Project	**Hedge Accounting**
Topic	**User Outreach Feedback**

Introduction

1. Phase 3 of the comprehensive project to replace IAS 39 is hedge accounting. The goal of this phase is to fundamentally reconsider the existing hedge accounting model including presentation and disclosures. Since September 2009 we have actively reached out to interested parties. Between September 2009 and January 2010, we reached out to preparers and auditors to seek feedback on common practice issues. During that period, we along with some Board Members met with more than 40 interested parties.

2. Since January 2010, we have focused on users of financial statements. The purpose of this outreach was to gain an overall understanding of how users view hedging and how an entity's hedging activities affect their analysis and decisions including soliciting views on presentation and disclosure. We also sought insights on how users understand the existing IAS 39 hedge accounting model.

3. **The purpose of this paper is to:**

   (a) provide an update of our recent user outreach activities; and

   (b) summarise the views we have received from these user outreach activities to the Board.

4. An overall comment. Of all the phases of the project to replace IAS 39, this phase of the project has elicited the highest number of requests from constituents for meetings with the staff and Board members (that is, meetings were not

solicited by us). Furthermore, the requests have come from the broadest range of constituents (most notably, from non-financial entities who generally did not appear particularly engaged with the classification and measurement and impairment phases). The staff has spent a considerable amount of time satisfying the requests for meetings. The staff also believes that the meetings have provided valuable feedback and input. We continue to receive requests for meetings, and of course believe it is important that the staff and Board members continue to meet with interested constituents. However, it is important for the Board to note that such meetings do involve significant staff time and resources.

User Outreach update

5. Our aim is to reach out to a broad range of individual buy and sell side analysts across different industries and geographical regions. As hedging is more common in some industries, we reached out to sector specific analysts such as those following companies in the mining, airlines, banking, oil and gas, utilities and shipping industries. We are also mindful of the different levels of understanding of hedge accounting among users and hence we reached out to analysts from both large and boutique firms. To date we have reached out to over 30 individual analysts. We have also reached out to various user groups including the Analyst Representative Group (ARG) and the Corporate Reporting Users Forum (CRUF).

6. We used a 'free format' approach for our outreach meetings in order to understand the perspective of the people we talked to and because of the diversity of backgrounds and views among the analysts. Broadly speaking, within that free format we covered the following key aspects:

   (a) How do you deal with derivatives in your analysis?

   (b) How do an entity's hedging activities affect your analysis?

   (c) What information do you find useful for your understanding of an entity's hedging activities?

(d) What are examples of good disclosures you have come across (both within in financial statements and elsewhere ie in non-GAAP disclosures, investor presentations, management reports)?

Feedback summary

7. Overall there was a broad spectrum of views among different analysts. Views varied among buy and sell side analysts, analysts from larger firms and smaller firms and various sector analysts.

8. Broadly speaking, analysts are interested in long-term, recurring value drivers that impact cash flows of the business. Their goal is to project an underlying earnings figure that excludes one-off, non-recurring items such as interim fair value changes on derivatives that will not be realised. When considering forecast transactions affected by exchange rate or commodity price volatility, analysts are interested in the 'hedged' sale or purchase prices in order to forecast future cash flows of the business.

9. Moreover, in performing their analysis, analysts apply a cost-benefit assessment. Analysts generally do not spend a great amount of time to perform detailed analysis on or closely examine the information relating to hedging. Their main reasons are as follows:

   (a) derivatives by their nature are difficult to understand and analyse;

   (b) analysts tend to focus on the more immediate risks that potentially have significant impact on the cash flows of the business, eg for aviation companies, the impact of macro economic activity, supply and demand of air travel and oil prices;

   (c) lack of transparent information in the financial statements on the use of derivatives and the complexity of the accounting requirements; and

   (d) the long-term underlying performance is not affected.

Dealing with derivatives

10. Almost all analysts we spoke to exclude fair value changes arising from derivatives used for hedging when analysing the entity's performance. They perceive these non-cash fair value changes as 'noise' that should be 'stripped out' in order to normalise earnings. Consequently, many analysts want information that allows them to unwind the effects of hedge accounting so they can apply their own judgment on how effective an entity's hedging strategy is. Where derivatives do not qualify for hedge accounting but are considered reasonable hedges the change in fair value is typically eliminated from profit or loss (ie backed out) and the forecast of future hedged items (eg sales or purchases) to the extent hedged is adjusted so that it is based on the contractual terms of the derivatives (eg strike prices or forward rates).

