.2**, it would be beneficial for investors if all companies disclosed the notional amount of derivatives as it is a useful indicator of overall risk exposure and the volume of derivatives use. The notional amount should be provided on a gross basis. It should always be disaggregated by the following:
    - Risk category (e.g. foreign currency, interest rate, or commodity),
    - Nature (i.e. hedging or trading),
    - Method of hedge accounting (i.e. cash flow, fair value, or net investment), and
    - Long versus short exposures.

- *The Potential Future Exposure of Derivatives Contracts Should Be Provided* — As discussed in **Section 4.2.2.1**, PFE is a useful form of sensitivity analysis for derivatives contracts. The potential future exposure can help to convey the upper bound of potential losses of derivatives instruments.

- *Disclosures Related to Derivatives Counterparty Credit Risk Should Be Provided* — Companies should provide disclosure that informs on the credit risk arising from derivatives counterparties. Such disclosure should include information regarding the credit ratings of derivatives' counterparties as well as the assumptions underpinning CVA adjustments.

- *The Funding Liquidity Risk Details of Key Covenants with Derivatives Counterparty Risk Should Be Provided* — We reiterate the recommendation made in **Volume 1** for the disclosure of all significant covenants, including those that create either exposures from, or commitments to, counterparties in the event of a change in the credit rating of either the company or its counterparties. The report also called for improved reporting of counterparty-related information for all financial instruments, including derivatives.

- *Maturity Analysis of Derivatives Assets Should Be Provided —* We reiterate the recommendation made in **Volume 1** for the disclosure of maturity analysis of derivatives assets. The maturity analysis should reflect both the contractual and expected maturities. Comprehensive maturity disclosure of both derivatives assets and liabilities is especially important and useful for investors due to the noted poor reporting of the cash flow effects of derivatives and also due to the possibility that a derivative asset can turn into a liability during the holding period. For example, a swap with a positive fair value can also have a negative fair value.

- *Disclosures that Inform on Financial Instrument Liquidity Risk Should Be Provided —* We emphasise the need for companies to, where appropriate, always provide the required fair value disclosures (i.e. fair value hierarchy categorisation), as these disclosures help investors to monitor the extent of illiquidity of instruments held. In addition, we recommend that companies always clearly distinguish between OTC and exchange traded derivatives instruments as these are subject to different levels of market liquidity risk.

5.1.3 Improved Communication of Overall Derivatives Use and Hedging Strategies is Necessary

Companies Should Adequately Describe Derivatives Use

Companies should always provide an adequately disaggregated presentation and disclosure related to the full range of derivatives instruments that they use. This disaggregation should clearly differentiate, by risk category, the following:

- Derivatives used for risk management where hedge accounting is elected. Where hedge accounting is elected, entities should always disclose the type of hedge accounting (i.e. cash flow, fair value or net investment);
- Derivatives used for trading purposes;
- Derivatives used for risk management where hedge accounting is either not elected or ineligible (i.e. undesignated economic hedges); and
- Own-use exceptions derivatives. Reporting companies should outline the nature and amounts of these derivatives.

Comprehensive Explanation of Risk Management Policy and Hedging Strategies Is Required

As described in **Section 4.2.2.3** there is often insufficient information for users to adequately understand the entity-specific risk management policy and the hedging strategies employed. Companies should adequately explain their risk management policies and link their descriptions of risk exposures and risk management to the disclosures of quantitative information. Companies providing a comprehensive and entity-specific description of risk management will improve existing qualitative disclosures and will be consistent with the general recommendation made in **Volume 1** of this study that qualitative disclosures should better explain quantitative measurements.

Comprehensive qualitative disclosures of hedging strategies can enable users to better evaluate hedge effectiveness. The qualitative disclosures should describe the risk management policy and they should include the following information:

- *Hedging Objectives and Strategies —* Companies should provide detailed descriptions of hedging strategies, including complex hedging strategies, such as those relating to synthetic exposures (i.e. exposures that result from either netting or aggregation of derivatives instruments) and the objective of these hedging strategies (e.g. manage volatility, manage a particular downside risk). As noted in **Section 4.2.2.3**, banks in particular, ought to provide comprehensive qualitative disclosures related to macro-hedging and/or synthetic risk exposures that are deemed to be hedges regardless of whether such hedges qualify for hedge accounting.

- *Hedging Ratios and Rebalancing Strategies —* Companies should disclose their hedging ratios as well as discuss the extent of hedging in the current-period and the intended level of hedging for future periods. Companies should also discuss to what extent hedging strategies initiated during previous reporting periods were realised. They should also provide disclosures regarding the requirement, or election, to rebalance and the impact of such rebalancing actions on hedge ratios or hedge accounting relationships.

- *Sources, Methods and Assumptions of Hedge Effectiveness —* We recommend clear disclosures that allow users to be aware of: a) the sources[67] of hedge ineffectiveness (e.g. basis risk if crude oil derivatives are used to hedge jet fuel prices); b) methods applied to determine effectiveness (e.g. regression analysis, dollar offset); and c) underlying assumptions made in judging hedge effectiveness (e.g. if hypothetical derivatives are used as the proxy for the hedged item when determining cash flow hedge effectiveness). The multiple methods and diversity of possible assumptions[68] that can be made while determining hedge effectiveness necessitate greater disclosure as these different methods and assumptions can lead to different conclusions about hedge effectiveness and hedge effectiveness impacts on reported gains or losses.

- *Cost of Hedging —* Significant cost and periodic cash outflows can arise from designated hedge accounting relationships and also from economic hedges. Some of the high profile failed hedges with significant losses incurred by companies have shown that imperfect aggregate hedges are often entered into so as to minimise the periodic cost of hedging. Therefore, the cost of hedging can be a useful indicator of management's incentive to assume additional risk by adding layers to the core hedging strategy, with the objective of offsetting the cost of hedging.

Taken together, the above disclosures will help give users an understanding of the risk management strategies elected by a company.

67 Ibid 3 — The discussion of cross currency interest rate swaps (CCIRS) used to hedge foreign currency borrowings provides a good example of why disclosures of sources of ineffectiveness are important for investors.

68 For example, during the application of regression models to establish the statistical association between changes in fair values of the hedging instrument and hedged item. When regression models are used to determine ineffectiveness, there can be diversity between financial statement preparers in the following: a) the horizon of historical data and b) assumptions of the acceptable goodness-of-fit measure (i.e. *R*-squared statistic). This could lead to incomparable judgements on ineffectiveness.

5.1.4 Enhanced Disclosures Related to the Effects of Hedging Activities on Financial Statements Is Required

As discussed in **Sections 4.2.2.4**, the reporting of the effects of hedge accounting designated activities on the income statement and balance sheet requires significant improvement. Better disclosures should include: a) roll forwards; b) fair value hedges disclosure improvements; c) cash flow hedges disclosure improvements; and d) improved cash flow presentation and disclosures.

Roll forward for Cash Flow, Net Investment and Fair Value Hedges and Non-Designated Derivatives

As noted earlier, reporting companies should provide roll forwards that show the fair value gains or losses on additions, maturity, terminations, and settlements of derivatives instruments. The roll forwards should be provided by use and by instrument type. Such roll forwards will highlight key investor information requirements and enhance their understanding of period-to-period movements in reported derivatives fair value. A roll forward is especially useful for derivatives as many of these instruments can fluctuate from asset to liability positions through their holding periods.

