Illustrative example

Proposed disclosure requirements for hedge accounting (paragraphs 40-52, BC183-BC208 and IE1-IE3)

This example has been prepared by the staff of the IASB. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

This example:

(a) aims to illustrate the application of the proposed disclosure requirements in the exposure draft *Hedge Accounting*;

(b) does not illustrate disclosures required by existing IFRSs; and

(c) uses a small oil producing company as a basis for the information presented.

The objective of this example is to assist users of financial statements to understand the extent of the information provided by the proposals set out in the exposure draft.

The example consists of:

(a) an extract from the statement of financial position and the statement of comprehensive income (this does not form part of the proposed disclosures); and

(a) proposed disclosures in the notes of the financial statements.

Extract from the primary financial statements

The statement of financial position had the following balances in the accounts at 30 June 20X9:

	CU millions
Assets	
Derivative financial instruments	8.90
Loans receivable	15.00
Firm commitment	0.40
Liabilities	
Derivative financial instruments	(15.00)
Accounts payable	2.00
Loan payable	40.00
Loan payable—hedge adjustment	2.90
Equity	
Cash flow hedge reserve	(9.00)

The statement of profit or loss and other comprehensive income had the following totals at 30 June 20X9:

	CU millions
Profit or loss	
Other financial gains/losses (time value of options)	(1)
Hedge ineffectiveness	(7.00)
Foreign exchange gain	0.60
OCI	
Fair value hedges	
Changes in value of the hedged item	2.50
Changes in value of the hedging instrument	(2.60)
Ineffectiveness transferred to profit or loss	0.10
Cash flow hedges	
Changes in the value of the hedging instrument	43
Amounts transferred to profit or loss	(32)

Proposed disclosure requirements

Notes to the financial statements of XYZ
Note xx: Hedge Accounting

Commodity price risk

Commodity price risk is the most important market risk for the company. The risk is managed in USD. The company has established guidelines for entering into contractual arrangements (derivatives) in order to manage its commodity price risk. Commodity price risk is managed on a mid-term basis. The commodity derivatives are priced using pricing benchmarks (mainly Brent).

The company estimates production to be on average 55,000 barrels of oil per day for 20X0 and hedges only a certain proportion of that production. This leaves the company in a position to benefit from rises in prices for crude oil while protecting a minimum level of profitability of its main production assets (refer to the management report, Section XX). To manage the commodity price risk, the company enters into commodity-based derivative contracts, which consist of exchange-traded put options and over-the-counter forward contracts. The company is able to integrate all their oil production (and forecasts) into a centralised risk management system because of the small size of its operations and the fact that production operations are managed from one subsidiary.

The company's hedge position can be summarised as follows:

	20X0	**20X1**	**20X2**
Basis of total price risk exposure (barrels of oil per day)	55,000.00	60,000.00	65,000.00
Exposure hedged			
Forward sales contract			
Basis of hedged exposure (barrels of oil per day)	14,500.00	6,000.00	6,000.00
Average hedged rate USD/per barrel	81.75	85.50	88.00
Put options			
Basis of hedged exposure (barrels of oil per day)	14,500.00	6,000.00	nil
Average hedged rate USD/per barrel	≥75.00	≥70.60	nil

The oil hedges of the company involve basis risk. The grade of the oil that the company produces differs from the grade of the oil referenced in the derivative contracts. Those contracts (both for the OTC and exchange traded derivatives) mainly refer to the Brent crude oil price as a benchmark. The company's oil production trades on average at about 80 per cent of Brent crude oil prices. Hence, fluctuations around this average create hedge ineffectiveness.

OTC derivatives involve credit risk. The company uses collateral arrangements with its main lenders that are also the counterparties to the company's OTC derivative contracts to reduce credit risk (see Note XX.b on Financial Risk Management—Credit Risk). However, some credit risk remains and can result in hedge ineffectiveness.

Interest rate risk

The company manages its interest rates by converting the cash flows from long-term loans payable (CU 50 million) with fixed interest rates into floating rate interest payments. The company applies this strategy because it wants its funding costs to flow in step with market changes.

Loans payable are normally borrowed at a fixed rate in local currency. These loans are converted to floating rate loans using interest rate swaps. Under interest rate swaps, the group agrees with other parties to exchange, at specified intervals, the difference between interest amounts calculated by reference to an agreed notional principal and agreed fixed and floating interest rates. The company hedges only the benchmark risk component.