11. Most analysts of non-financial institutions were not overly-concerned with management speculating with derivatives that are portrayed as hedges. Most analysts also believe that within the sectors or industries they cover, hedging activities are relatively standard and straight-forward and the companies' hedging activities are generally consistent with the underlying business of the companies they follow. Although most analysts admit that speculation portrayed as hedging might be a risk they further noted that the industries they follow are full of risks and risks associated with hedging are only one of many. The differentiation between hedge accounting and 'trading' under IAS 39 was generally not considered a useful indication of when derivatives are used for speculation occurs rather than hedging. This often results in reliance on non-GAAP information for lack of a better alternative.

12. Banking analysts were slightly more concerned with management speculating with derivatives portrayed as hedges. There were divided views among banking analysts on whether existing derivative disclosures were adequate. Some believe that current disclosures are adequate while others would prefer more disclosures, particularly disclosures on counterparty credit risk.

13. Most analysts agree that the distinction between speculative[1] and hedging derivatives along with the respective volumes and gains/losses is useful. Users are interested in the entity's purpose in holding a particular derivative. The outreach discussions showed that many users would use the risk management of the entity at least as the starting point for distinguishing between speculation and hedging.

Hedging activities

14. The level of detail in which hedging activities are analysed varied between buy and sell side analysts and analysts from larger and smaller firms. Buy-side analysts tend to look at hedge activities in less detail compared to sell-side analysts. Analysts from smaller boutique firms also spend less time considering an entity's hedging activities and focus their resources on operational aspects of the entity that they believe are key value drivers. This is because these analysts tend to cover a wider range of entities in less depth.

15. Several analysts of non-financial institutions indicated that within industries that actively hedge, best practices have developed on how to communicate hedging activities and their effects to investors. Although this information is often not provided within the financial statements, analysts find such non-GAAP information useful. Most analysts also indicated that they are relatively comfortable relying on management to provide them with information on an entity's hedging activities.

16. Overall, analysts are interested in an entity's risk exposures and how the entity manages those exposures through the use of hedging instruments. This involves identifying the underlying performance and how that is influenced by hedging. The time horizon of the hedges is of particular relevance as hedges influence the

[1] This is not to be confused with the use of (held for) 'trading' in IFRS literature, which reflects a *deemed* purpose depending on accounting definitions and criteria rather than actual circumstances.

performance only over a finite period after which the exposure are unhedged.[2] Most analysts believe that hedge accounting should reflect the entity's internal risk management approach. Some analysts noted that the current IAS 39 requirements have changed behaviour ie some entities stopped entering into economic hedges as they cannot achieve hedge accounting. This was considered a concerning knock-on effect of today's hedge accounting rules. These analysts believe that accounting should reflect the economics of an entity's hedging strategy rather than change it.

17. For *some* analysts, management's assessment on how effective its hedging activities are is useful. Such information provides insight on how an entity positions itself and thinks of its risk exposures. This information along with information that allows unwinding the hedges allows analysts to build their own models on effectiveness and compare that to management's view. Moreover, when combined with retrospective information on how effective a hedging strategy actually is, analysts can track how accurate management is in determining the effectiveness of its hedging strategies.

18. Other analysts are not overly-concerned about the recognition of hedge ineffectiveness because:

    (a) they consider their own understanding of the sector they cover as sufficient to gauge whether ineffectiveness (eg basis differences) could be significant (and choose to ignore it under cost/benefit considerations if they think it is unlikely to have a significant impact); and

    (b) it is more important that the 'big picture' is right (ie that derivatives used for hedging are treated as hedges) rather than determining exactly the hedge ineffectiveness (eg this view was expressed regarding the use of credit default swaps as hedging instruments[3]).

[2] Until new hedges are entered into, which would reflect different circumstances though (ie those when they are put in place).
[3] See paragraph 29(b).