Proposed Improvements of Disclosures of Fair Value Hedges

The following enhancements should be made for the balance sheet presentation of fair value hedge accounting items or, alternatively, the information should be included within the disclosures:

- *Disaggregation of Carrying Amounts of Hedged Items That Are Part of a Hedging Relationship —* This should clearly differentiate between amounts included and those excluded from the designated hedge accounting relationship. This will help users to make an evaluation of the extent to which a particular item has been hedged when a partial hedging strategy is adopted.

- *Disaggregated Cumulative Fair Value Adjustments —* These will help users assess hedging effectiveness over multiple reporting periods. They will also enable users to identify if under-hedging is occurring (i.e. whenever the derivative fair value change is less than the value change of the hedged item).

- *Linked Presentation or Disclosure of Hedging Instrument and Hedged Item —* A linked gross presentation or disclosure that matches risk management pairs (i.e. hedging instrument or hedged item) can help users to understand and monitor any such relationships.

- *Bifurcation by Risk Category —* The disclosures required to enable users to differentiate between hedged and unhedged risk exposures, including hedging of discrete categories (e.g. only the foreign currency or interest rate component), are inadequate. Hence, these should be improved to make it clear what components and amount of a financial instrument is being hedged.

- *Distinguish between Operating versus Investing versus Financing Gains or Losses —* There should be sufficient disaggregation of fair value hedge gains or losses to allow users to identify whether they relate to operating, investing, or financing activities.

Proposed Improvements of Disclosures of Cash Flow Hedges

As discussed in **Section 4.2.2.4**, cash flow hedge deferrals can be potentially significant in magnitude. In addition, **Section 3.2.5** highlights that cash flow hedges can be used for earnings management. This makes it important to have comprehensive disclosure of cash flow hedges. Cash flow hedges can be improved upon as follows:

- *Improve Disclosure on Nature of Gains or Losses* — The disclosures related to items recognised on the income statement or deferred through OCI should sufficiently disaggregate gains and losses clearly informing on the following:

    - *Distinguish Gains or Losses on the Income Statement and OCI Relating to Designated versus Discontinued Hedging Relationships* — For designated hedging relationships, hedge ineffectiveness (i.e. for over-hedges) is recorded in the income statement and hedge effectiveness is recorded in OCI. For discontinued hedging relationships, gains or losses on hedging instruments continue to be recognised in OCI and are only transferred to the income statement during the period that the hedged item impacts the income statement. As such, for income statement gains or losses there should be a clear differentiation between amounts due to hedge ineffectiveness, and due to reclassification from OCI to income statement (i.e. due to termination, selling or voluntary de-designation of hedges). Similarly, for OCI gains or losses, there should be clear differentiation between amounts due to termination, selling or voluntary de-designation of hedges.

    - *Link Gains or Losses of Hedging Instrument to Associated Hedged Item to Explain Hedge Ineffectiveness* — There should be the linked gross disclosure of gains or losses related to the hedging instrument and hedged item so as to allow users to assess the reported ineffectiveness.

    - *Distinguish between Operating, Investing and Financing Gains or Losses* — There should be sufficient disaggregation of cash flow hedging gains or losses recognised in the income statement. Such a disaggregation should inform on whether the gains or losses relate to operating, investing or financing activities.

    - *Gains or Losses by Hedging Strategy and Risk Type* — There should be disaggregation of gains or losses differentiating between amounts due to different types of hedging strategies. As an example, for an airline company, such as the one reviewed in **Appendix, Section 6.1**, there should be a distinction between cash flow hedge ineffectiveness-related gains or losses arising from the following: hedging fuel price; hedging currency risk from ticket sales; and hedging foreign currency purchases of airline fleet.

- *Provide Disclosures of Under-hedges* — Another issue related to cash flow hedges is that recognition of ineffectiveness is only required when over-hedging occurs. There is no disclosure about the level of under-hedging that is not recognised but has occurred. This is an aspect of recognition and measurement of hedging derivatives that investors need to be aware of and monitor if it is occurring, as there is the temptation[69] for companies to under-hedge, notwithstanding that systematic under-hedging is prohibited under IFRS. When companies under-hedge, gains or losses on derivatives are deferred through OCI and there is no signal of ineffectiveness through the income statement. Disclosures of under-hedged amounts and the associated ineffectiveness can assist users in assessing whether there is systematic under-hedging.

[69] Ibid 57 — Juan Ramirez's book on derivatives accounting highlights the incentive of companies to under-hedge as a means of avoiding recognising derivatives gains or losses during current reporting-periods.

- *Cash Flow Hedge Forecasts Need Improvement* — Forecasts of the impact of cash flow hedges on future reporting periods should be disaggregated by risk category and have accompanying explanatory disclosures about the nature of the cash flow hedge instruments and hedged items to which the forecast pertains. Companies should also disclose the extent to which previous-period forecasts for the current reporting period have been realised.

Improve Cash Flow Presentation and Disclosure

As noted in **Section 4.2.2.4**, IFRS 7 disclosure requirements do not address cash flow effects of derivatives; they focus only on income statement and balance sheet effects of derivatives. The cash flow statement presentation and disclosure could be improved to communicate the cash flow statement effects of derivatives use. As highlighted by CFA Institute member survey feedback[70] on the cash flow statement, one of the potential benefits of the direct cash flow statement is that it can enhance the transparency of cash flows related to derivatives.

5.1.5 The Scope of Disclosures Should Be Extended to Non-Qualifying and Non-Elected Economic Hedges

As discussed in **Section 4.2.2.5**, companies rarely provide disclosures related to unqualified or unelected hedges. To fully meet user needs, the disclosure of risk management should not be restricted by accounting constructs such as whether an item qualifies for hedge accounting treatment. Thus, the scope of disclosures should be extended to cover economic hedges where derivatives are hedging instruments but hedge accounting is not applied. The following comments illustrate that it is useful for investors to obtain more details about economic hedges.

> *I would like to understand the risk management strategies deployed by the company that are not eligible or have difficulties qualifying for hedge accounting. For example, if a credit default swap is used to hedge the credit risk of specific loan or portfolio of focus. Another example is using interest rate derivatives to hedge mortgage securities strips. These strategies may not be eligible for hedge accounting but they are important to be aware of.* — Structurer

> *I require more information about derivatives used as economic hedges including an explanation of the purpose of the derivatives, and the use of derivatives for any purpose other than hedging*.
>
> — Valuation Consultant

5.2 Review of Proposed Additional IFRS Disclosures

The Hedge Accounting Staff Draft proposes new disclosures that are meant to enhance current IFRS 7 requirements and improve the communication of risk management practices by reporting entities. The IASB describes its proposals as aiming to provide a top-down portrayal of risk management. These proposed disclosures overlap with many of our recommendations and include information about:

- Risk management strategy (e.g. selected risk exposure information);
- Effects of hedge accounting on the primary financial statements; and
- Sources of hedge ineffectiveness.

However, as noted in the CFA Institute comment letter[71], the disclosures proposed by the IASB have been scoped to address only those items that qualify for hedge accounting, thus retaining the current IFRS 7 approach. As pinpointed in **Section 3.2.1**, given the risk profile of derivatives instruments, there should be

[70] Ibid 37.

[71] Ibid 12.

explicit disclosure requirements addressing these instruments' specific risk exposures. The absence of explicit requirements most likely contributes to the observed poor quality of disclosures about derivatives instrument risk exposures, as discussed in **Section 4.2.2.2**. The updated requirements do not explicitly address the full range of derivatives instruments risk exposures (e.g. credit risk contingent commitments discussed in **Sections 3.2.1** and **4.2.2.2**).

Another shortcoming of existing requirements that remains unresolved by the updated requirements is the exclusion from scope and failure to develop disclosures related to economic hedges. The exclusion of disclosures of economic hedges curtails the broad objective of providing financial reporting information that communicates about risk management to investors.