The company's interest rate risk exposure can be summarised as follows:

Fixed interest—loans payable				
	20X0	**20X1**	**20X2**	**20X3**
Basis for total interest rate risk exposure (CU million)	40.00	30.00	20.00	10.00
Average fixed interest rate	6%	6%	6%	6%
Exposure hedged				
Basis for the exposure hedged	40.00	30.00	20.00	10.00
Receive fixed interest payments	5.90%	5.90%	5.90%	5.90%
Pay floating interest rate	LIBOR+2%	LIBOR+2%	LIBOR+2%	LIBOR+2%

At the year end the entity had only receiver swaps. With effect from 1 January 20X9 a notional amount of CU 50 million with a 6% fixed rate was swapped for a floating rate of 3m LIBOR +200bps. This contract expires on 1 January 20X5. The result of the hedge is an effective interest expense of LIBOR +245bps (3m LIBOR + 200bps + 40bps [fixed leg differential] + 5bps [transaction cost]).

The company's interest rate swaps are subject to credit risk. The company uses collateral arrangements to mitigate credit risk (refer to the disclosure of commodity price risk above). However, the remaining credit risk can result in hedge ineffectiveness.

Under the approach used by the company, the fair value hedging of fixed rate liabilities gives rise to limited hedge ineffectiveness because of the reset interval (3 months) of the floating leg of the interest rate swap.

Please note:
This example illustrates a simplified scenario. In situations where an entity hedges the interest rate risk of many loans (or other items), it might be more appropriate to present the disclosure using a maturity analysis format for each type of hedge.

For example:

	1 year	***2-5 years***	***>5 years***
Fixed interest loans payable			
Etc…			

Foreign exchange risk

The company has limited exposure to foreign exchange risks. Its purchases and sales are mostly denominated in its functional currency.

The company's hedge position can be summarised as follows:

USD/EUR exposure—Assets	**20X0 USD million**
Basis for total foreign exchange risk exposure managed (firm commitment)	6.00
Exposure hedged	
Basis for the foreign exchange risk hedged	6.00
Average hedged rate	n/a

During the year the company entered into a firm commitment transaction to purchase property, plant and equipment of EUR10m. The investment appraisal was based on the functional currency because of the related cash flows generated by the equipment. Consequently, the cost of the investment was locked in as an amount in the functional currency using foreign currency hedging.

The company designated EUR10m of a high credit quality loan of EUR25m as the hedging instrument for foreign exchange risk. The loan is denominated in the same currency as the currency of the firm commitment. The company did not hedge the remaining EUR15m of the loan. This is because that loan is naturally offset against other assets and liabilities of the entity.

This hedge is fully aligned with the exposure regarding the hedged FX risk, which is measured using the spot rate method.

Statement of financial position information related to the designated hedging instruments

	Notional amount of the hedging instrument	Carrying amount of the hedging instrument	
		Assets CU millions	Liabilities CU millions
Cash flow hedges			
Commodity price risk *(see page 5)*			
- Oil forward sales contracts	9,540,000 barrels	2.00	15.00
- Oil put option contracts	7,380,000 barrels	3.90	-
Fair value hedges			
Interest rate risk *(see page 7)*			
- Interest rate swaps	CU 50,000,000.00	3.00	-
Foreign exchange risk *(see page 8)*			
- Loan	FC 10,000,000.00	6.00	-

Statement of financial position information related to designated hedged items

	Separate line item recognised in the balance sheet for the gain or loss on the hedged item		Cash flow hedge reserve
	Asset	Liabilities	
Cash flow hedges			
Commodity price risk *(see page 5)*			
- Forecast sales	n/a	n/a	(9.00)
- Discontinued hedges (forecasted sales)	n/a	n/a	-
Fair value hedges			
Interest rate risk *(see page 7)*			
- Hedge adjustment loan payable	-	2.90	n/a
- Discontinued hedges (hedge adjustment—loan payable)	-	-	n/a
Foreign exchange risk *(see page 8)*	0.40	-	n/a
- Firm commitment			
- Discontinued hedges			

Effect of hedging activities on the statement of profit or loss and other comprehensive income

Cash flow hedges[1]	**Change in the value of the hedging instrument**	**Ineffectiveness in profit or loss**	**Line item in profit or loss (that includes ineffectiveness)**	**Amount transferred out of AOCI to profit or loss**	**Line item in profit or loss (that includes transfer)**
- commodity price risk *(see page 5)*	43.00	(6.90)	*Hedge ineffectiveness*	(32.00)	*Revenue*

Fair value hedges	**Change in the value of the recognised hedged item**	**Change in the value of the hedging instrument**	**Ineffectiveness in profit or loss**	**Line item in profit or loss (affected because of ineffectiveness)**
- interest rate risk *(see page 7)*	2.90	(3.00)	(0.10)	*Hedge ineffectiveness*
- foreign exchange risk *(see page 8)*	(0.40)	0.40	-	n/a

[1] The information disclosed in the statement of changes in equity (cash flow hedge reserve) should be presented using the same level of granularity as the proposed disclosure requirements.