19. Many users noted that today's hedge accounting requirements are overly-complex. Many do not understand why hedge accounting is achieved in some situations and not in others. The arbitrariness (and the technicality of the reasons why hedge accounting is disallowed in some situations) is contributing to the use of non-GAAP information instead of IFRS-based information. Some also treat all derivatives that are considered hedges as if they were perfectly effective. This reduces the complexity of their analysis when the hedge ineffectiveness is not considered potentially significant enough to change the 'big picture'. This complexity has encouraged analysts to 'strip out' the effects of hedges (whether hedge accounting was achieved or not) and/or to simply rely on information provided by management.

20. As part of our outreach we specifically asked whether hedge accounting should be mandatory. Analysts' responses were mixed. Some think that mandating hedge accounting enhances comparability and reduces time needed in performing analysis while others think that the current option should be retained. Most analysts were unsure.

Useful information in understanding hedging activities

21. In gathering feedback on analysts' views on hedge accounting, we also solicited views on useful information that could potentially be required within the financial statements. Some general comments included:

    (a) *Nature of information: GAAP v non-GAAP information* – most analysts do not have a strong preference for whether the information is GAAP or non-GAAP. For many analysts, the key difference is that GAAP information is audited. However, for purposes of understanding an entity's hedging activities, many analysts find information within non-GAAP sources such as non-GAAP reconciliations of the reported to an underlying earnings figure (that strips out the effects of gains and losses on derivatives), investor presentations, and production forecasts more useful than GAAP information. Analysts believe this is because management has more flexibility in how and what to present, which facilitates an explanation of what is done, and why. Non-GAAP sources often include graphs, charts and tables. Management is also able to present forward-looking forecasts in non-GAAP reports. We note that mining and aviation companies in particular provide a wide-range of non-GAAP information to their analysts.

(b) *Amount of information: more v less* – views on how much information should be provided varied significantly between analysts. Some analysts believe that to fully understand an entity's hedging activities a large volume of detailed information would need to be provided. Some of these analysts believe that this would be *too much* information and is of marginal benefit to their overall analysis whereas others would prefer more information relating to hedging activities to be disclosed. However, other analysts think that hedge accounting information would be more useful if it was concise focusing on the key points (rather than abundant detail) so that the 'message' does not get lost.

(c) *Frequency of information: quarterly v annual:* – most analysts prefer quarterly information. However, some analysts preferred better quality annual disclosures compared to more frequent disclosures that analysts might not have time to fully analyse. Several analysts noted that fair value information relating to the reporting date (interim or annual) is generally useless by the time analysts perform their analyses. The time lag between reporting date and publication of financial statements means analysts work with outdated information.

(d) *Geography of information: dispersed v in one note:* – most analysts did not have a particular preference on where the information should be provided (so long as the information is available). Some analysts think that providing disclosures on hedging activities in one note helps them save time in their analyses.

22. Most analysts emphasised the importance of comparability in information provided both across entities and across reporting periods. Some analysts noted that specific hedges can be very long-term hence comparability across reporting periods is important.

23. More specifically, analysts would like information on the following:

    (a) gross exposures and hedged volumes (ie terms and conditions or forecasts);

    (b) how exposures are mitigated ie what strategies or instruments are used;

    (c) the effects of the risk management strategy ie the resulting net exposure; and

    (d) timing ie when the hedging activity will have cash flow effects.

24. Analysts want qualitative information ie a description of an entity's hedging strategy. Analysts also emphasised the importance of simple and clear language when describing complex hedging strategies.

25. As there are qualification requirements to hedge accounting, analysts want information on which derivatives qualify for hedge accounting and which ones do not but are economically used to hedge. In cases where a hedging relationship does not qualify, information on why it did not qualify is useful. With this information, analysts can determine for themselves how effective the entity's hedging strategy is.

26. Moreover, as mentioned above, analysts want information that allows them to unwind the effects of hedge accounting. Specifically analysts think the following information is useful:

    (a) notional amounts;

    (b) fair values (at year end and latest fair value) and changes in fair values from derivatives that are hedges; and

    (c) contractual terms including timing/maturities.