Finally, as more fully described in the **Appendix**, **Section 6.3**, the Hedge Accounting Staff Draft proposes to expand the application of hedge accounting so that it can be applied to a variety of synthetically constructed exposures as well as aggregated and netted hedging instruments. In our comment letter, we highlighted that the expansion and increased complexity of hedge accounting allowed under the updated proposal will increase user interpretation difficulties. We also noted that the expanded eligibility for hedge accounting warranted a significant increase in disclosure requirements around all key judgements regarding eligibility, hedging designation, and effectiveness of designated hedge accounting relationships. It remains to be seen whether the updated requirements will yield enhanced communication of risk management practices from companies. Or alternatively, whether companies will simply comply with the bare minimum of any disclosure requirement 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 risk management choices and effectiveness.

5.3 Overall Report Conclusion

This report has highlighted the importance of, satisfaction with and usefulness of disclosures of derivatives and hedging activities from the point of view of users. The study has reviewed literature on the subject, obtained user feedback and assessed company disclosures. From these, it is clear that users require the multi-dimensional portrayal of hedged risk exposures, unhedged risk exposures, intended risk management strategies, risk management effectiveness, and operating performance with and without hedging activities. They also need to be aware of complex hedging strategies, synthetic risk exposures created and specific risks associated with derivatives instruments.

However, existing disclosure standards (i.e. IFRS 7) do not result in sufficiently informative disclosures. In addition, proposed accounting standards have yet to go as far as is required to address the full range of investor disclosure requirements. Accordingly, we believe that standard-setters should consider further enhancements to derivatives and hedging disclosures.

6 Appendix – Case Study, Survey Design and Hedge Accounting Requirements

The Appendix consists of the following:

- A case study of the usefulness of an airline company's derivatives and hedging disclosures (**Section 6.1**). The case study analysis complements the review of disclosures in annual reports in **Section 4**;
- A description of the survey design and study limitations (**Section 6.2**); and
- A comparison of the current and prospective derivatives and hedge accounting requirements (**Section 6.3**).

6.1 Case Study — Usefulness of Airline Company Derivatives and Hedging Disclosures

This section comprises a case study evaluation of the Lufthansa Airlines (Lufthansa), an IFRS-reporting company, derivatives and hedging disclosures. In the case study analysis, we review disclosures contained in the 2010 Annual Report and evaluate whether the disclosures adequately inform investors regarding the effectiveness of derivatives and hedging activities. The case study illustrates useful disclosures as well as the shortcomings of existing disclosures and helps to reaffirm the recommendations to improve derivatives and hedging disclosures made in earlier sections.

The case study analysis draws information from both the management commentary section and IFRS 7 disclosures made through the notes to the accounts. Although the primary focus of this study is on IFRS 7 disclosures, the approach of considering both management commentary and notes to the accounts disclosures is appropriate because this report aims to shed light on the full range of useful derivatives and hedging activities disclosures. Useful voluntary disclosures that were discussed in earlier sections could be located within the management commentary section — although there is a user preference for these items to be located in the financial statements. Disclosures in the notes to the financial statement are likely to have greater auditor assurance than disclosures in management commentary.

6.1.1 Key Considerations When Analysing an Airline's Fuel and Other Key Hedging Activities

Various factors dictate the choice of derivatives used within the airline industry. They include the following:

- *Fuel Cost Risk* — As discussed in a paper[72] that evaluated jet fuel hedging strategies in the airline industry, different types of instruments are optimal for different stages of the jet fuel price cycle because volatile jet fuel prices have a mean-reverting characteristic. For example, swaps would be preferred when prices are perceived to have troughed, collars would be preferred mid-cycle when prices are expected to either rise or fall and hedging volatility is important, and caps would be preferred when the price cycle is seen as having peaked.

- *Basis Risk* — As an alternative to jet fuel-based derivatives, airlines that are engaged in hedging activities tend to use either heating oil, kerosene gas, or crude oil derivatives, as these are assumed to have a high correlation with jet fuel prices. However, the assumed correlation does not always hold[73], and this leads to basis risk, where the change in spot price of the hedged item is significantly different from the change in the price of the underlying risk factor of the derivative.

- *Fuel Volume Uncertainty* — In addition to jet fuel cost uncertainty, there is inherent uncertainty regarding the future quantity of jet fuel consumption due to uncertainty associated with future demand (i.e. revenue passenger miles). The combination of jet fuel cost and consumption quantity uncertainty and the associated difficulties of selecting optimal hedging instruments have contributed to the observed pattern of partial hedging within the airline industry.

[72] Cobbs, R. and Wolf, A. (2004), *Jet Fuel Hedging Strategies: Options Available for Airlines and a Survey of Industry Practices*, Finance, pp. 467.

[73] The crack spread margin (i.e. difference in spot price between crude oil and jet fuel prices) can rise significantly and this lowers the assumed correlation. For example, the margin has risen during periods of conflict when there has been a spike in the demand for jet fuel and a corresponding increase in jet fuel prices.

- *Liquidity Risk* — There is significant derivative instrument liquidity risk (i.e. low tradability) when the underlying risk factor is the jet fuel price. This liquidity risk stems from the fact that contracts based on jet fuel prices are not exchange traded and are mainly transacted over-the-counter where there are a limited number of counterparties and market makers.

- *Other Key Financial Risks (e.g. Currency Risk)* — A multinational airline is likely to face other key risks, such as foreign currency risk, that can arise due to the following,
    - Ticket sales denominated in multiple foreign currencies,
    - Foreign currency capital expenditure (e.g. purchase of airline fleet), and
    - Foreign currency borrowings.

6.1.2 Assessment of Derivatives and Hedging Disclosures within the 2010 Annual Report

To undertake the analysis of derivatives and hedging disclosures, key data were extracted from Lufthansa's 2010 Annual Report. The analysis of the disclosure information contained in the 2010 Annual Report shows that Lufthansa provided some useful disclosures. That said, there were also several shortcomings in the disclosures. In the following sections we analyse the usefulness and shortcomings of such disclosures:

- Aggregate risk exposure disclosures;
- Hedging strategy disclosures; and
- Disclosure which assist users in interpreting effects of hedging activities on financial statements.

6.1.2.1 Analysis of Aggregate Risk Exposure Disclosures

Useful Aggregate Risk Exposure Disclosures

Examples of useful aggregate risk exposure disclosures contained in Lufthansa's 2010 Annual Report include the following:

- *Disclosure of Aggregate Fuel, Currency, Capital Expenditure and Interest Rate Risk Exposures* — **Tables 6-1.1**, **6-1.2 and 6-1.3** are extracts from Lufthansa's 2010 Annual Report (Note 46) and provide a breakdown of risk exposure and hedged item details for the following exposures which are useful information.

    - *Fuel Risk Exposure* — **Table 6-1.1** contains an extract regarding the future fuel exposure as of December 31, 2010 related to 2011 and 2012.

Table 6-1.1: Fuel Risk Exposure and Related Hedges

(In 1000 tonnes)	2011	2012
Hedges	6,951	2,681
Fuel Requirements	9,854	10,579
Hedging Ratio (Hedges/Fuel Requirements)	70.5%	25.3%

Source: 2010 Lufthansa Annual Report, Note 46 (Page 201).

- *Currency Risk Exposure* — Disclosure in the notes to the accounts (Note 46, Pages 200-201) indicates that currency exposures arise due to:
  a) Foreign currency-denominated borrowings (100% hedged by means of interest rate/currency swaps);
  b) Foreign currency-denominated fleet purchases (management indicated that the purchase of planes is 50% hedged and in the last 24 months before payment the hedging level was increased in semi-annual steps of 10% to reach 90% at the end); and
  c) Ticket sales in multiple jurisdictions. We could not identify any Lufthansa disclosures that provided details (e.g. percent hedged) of respective ticket sales amounts being hedged.

  In the management commentary (Page 141), Lufthansa management indicated that they have currency exposures in 69 currencies and with 22 of these currencies being hedged. Concurrently, they highlighted that as at end of 2010, the primary currency exposures from operations for the next 24 months were in USD, JPY, and GBP. Details of the currency risk exposure and related hedges are as shown in **Table 6-1.2**.

Table 6-1.2: Currency Risk Exposure and Related Hedges

In Millions	USD	JPY	GBP
Hedges (Foreign Currency)	4,967	(73,529)	(387)
Exposure (Foreign Currency)	(11,645)	161,414	1,091
Exposure (EUR at Spot Rate)	(8,715)	1,486	1,267
Hedging Level	43%	46%	35%

Source: 2010 Lufthansa Annual Report, Note 46 (Page 200).

- *Capital Expenditure Exposure* — **Table 6-1.3** provides a breakdown on forecast capital expenditures and intended hedges as of December 31, 2010, related to future periods 2011 through 2016.

Table 6-1.3: Capital Expenditure Exposure and Related Hedges

In Millions	2011	2012	2013	2014	2015	2016
Hedges (USD)	1,946	1,504	900	604	329	207
Net Capital Expenditure Exposure (USD)	(2,235)	(1,902)	(1,081)	(742)	(457)	(280)
Net Capital Expenditure Exposure (EUR at Spot Rate)	(1,673)	(1,424)	(809)	(555)	(342)	(210)
Hedging Level	87%	79%	83%	81%	72%	74%

Source: 2010 Lufthansa Annual Report, Note 46 (Page 201).

- *Interest Rate Risk Exposure* — Lufthansa management indicated that their stated interest rate hedging objective is to minimise the cost of funding. Management stated that they have a target of 85% of floating-rate debt liabilities and this is achieved by either obtaining floating-rate funding at inception or by using derivatives to transform fixed-rate to floating-rate exposure. They also provided an expected debt schedule that forecasts debt levels for future years (i.e. from 2011 to 2020), corresponding hedges and the expected floating/fixed ratio. Unlike the fuel exposure and foreign currency exposures, whose details we have outlined in **Tables 6-1.1**, **6-1.2** and **6-1.3**, we have not included the schedule of debt/interest rate exposure within this report as it is too extensive for illustrative purposes in terms of number of years of coverage. It may be found in Note 46 (Page 201) of the 2010 Lufthansa Annual Report.

- *Market Risk Sensitivity Analysis Provided —* Lufthansa's disclosures include a sensitivity analysis of derivatives fair values showing the impact of changes in fuel price, currency, and interest rate risk exposures on net income and reported equity. They may be found in Note 46 (Page 202) of the 2010 Lufthansa Annual Report.

- *Derivatives Liquidity Risk (i.e. Tradability) —* As described earlier, derivatives contracts such as jet fuel derivatives can have low tradability. A fair value hierarchy disclosure that outlines the different categories of the fair value determination approach can inform on the extent to which valuation is based on either observable market prices or internal models. In turn, this type of disclosure can inform investors regarding the tradability of derivatives held by reporting companies. Lufthansa provided a hierarchy of fair value measurement showing that most of its derivatives were classified as Level 2 fair value financial instruments. They may be found in Note 23 (Page 184) of the 2010 Lufthansa Annual Report.

- *Derivatives Maturity Analysis —* Lufthansa's disclosures included a maturity analysis showing the projected cash inflows and outflows that are based on gross undiscounted cash flows. They may be found in Note 46 (Pages 202-203) of the 2010 Lufthansa Annual Report.

- *Derivatives Counterparty Credit Risk —* Lufthansa's disclosures (Note 46, Page 204) include a tabular breakdown of the credit ratings of transactions with counterparties in respect of: a) hedging derivatives with positive market values worth a total of €543 million and b) non-designated derivatives with positive market values worth a total of €290 million.

Shortcomings of Aggregate Risk Exposure Disclosures

Despite the generally useful risk exposure disclosures, the following shortcomings with the disclosures were noted:

- *Difficult to Reconcile Risk Exposures to Hedged Items in Financial Statements —* There is no explicit linkage between the exposure information in Note 46 (Pages 201–202) and the disclosures in Note 26 (Page 186) explaining the hedging instruments and hedged items recognised on the balance sheet and income statement. Although **Tables 6-1.1**, **6-1.2** and **6-1.3** contain useful risk exposure information, readers of Lufthansa's 2010 Annual Report cannot readily translate the information within these tables to financial statement impacts.

- *No Explicit Post-Hedging Exposure —* The disclosures do not explicitly communicate both pre-hedging and post-hedging aggregate exposure. As noted in **Section 5.1.1**, the 2011 Annual Report of Anheuser Busch provided several useful disclosures of pre-hedge and post hedge exposures and these should also be provided by other reporting entities. These disclosures (Note 28 of Anheuser Busch 2011 Annual Report) highlight the following:
    - *Foreign currency operations exposure —* A breakdown of firm commitments and forecast transactions showing the following items in separate columns: total exposure of firm commitments and forecast transactions by multiple currency pairs (e.g. USD/EUR etc.) before hedging; total derivatives used for hedging the exposure; and open position or exposure after the application of derivatives (Note 28, Page 121).
    - *Foreign currency borrowing exposure —* Financial liabilities split by currency and distinguishing the effective interest rate and amount of financial liabilities on a pre-hedging and post hedging basis (Note 28, Page 125).

- *Fuel Exposure and Hedging Level Information Not Provided in Monetary Terms —* Exposure and the hedging level of fuel were only disclosed in terms of volume quantity and not in terms of currency units.

- *Nature of Capital Expenditure Exposure Unclear —* From the disclosure in Note 46, it is not clear whether capital expenditures relate to firm commitments to purchase aircraft fleet. It is also not clear whether capital expenditure forecasts were treated as cash flow hedges.

- *Notional Amounts of Derivatives Not Disclosed —* As discussed in **Section 4.2.2.2**, the notional amount is useful for investors as it can help users to understand and monitor the overall risk exposure. Thus, the notional amount should always be provided as discussed in our recommendations.

- *Partial Coverage of Currency Risk Exposure (i.e. Only Focuses on Major Currencies) —* Although management indicated that they have 69 foreign currency exposures and 22 hedged currencies, they only provided exposure and hedging details of the three major currencies with significant exposures (i.e. USD, JPY and GBP). Thus, it is not clear whether the other 19[74] unreported hedged currencies and 47[75] unhedged currencies are materially significant if considered in the aggregate. The extract from the Annual Report of Anglo-American shown in **Table 6-1.4** illustrates a format of disclosure outlining the pre-hedge and post-hedge currency risk exposure which is useful to investors. It outlines exposures of all currencies rather than those of a few major currencies. This disclosure format, if provided, can enhance investor understanding of overall currency risk exposure disclosures.

[74] The 19 unreported hedged currencies consist of the 22 total hedged currencies minus the three major reported hedged currency exposures (i.e. USD, JPY and GBP).

[75] The difference between 69 currencies and 22 hedged currencies (i.e. 47 = 69-22).