27. Other useful information analysts identified include:

(a) sensitivity analysis – views on the usefulness of sensitivity analyses varied among analysts. Some find such analysis useful in forming forecasts ie analysts can make an independent prediction on the change in interest rates or oil price and use the sensitivity analysis to determine the financial effects. However, some analysts think that sensitivity analyses provided under IFRS 7 are not useful as they never depict the right scenarios and because of their limitation to effects arising from recognised financial items. Consequently analysts build their own sensitivity analyses and use the sensitivity analyses within the financial statements for back testing. Some suggested sensitivity analyses to include the effects of extreme scenarios ie maximums and minimums. Tables with the effects of hedging for common scenarios (eg sales revenue depending on FX rate scenarios or oil sales revenue depending on oil price scenarios) was useful particularly when complex derivatives are used (eg options).

(b) run-off profiles/maturity tables – some analysts think that disclosures that provide information that spans the life of a hedging relationship (noting that some hedges are long-term) is useful. For many analysts information on expectations and timing ie when deferred items will impact earnings are essential to their analyses.

(c) roll-forward disclosures – some analysts think that roll-forward disclosures on balance sheet items subject to fair value changes and derivatives is useful.

28. Some analysts commented that Topic 815 (FAS 161 *Disclosures about Derivative Instruments and Hedging Activities*) resulted in useful disclosures.

Specific issues

29. At our meetings the following specific issues were discussed:

(a) *Counterparty credit risk* – many analysts want more information on counterparty credit risk. More specifically, they want disclosure of the counterparties and the concentration of counterparty credit risk. Some other suggested disclosures included counterparty credit ratings and positions by counterparty. For some analysts, information on whether the derivative is exchange traded or over the counter is also useful. Some analysts further indicated that information on margin and collateral requirements is also useful. Most analysts believe that enhanced credit risk disclosures in a broader context are helpful. Analysts noted that counterparty credit risk is more of an issue to smaller entities whose counter parties are not large financial institutions.

(b) *Ineffectiveness* –Many analysts were not overly-concerned about hedge ineffectiveness. Some analysts think that ineffectiveness is secondary information and many currently assume that hedges are perfectly effective. When asked whether items like basis risk and location differences should be accounted for as ineffectiveness, analysts had mixed views. However, analysts broadly think that it is reasonable to use the closest possible derivative (or non-derivative hedging instrument). Analysts generally do not think all hedges must be 100% (or nearly perfectly) effective to be sound. They agree that any thing that falls short of offsetting should be recognised in profit or loss. For example, some banking analysts think it is acceptable for banks to hedge their loan books with CDSs even if the hedging relationship will involve potentially substantial ineffectiveness. In their view such derivatives are the best available hedging instruments. The ineffectiveness that results reflects the cost the bank is willing to bear to hedge. With regard to information on ineffectiveness, some analysts suggested information about the cause of ineffectiveness and disaggregation of the ineffective amount might be useful. This information allows analysts to track historically how effective management is in assessing the effectiveness of their hedging strategies.

(c) *Time value of options* – views on the treatment of the time value of option hedging instruments varied. Some analysts prefer that the amount be amortised over the life of the derivative and some prefer that the amount be an adjustment to the carrying amount of the hedged item.

(d) *IASB's tentative approach* – views on the IASB's tentative approach also varied. Some analysts think the tentative approach enhances transparency by presenting all hedging activities in OCI with adequate disaggregation. However, some analysts do not favour the approach as they see a distinction between hedging balance sheet items or periodic flows for operating items ie fair value hedge versus cash flow hedge distinction.

Next Steps

30. As highlighted in the above summary, there was a broad spectrum of views among different analysts on what is useful information for understanding an entity's hedging activities. We will continue reaching out to more analysts, particularly those in sectors and geographical regions that we have not yet covered. Many of the analysts we spoke to directed us to examples of good disclosures both within annual/interim reports and non-GAAP sources ie non-GAAP reconciliations and investor presentations. We will take these best-practice examples into consideration in developing presentation and disclosure requirements.

31. On the basis of the outreach feedback to date we think it is important:

(a) to continue our outreach; and

(b) to continue to approach hedge accounting by *fundamentally* revisiting the topic in order to be able to address the concerns about today's hedge accounting rules. A common message the staff have heard from users and others is that the Board should not 'rush' this phase, but rather should spend whatever time necessary to overhaul current requirements (rather than simply ‘tweak’ current requirements).