Table 6-1.4: Illustrative Extract from Anglo-American 2011 Annual Report Showing Useful Pre-Hedge and Post-Hedge Currency Exposure Breakdown

US $ Millions	Financial Assets (Excluding Derivatives)	Impact of Currency Derivatives	Currency Derivatives Assets	Total Financial Assets Exposure to Currency Risk
ASSETS				
US Dollar	10,639	(186)	742	11,195
Rand	5,761	186	98	6,045
Brazilian Real	839	—	—	839
Sterling	467	—	—	467
Australian Dollar	383	—	—	383
Euro	9	—	—	9
Other Currencies	382	—	—	382
Total Financial Assets	**18,480**	**—**	**840**	**19,320**
LIABILITIES				
US $ Millions	**Financial Liabilities (Excluding Derivatives)**	**Impact of Currency Derivatives**	**Currency Derivatives Liabilities**	**Total Financial Liabilities Exposure to Currency Risk**
US Dollar	(6,970)	(5,282)	(1,096)	(13,348)
Rand	(3,595)	(37)	(16)	(3,648)
Brazilian Real	(1,608)	1,138	—	(470)
Sterling	(1,181)	740	—	(441)
Australian Dollar	(564)	—	—	(564)
Euro	(3,436)	3,428	—	(8)
Other Currencies	(473)	13	—	(460)
Total Financial Liabilities	**(17,827)**	**—**	**(1,112)**	**(18,939)**

Source: 2011 Anglo-American Annual Report, Note 25 (Page 156).

In sum, although Lufthansa provides a range of useful risk exposure disclosures, the main shortcoming is that in several instances the quantitative risk exposure information is incomplete and it is difficult to map risk exposures to the hedged items in the main financial statements.

6.1.2.2 Analysis of Hedging Strategy Disclosures

Useful Hedging Strategy Disclosures

Examples of useful hedging strategy disclosures provided by Lufthansa include the following:

- *Useful Communication of Fuel Hedging Strategy through Management Commentary* — Lufthansa management indicated in the 'risk and opportunities' report contained in the management commentary section of the 2010 Annual Report (Page 140) that they undertake a dynamic hedging strategy whereby up to 85% of planned fuel consumption is hedged on a monthly basis. They articulated the objective of hedging as that of reducing earnings volatility. They provided helpful tables and graphs outlining the fuel hedging strategy for a time horizon of up to 24 months.

- *Breakdown of Derivatives Instruments Designated as Hedges* — We have extracted from the notes to the accounts, and included at **Table 6-1.5**, a useful breakdown of derivatives by instrument type (swaps, spread options and futures), risk type and hedge accounting approach. From that table we have constructed **Table 6-1.6**, which summarises the hedging instrument by hedge accounting approach for qualified hedges (i.e. cash flow and fair value) and by risk type.

Table 6-1.5: Balance Sheet Derivative Balances —
Breakdown by Type of Derivative Instrument and Type of Hedge Accounting

€ Millions	Fair Value Hedges		Cash Flow Hedges	
	As of December 31,			
	2010	2009	2010	2009
Interest rate swaps	145	101	—	—
Futures contracts for currency hedging	(6)	(14)	(152)	(227)
Spread options for fuel hedging	—	—	43	142
Hedging combinations for fuel hedging	—	—	268	49
Spread options for fuel hedging	—	—	82	(9)
Total hedging derivatives	**139**	**87**	**241**	**(45)**

Source: 2010 Lufthansa Annual Report, Note 46 (Page 201).

Table 6-1.6: Balance Sheet Derivative Balances —
Designated Hedging Derivatives: Summary by Risk Category

€ Millions	As of December 31,	
	2010	2009
Interest rate hedging (Fair value hedges)	145	101
Currency hedging (Fair value and cash flow hedges)	(158)	(241)
Fuel hedging (Cash flow hedges)	393	182
Total hedging derivatives	**380**	**42**

Source: Prepared from Table 6-1.5 above.

- *Breakdown of Hedged Items* — **Table 6-1.7** has been extracted from the notes to the accounts (Note 26, Page 186). However, this disclosure appears to have reported the total amount of hedged risk categories –it does not agree with our analysis by risk categories in **Table 6-1.6 —** and cannot be reconciled to any identifiable amounts of hedged items either on the balance sheet (e.g. interest rate hedging of borrowings) or off-balance sheet (e.g. future capital expenditure hedges). Said differently, its usefulness is limited by its inability to be connected to hedged risks, hedging instruments, or the basic financial statements more broadly.

Table 6-1.7: Extract of Hedged Items

€ Millions	As of December 31,	
	2010	2009
Interest rate hedges	145	105
Exchange rate hedges	(76)	(251)
Fuel price hedges	311	192
Total hedged risks	**380**	**42**

Source: 2010 Lufthansa Annual Report, Note 26 (Page 186).

- *Breakdown of Non-Designated Derivatives* — **Table 6-1.8** outlines positive and negative market values of non-designated derivatives that do not qualify under IAS 39 as effective accounting hedges.

Table 6-1.8: Balance Sheet Derivative Balances — Non-Designated Derivatives: Summary by Gross Derivative Assets and Liabilities

€ Millions	As of December 31,	
	2010	2009
Gross derivatives assets (i.e. positive market values)	291	228
Gross derivatives liabilities (i.e. negative market values)	(51)	(94)
Net derivatives assets	**240**	**134**

Source: 2010 Lufthansa Annual Report, Note 26 (Page 186).

Shortcomings of Hedging Strategy Disclosures

Shortcomings noted with respect to the hedging strategy disclosures are highlighted below:

- *Difficult to Assess Realisation of Described Management Strategy* — Although the company has articulated intended hedging strategies, there is not sufficient information to evaluate the extent of realisation and effectiveness of its intended hedging strategy during prior periods. For example, as **Table 6-1.1** regarding fuel risk exposure shows, the hedging ratio articulated in the 2010 Annual Report was as follows: 70.5% of fuel would be hedged in 2011 and 25.3% would be hedged in 2012. In the same vein, through its 2008 and 2009 Annual Reports, Lufthansa management would have articulated the percentage of fuel they expected to hedge in 2010. The question then arises as to whether management was able to fulfill the previously articulated hedging targets. In other words, whether during 2010 they actually fulfilled the projected hedging targets articulated through the 2008 and 2009 Annual Reports.

- *Nature of Some of the Hedging Derivatives Instruments Is Unclear* — A useful breakdown of hedging derivatives is provided in **Table 6-1.5**. However, the nature and purpose of these derivatives designated as hedges was not fully clear due to the following reasons:
    a) *Insufficient Description of Interest Rate Swaps* — It is unclear whether the interest rate swap instruments are pay-fixed or receive-fixed instruments. They are likely to be receive-fixed swaps given that the articulated interest rate hedging objective, as described within the management commentary, is to convert fixed-rate debt to floating-rate debt so as to achieve a target of 85% floating-rate and minimise the cost of funding. That said, it would be helpful for users if management explanations, with a high level of specificity regarding the hedged items, were provided alongside the disclosed quantitative information.

    b) *Insufficient Explanation Regarding the Use of Exotic Options for Hedging* — The derivatives instrument breakdown shows spread options and hedging combinations are used for fuel hedging. However, there is no accompanying explanation about the nature of these exotic derivatives instruments and why they were appropriate as hedging instruments.

- *Insufficient Disclosure of Hedged Items* — **Table 6-1.7** above was described as the disclosure of hedged items. However, this disclosure has mainly reported the total amount of hedged risk categories (e.g. exchange rate hedges) and not the respective hedged item amounts that could be either identified on the balance sheet (e.g. interest rate hedging of borrowings) or identified as relating to future commitments (e.g. hedging of capital acquisitions). It is also not clear from the breakdown of hedged risks as to whether they relate to cash flow or fair value hedges. Thus, it would be helpful for investors if the information in **Table 6.1.7** that is described as hedged items (but more properly reflecting hedged risks) had been further disaggregated to provide greater detail of the financial statement line items related to such hedged risks as well as the respective hedge accounting category.

- *Insufficient Disclosure of Linkage between Hedged Risks/Items and Hedging Instruments* — In addition, it is not clear how hedged risks or hedged items in **Table 6-1.7** link to the hedging instruments in **Table 6-1.5**, whose details are also summarised in **Table 6-1.6**. For example, the total of hedged items in **Table 6-1.7** matches the total of derivatives instruments in **Table 6-1.6**, but the fuel hedged risk of €311 million in **Table 6-1.7** does not match the fuel hedging instrument of €393 million in **Table 6-1.6**. Similarly, the currency hedged risk liability of €76 million is presumably related to the currency hedging instrument liability of €158 million. The absence of reconciling or linked disclosures between the hedging instrument risk and hedged item risk makes it difficult for users to discern the structure of the hedging relationship. Thus, an explanatory note alongside the respective tabular disclosure, of the hedged items would give more texture to any articulated hedging strategies and make it easier for investors to understand and monitor the hedging strategies. Further, the linkage to the balance sheet disclosures in **Table 6-1.9** below, other than an agreement in total, would be helpful to investors.

- *Insufficient Information on Non-Designated Hedges* — **Table 6-1.8** outlines non-designated derivatives. Judging from management's assertion that they only use derivatives for hedging, the non-designated derivatives are likely to be economic rather than accounting hedges. However, it is unclear what the hedging strategy on non-designated hedges is and, correspondingly, whether they are actually speculative in nature. The disclosures do not inform on the nature of these economic hedges and which risk exposures are being economically hedged.

The analysis of hedging strategy disclosures shows that there is room for refinement by financial statement preparers in communicating about their risk management practices and this could have been achieved better if management had explained the nature of derivatives used as hedging instruments and provided a comprehensive linkage between hedging instruments and hedged items.

6.1.2.3 Analysis of Disclosures Which Assist Users in Assessing Effects of Hedging Activities on Financial Statements

Useful Disclosures Which Assist Users in Assessing Effects of Hedge Activities on Financial Statements

Extracts of disclosures from the 2010 Lufthansa Annual Report regarding the effects of derivatives and hedging activities on balance sheet and income statement line items are summarised in **Tables 6-1.9** and **6-1.10** below and include:

- *Balance Sheet Information* — The notes to the financial statements provide a breakdown of derivative assets and liabilities balance sheet information on a gross and net basis as summarised here in **Table 6-1.9**.

Table 6-1.9: Balance Sheet Extracts — Designated Accounting Hedges

€ Millions	For Year Ending 2010	For Year Ending 2009
Gross derivatives assets (i.e. positive market values)	543	279
Gross derivatives liabilities (i.e. negative market values)	(163)	(237)
Net derivatives assets	**380**	**42**

Source: 2010 Lufthansa Annual Report, Note 26 (Page 186).

- *Income Statement and OCI Information* — The notes to the financial statements provide the gains and losses on both the fair value hedging instrument and hedged item. In addition, cash flow hedge information related to gains or losses recognised in OCI and the net ineffectiveness from cash flow hedges recognised in the income statement are disclosed in the notes to financial statements. Both have been extracted from the notes and reflected in **Table 6-1.10**.

  What's interesting for analysts to consider about this information is its relative importance to key income statement measures. As an example, it is noteworthy that the deferral of cash flow hedge losses to OCI in 2009 was in a year where there was a net loss and if the cash flow hedge losses had been recognised through the income statement, a larger loss would have been reported.

Table 6-1.10: Income Statement Extracts — Cash Flow Effects, Fair Value Effects and Measures of Net Income and Other Comprehensive Income

€ Millions	For Year Ending 2010	For Year Ending 2009
Profit/(Loss) after tax	1,143	(22)
Other comprehensive income/loss after tax	1,015	(43)
Comprehensive income/loss	2,158	(65)
Cash flow hedge gains/(losses) posted to OCI	288	(188)
Ineffectiveness of cash flow hedge recognised in income statement	(18)	95
Gains/losses on fair value changes of hedged items	(43)	3
Gains/losses on fair value changes of derivatives used as fair value hedges	43	5

Source: 2010 Lufthansa Annual Report — Consolidated Income Statement (Page 150), Statement of Comprehensive Income (Page 151), and Note 13 (Page 171).

Other useful disclosures regarding the effects of derivatives and hedging activities on the balance sheet and income statement include the following:

- *Disclosure on OCI Reclassification Adjustments* — The note disclosures state that for the year 2010:
  a) €136 million was transferred for maturing fuel price hedges from equity to fuel expenses;
  b) €541 million was transferred related to currency hedges into other operating income and €502 million to other operating expenses; and
  c) €111 million related to hedging of capital expenditures was recognised by reducing the acquisition costs for aircraft. This disclosure is not provided in tabular format but is located in Note 46 (Page 202).

- *Cash Flow Hedge Effects Forecast Provided* — **Table 6-1.11** provides a forecast of the anticipated effects of cash flow hedges on future-period profit or loss and/or on first time measurement of acquisition costs.

Table 6-1.11: Extracted Data on Anticipated Impact of Cash Flow Hedges on Future Reporting Periods

Financial Year	Income Statement Impact	First Time Measurement of Acquisition Costs	Total
	€ Millions		
2011	215	14	229
2012	40	17	57
2013	0	24	24
2014	0	(10)	(10)
2015	0	(31)	(31)
2016	(1)	(27)	(28)
Total	**254**	**(13)**	**241**

Source: 2010 Lufthansa Annual Report, Note 46 (Page 202).

Shortcomings of Disclosures Which Assist Users in Assessing Effects of Hedging Activities on Financial Statements

- *The Nature and Sources of Reported Hedging Ineffectiveness for Both Fair Value and Cash Flow Hedges Could be Better Explained* — There is no disclosure of the sources of reported ineffectiveness and there is no disclosure that disaggregates ineffectiveness by:
    a) Different types of derivatives instruments (i.e. swaps versus futures versus spread options) or
    b) Risk type (i.e. interest rate versus currency for fair value hedges; currency versus fuel for cash flow hedges).

  In addition, there is no discussion regarding whether the sources of reported hedge ineffectiveness are due to any of the following factors:

    a) Basis risk due to the choice of derivatives instruments with different underlying risk factors. For example, if crude oil derivatives are used to hedge jet fuel risk and at the same time the crack spread margin widens.
    b) Maturity mismatch between hedging instrument and hedged item. For example, hedging fuel requirements for a time horizon of the next 24 months using three month futures contract. Such a hedging strategy will require the rollover of derivative instruments every three months and entities can incur rollover gains or losses that are incremental to the offsetting gains or losses of a hedging instrument that has the same maturity as the hedged item.
    c) Non-eligibility of portions of designated hedging instrument (e.g. time value of options).

- *Fair Value Hedge Ineffectiveness Needs Further Explanation* — Fair value hedges are used to hedge interest rate and currency risk. The disclosure provides a breakdown of the gains and losses on both the hedging instrument and hedged item. Offsetting the hedging instruments and hedged item fair value changes informs on ineffectiveness. However, this ineffectiveness is not explained. For example, there is a hedge ineffectiveness of €8 million (i.e. due to gains of €3 million and €5 million, respectively, for the hedged item and hedging instrument) during the year 2009, but there is no explanation on the source of this ineffectiveness.

- *Difficult to Identify Fair Value Hedged Items on the Balance Sheet* — In the analysis of hedging strategy disclosures, we observed that it is difficult to reconcile hedging instruments amounts to hedged items. This difficulty is due to the fact that there is no disclosure that disaggregates the fair value of the hedged item and its related adjustment. There is also no disclosure of portions of carrying amounts of balance sheet line items that have been designated as fair value hedged items. The ability to identify hedged items is particularly important for fair value hedges as these should be on the balance sheet as either assets or liabilities. As discussed in the recommendations in **Section 5.1.4**, if users could identify the fair value hedge amounts included on the balance sheet and the movements that occur from period to period, they would be better placed to have a complete picture of additions and removals to the hedged item. To this effect, a roll forward disclosure can be very helpful for investors.

- *Cash Flow Hedge Amounts Recognised in the Income Statement and OCI Need Better Explanation* — Cash flow hedges are used to hedge fuel prices and currency risk. The cash flow hedge recognised in the income statement (i.e. a loss of €18 million and a gain of €95 million, respectively, during 2010 and 2009) is reported in net terms. The disclosure does not clarify the nature of the amount recognised in the income statement. For example, the reported amount could be due to ineffectiveness of hedges, voluntary de-designation, termination, or maturity of the hedging instruments.

- *Poor Disclosure of OCI Reclassification Adjustments* — As noted, there is a non-tabular disclosure of the amounts reclassified from OCI to the income statement and balance sheet. However, the disclosure of this key information

is all in textual rather than user-friendly tabular format. Additionally, the disclosure does not provide prior-period (i.e. 2009) comparative information.

- *Anticipated Cash Flow Hedge Forecast* — The forecast of cash flow hedge effects on future reporting periods and/or on the carrying amount of acquisition costs has limited information content as it does not provide any details of the specific hedging instruments and hedged items.

6.1.3 Case Study: Concluding Thoughts

As discussed above, Lufthansa's 2010 Annual Report provides a range of useful disclosures. However, even for a company such as Lufthansa that provides certain disclosures that are better than those provided by most of the companies we reviewed, the information gleaned from the disclosures is often rudimentary, incomplete, and not cohesive for purposes of a user fully evaluating risk management practices. For example, the disclosures provided do not enable users to make an informed judgement on how effectively the aggregate risk exposure is modified (i.e. pre-hedging versus post-hedging). In addition, due to partial information in disclosures related to the income statement and balance sheet, it is difficult to discern the reasons (e.g. sources) behind the reported hedge ineffectiveness arising from fair value and/or cash flow hedges. Improvements in derivative disclosures are essential for even the existing disclosures to be decision-useful to investors.

6.2 Survey Design and Study Limitations

6.2.1 Survey Design

Table 6-2 below outlines the profile of users who provided input and their mechanisms for providing input to this study.

Table 6-2: Survey Respondent Profile

Respondent Profile	Target Respondents	Actual Respondents	Effective Response Rate
Comprehensive member survey	50	26	50%
Abridged survey sent to members	274	57	21%
Abridged survey sent to external sell-side analysts	204	50	25%
Total	**504**[76]	**133**	**26%**

The survey participants were identified as follows:

- An invitation was sent to a pool of 300 CFA Institute members known to be users of financial statements based on their occupational category profile. These members are part of an internal CFA Institute financial reporting survey pool.[77]The invitation broadly expressed the objective of the study and intended data gathering approach.
- Fifty members indicated their willingness to participate in the study. Hence, the comprehensive questionnaire along with a background document outlining the disclosure requirements and illustration of these disclosures was sent to the 50 members expressing a willingness to participate. Of these, 26 responded to the comprehensive questionnaire. These respondents included credit analysts, buy and sell-side equity analysts, portfolio managers, financial institution consultants, and corporate finance analysts.

In addition, an abridged version of the survey was sent to the balance of 300 members that had not participated in the comprehensive survey feedback (i.e. 274 members). The abridged version was also sent to a sample (204 analysts) of external sell-side analysts known to cover companies that had reported IFRS 7 disclosures. The use of external analysts provides a control sample and enables the evaluation of the consistency of responses relative to CFA Institute member responses. The sample characteristics of the abridged version of the survey are as follows:

- 274 survey pool members yielded 57 responses representing a 21% response rate; and
- 204 mostly sell-side equity analysts yielded 50 responses representing a 25% response rate.

Further to the survey feedback, three expert users were probed in further detail, through telephone interviews, so as to substantiate the application of IFRS 7 disclosures and the potential areas for improvement.

[76] 24 members were included in both the comprehensive and abridged surveys. Hence, the total number of target respondents is 504 ([i.e. 528 (50+274+204) – 24]) rather than the 528 which would result from the pure sum of target respondents. The determination of respondents as shown ensures that there is no duplication in the counting of actual respondents to our surveys.

[77] The pool comprises members with an expressed interest in contributing to financial reporting matters based on their expertise in accounting and/or extensive use of financial statements.

6.2.2 Study Limitations

There are two principal limitations in relation to the user feedback and company analysis as noted below:

User Input

The user assessment was based on input from 133 respondents. Although this was a high response rate (i.e. 26% of 504 respondents), there are still challenges generalising these findings to the universe of investors. However, the focus of this paper was on obtaining high-quality feedback from expert users through the comprehensive survey and thereafter, reinforcing findings through an abridged version of the survey so as to ensure broad-based input. The underlying assumption is that expert users are likely to better appreciate the potential utility of the relatively complex IFRS 7 disclosures. However, it should be noted that the abridged survey directed at non CFA Institute members was primarily focused on equity analysts. As a result, this could have skewed some of the overall findings.[78] Further studies could be conducted that include greater input from a more diversified mix of investment professionals (e.g. credit/fixed income analysts) so as to further verify the views of different types of investment professionals regarding risk disclosures.

Company Analysis

A potential shortcoming is that it is possible that the DQI score for some of the voluntary disclosure dimensions could be understating the level of compliance due to these voluntary disclosures not being applicable for all companies and it being difficult to determine the applicability for individual reviewed companies. However, as discussed in **Section 4.1.2**, understating compliance in such a manner is unlikely. Moreover, the situation where it was difficult to determine the applicability of particular disclosures arose for only two of the 22 dimensions (i.e. disclosures on credit risk continent commitments, and unqualified economic hedges).

A second potential limitation of the DQI percentages reported in **Table 4-1** arises due to the nature of underlying data. The DQI percentages for each disclosure dimension were assigned to a company using a discrete data measurement basis (i.e. 100% for full compliance, 50% for partial compliance and zero for non-compliance). In effect, the DQI score does not precisely measure the extent of partial compliance at individual company level with each dimension. For example, there is no such measure as 40% or 60% compliance at the individual company level. However, for each dimension, taking the average of the ordinal score (i.e. either 100% for full compliance, or 50% for partial compliance, or zero for non-compliance) for the evaluated 30 IFRS reporting companies yields some continuous form data (i.e. percentages that can anywhere range from 0 to 100%), and this allows the evaluation of compliance of each dimension. For interpretation purposes, a higher DQI score for a particular disclosure dimension relative to other dimensions should simply connote a greater degree of compliance with underlying requirements.

[78] For example, this is the case with respect to the user assessment of the importance of, and satisfaction with, specific risk disclosures (i.e. credit liquidity, market risk disclosures and hedge accounting disclosures). The user assessment is derived from responses provided to the abridged and comprehensive surveys. The abridged survey had 107 respondents, including 50 non CFA Institute members who were mainly equity sell-side analysts.

6.3 Current and Proposed Hedge Accounting Requirements

Table 6-3.1 below is a description of characteristics of hedge accounting.

Table 6-3.1: Characteristics and Examples of Hedge Accounting

TYPE OF ACCOUNTING HEDGES	CHARACTERISTICS
Fair Value Hedges	• The gain or loss on the hedging instrument is recognised through profit or loss. The gain or loss on the hedged item adjusts the carrying amount of the hedged item and is also recognised in profit or loss. If the hedged item is already at fair value, hedge accounting is not necessary. • Fair value hedges relate to hedging of recognised assets and liabilities (e.g. borrowings, loans held) and previously unrecognised firm commitments. • *An example of a fair value hedge is the use of an interest rate swap to hedge the value changes of a fixed-rate bond. The gain or loss on both the swap and bond are recognised through profit or loss.*
Cash Flow Hedges	• The gains or losses on the hedging instrument that represent the effective portion of the hedge are deferred through the OCI and accumulated in equity. These amounts are then recycled from OCI to profit or loss during the same period that the gains and losses on the hedged item are recognised in profit or loss. Only the gains and losses on the hedging instrument that relate to the ineffective portion of the hedge due to over-hedging are recognised immediately in profit or loss. • Cash flow hedges relate to hedging of forecast, future highly probable transactions and firm commitments (e.g. exports/ imports, future capital commitments, interest payments/receipts) • *An example of the application of cash flow hedge accounting is if an airline manufacturer has orders for its planes from different airlines. The airlines are located in different countries and the orders are due in three years' time. The manufacturer hedges the anticipated foreign currency revenue receipts by entering into a foreign currency forward contract. The gains and losses on the forward contract that are considered to be effective hedges are deferred in OCI until the manufacturer recognises the revenues from its sales.*
Net Investment Hedges	• Net investment hedges use the same mechanics as the cash flow hedge accounting described above. They relate to hedging of foreign exchange risk due to net investments in foreign operations (for which foreign exchange gains or losses are recognised in OCI in accordance with IAS 21). • The hedging instrument may be either a derivative instrument or a non-derivative instrument (e.g. a borrowing denominated in the same currency as the net investment).

Table 6-3.2 outlines the current hedge accounting requirements under IAS 39. It also outlines the proposed hedge accounting requirements articulated in the Hedge Accounting Staff Draft. This table does not intend to provide an exhaustive breakdown of all hedge accounting requirements. The potential expansion of hedge accounting through IFRS 9 heightens the importance of holistic disclosures around both elected and unelected hedge accounting financial instruments. The CFA Institute letter[79] further addressed some of the more specific disclosure enhancements required in light of the proposals and our previous comments are consistent with recommendations made in **Section 5**.

Table 6-3.2: Current versus Prospective Hedge Accounting Requirements

HEDGE ACCOUNTING ATTRIBUTE	CURRENT IFRS REQUIREMENTS	IASB PROPOSALS UNDER HEDGE ACCOUNTING STAFF DRAFT
Disclosures	• Primary focus on financial statement (i.e. income statement and balance sheet) effects of hedge accounting. • Derivatives disclosures mandated by IFRS 7 (i.e. credit, liquidity, and market risk and fair value disclosures).	• Various disclosures proposed to help provide information about risk management strategies where the hedge accounting election is made. • Proposals are described by the IASB as disclosures that aim to provide a top-down portrayal of risk management. These disclosures include information about: o Risk management. o Effects of hedge accounting on the primary financial statement. • Scope restricted to hedge accounting disclosures.
Hedge Accounting Objective	• No explicit hedge accounting objective. • Focus is on offsetting gains or losses of the hedging instrument and hedged item. • Hedge accounting is optional.	• The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or OCI (e.g. for investments in equity instruments for which an entity has elected to present changes in fair value in OCI). • Hedge accounting is optional.

[79] Ibid 12.

Table 6-3.2: Current versus Prospective Hedge Accounting Requirements

HEDGE ACCOUNTING ATTRIBUTE	CURRENT IFRS REQUIREMENTS	IASB PROPOSALS UNDER HEDGE ACCOUNTING STAFF DRAFT
Hedge Accounting Qualifying & Effectiveness Assessment Criteria	• Quantitative criteria of '80-125%' offsetting gains or losses. • Effectiveness assessed on both a retrospective and prospective basis.	• Eliminates the '80-125%' offsetting effectiveness' quantitative threshold. • Will use only a prospective (or forward looking) assessment of hedge effectiveness that is required to be assessed at inception and on an ongoing basis (at a minimum at each reporting date or a significant change in circumstances). Entities must use assessment methods that capture the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Therefore, the method can be qualitative or quantitative as appropriate for the situation.
Changes to Designated Hedging Relationship	• Failed effectiveness tests result in termination of designated hedging relationship. • Voluntary de-designation of hedge relationships is allowed.	• Rebalancing required. Rebalancing consists of an adjustment of the quantity of hedging instrument or hedged item to ensure the continuing compliance with the hedge ratio related requirements. • Eliminates voluntary de-designation of hedging relationships.
Recognising Hedge Ineffectiveness	• Cash flow hedges: only over-hedged amounts are recognised as ineffective.	• Retains current requirements.

Table 6-3.2: Current versus Prospective Hedge Accounting Requirements

HEDGE ACCOUNTING ATTRIBUTE	CURRENT IFRS REQUIREMENTS	IASB PROPOSALS UNDER HEDGE ACCOUNTING STAFF DRAFT
Eligibility of Hedging Instrument	• Only derivatives instruments may be designated as hedging instruments for fair value and cash flow hedging treatment. • Non-derivatives instruments can be designated as hedges of foreign currency risk.	• Extends eligibility of hedge accounting to cash-based (i.e. non-derivative) financial instruments if they are already measured at fair value through profit or loss. Changes focus of eligibility for hedging instruments away from whether it meets the definition of a derivative.
Eligibility of Hedged Item	• Derivatives cannot be treated as hedged items.	• Allows aggregation (in some situations including derivatives) with other items for qualification as hedged items. • Net positions (including net nil positions0 allowed to qualify as hedged items.
Presentation	• Hedged items' gains or losses are not presented separately.	• Hedged items' gains or losses are not presented separately.

IFRS 7 mandates disclosures for financial instruments, including derivatives (i.e. credit, liquidity, and market risk and fair value disclosures). In addition, IFRS 7 specifies hedge accounting-related disclosures with a primary focus on financial statement (i.e. income statement and balance sheet) effects of hedge accounting. **Table 6-3.3** below has a breakdown of hedge accounting disclosure requirements under IFRS 7. Non-designated derivatives are addressed under the rest of IFRS 7 related to financial instruments. For example, there are no additional disclosure requirements for derivatives that are economic hedges.

Table 6-3.3: Hedge Accounting Disclosure Requirements

Cash Flow Hedge	Fair Value Hedge	Net Investment Hedge
Description of hedge type	Description of hedge type	Description of hedge type
Hedging instrument and its fair value at reporting date	Hedging instrument and its fair value at reporting date	Hedging instrument and its fair value at reporting date
Nature of risks being hedged	Nature of risks being hedged	Nature of risks being hedged
Periods when cash flow hedges are expected to occur and when they are expected to affect profit or loss	Gains or losses on hedging instrument	Ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations
A description of any forecast transaction for which hedge accounting had been previously used, but which is no longer expected to occur	Gains or losses on the hedged item attributable to the hedged risk	
Amount that was recognised in OCI during the period		
Amount reclassified from OCI (equity) to profit or loss, showing amount in each line item in income statement		
Amount removed from OCI during the period and included in initial cost or other carrying amount of either: o A non-financial asset or o Non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction		
Cash flow hedge-related gains/losses		