Disclosures on Derivatives and Hedging Transactions

A Review of Best Practices

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FASB’s disclosure requirements provide a fair amount of detail about derivatives and hedging transactions; yet, despite efforts by auditors to comply with them, readers of financial statements often find that these disclosures are not entirely satisfying. Some of the required information might be presented in a manner that is misleading or confusing. Perhaps more importantly, the discussion might fail to appropriately or adequately describe the nature or scale of the activities under consideration. The best practices described below can make disclosures on derivatives and hedging transactions more helpful to financial statement users.

Disclosure Pitfalls

U.S. GAAP requires a host of disclosures related to derivatives, irrespective of 1) the type of derivative, 2) whether it is used for hedging or speculative purposes, and 3) the type of accounting treatment applied—for example, nonhedge accounting, cash flow hedge accounting, fair value hedging, or hedges of net investments of foreign investments. The following nonexhaustive list highlights the disclosures required in all of the aforementioned circumstances:

- The context needed to understand intended hedge objectives (i.e., how the derivatives affect the entity’s financial position, financial performance, and cash flows)
- The accounting treatment applied in connection with derivative transactions, for both the hedged item and the hedging derivative when hedge accounting is applied
- The location of the fair value of the amounts of derivatives reported on a gross basis, presented as assets or liabilities, and segregated by market segment (e.g., interest rate, foreign exchange, commodity, or other)
- The location and amount of the gains and losses on any hedging derivative and related hedged items reported in the income statement or balance sheet
- Identification of effective versus ineffective outcomes, as well as components of results that had been excluded from consideration of hedge effectiveness
- The net gain or loss recognized in earnings when a firm commitment no longer qualifies as a hedged item in a fair value hedge
- For cash flow hedges, a description of the conditions that will result in the reclassification of accumulated other comprehensive income (AOCI) into earnings and a schedule of the estimated reclassification expected in the next 12 months
- For cash flow hedges, except hedges of variable interest rate exposures, the maximum length of time that hedging is anticipated
- The amount reclassified into earnings as a result of discontinued cash flow hedges because associated forecasted transactions are no longer probable.

Not all of this list is straightforward and unambiguous. Two of the preceding points are particularly prone to misinterpretation—the requirements relating to the disclosures of ineffective earnings and prospective reclassifications.

One of the critical preconditions for hedge accounting to be applied is that hedges have to be shown to be “highly effective” in offsetting the effects of the risks being hedged. If these offsets don’t occur with sufficient closeness, hedge accounting is simply disallowed. Presumably, if the high-effectiveness hurdle has been satisfied, these impacts on ineffective earnings would be of a relatively minor magnitude. The amount of ineffective earnings is a specific disclosure requirement; however, the value of this disclosure is questionable.

How should readers of the financial statements interpret this disclosure? One of the two following assumptions could be made:

- Ineffective earnings could simply reflect a transitory hiccup in a reasonably robust hedge relationship, in which case the ineffectiveness recorded in the current period would likely be reversed in subsequent periods.
- Ineffective earnings could be an indicator of things to come.

Without added discussion by preparers, readers might not know which interpretation is correct. Unfortunately, even the hedging entity might not have a clue as to whether the ineffectiveness is temporary or permanent. Given this inherent uncertainty and the fact that the magnitude of the ineffectiveness is necessarily constrained, why bother with this disclosure, aside from the obvious fact that it’s mandated? The prospect of the disclosure providing any information of value is limited, while simultaneously opening the door for misinterpretation. And if this is the case, perhaps the reporting entity should caution users about making an inappropriate judgment. To FASB’s credit, these kinds of qualitative disclosures are encouraged.

The second disclosure pitfall relates to the requirement to disclose the amount that is expected to be reclassified out of AOCI into earnings in the upcoming 12 months. Consider two companies, identical in every way except for this disclosure value. The first reports an expected gain of $X in the upcoming 12 months from this reclassification process, while the second projects a loss of...
$Y. (While hypothetical, this situation could arise if the two entities entered into their respective hedges at different times and different prices—for example, if one entity entered into the hedge when prices were high, and the other entered into the hedge when prices were low and then quarter-end prices moved to a midrange value.)

Most readers of the two respective disclosures would likely judge the first company (i.e., the one reporting deferred gains) to be in the more favorable circumstance. Unfortunately, just the opposite is likely to be the case. At first blush, financial statement users need to be reminded that this reclassification relates to an effective hedge, such that the earnings or losses associated with the derivative should be expected to be equal to and opposite of the earnings impact relating to the risk being hedged. That consideration might make it seem as if neither the magnitude nor the direction of the disclosed, projected reclassification amount would be relevant. That conclusion would only hold, however, if the entirety of the exposure were being hedged, which is rarely the case. Typically, companies hedge only a portion of their exposures, rather than the whole; in those cases, the preferred outcome would be one where the company could claim a huge loss due to reclassification as good news, because it could expect an even larger positive earnings effect coming from its overall (hedged plus unhedged) exposure.

**A Better Disclosure?**

The consideration above highlights what might be the most critical omission of the disclosure requirements: the rules fail to require a transparent presentation of the scope of the hedging activity—that is, the portion of the company’s exposure that is being hedged. Ideally, this information should be presented according to market and type of derivative. It would certainly be relevant to discussions about hedging activity (the first point in the list provided above), but it is not explicitly required; as a consequence, it is often difficult to discern.

At present, reporting entities must disclose the fair values, earnings, OCI allocations, and reclassifications for their derivative positions. This content is required to be broken down by the associated market segment (e.g., interest rate, foreign exchange, commodity contracts) and whether the positions are designated as hedging instruments. The way this information is presented generally follows examples offered in the Accounting Standards Codification (ASC), particularly ASC 815-10-55-182; however, these disclosures fail to show the portion of exposures covered by hedging contracts. This information is critical to understanding the company’s risk orientation and, thus, its prospects for future performance.

In order to provide the proposed information, reporting entities would have to offer a more detailed breakdown of the various instruments in use, reflecting the exposures for which hedging is intended. The following are the predominant interest rate risk exposures for interest rates, foreign currencies, and commodity price risk:

- Uncertain interest rate payments on existing or planned assets and liabilities
- Price risk associated with recognized fixed-rate assets and liabilities
- Foreign currency risks
- Anticipated transactions with foreign counterparties
- Existing assets or liabilities denominated in foreign currencies
- Net investments in foreign operations
- Commodity price risk
- Uncertain payments for commodity purchases or sales
- Inventory price risk.

In a limited number of cases, derivatives may be acting as hedges without hedge accounting being applied, either because the prerequisite qualifying conditions were not satisfied or because the entity simply elected not to seek hedge accounting. Nonetheless, readers of financial statements should be informed about the hedging objectives associated with any contracts that are designed as an economic hedge.

For each of the categories mentioned above, it would seem reasonable and appropriate to disclose information about the associated hedging relationships. For those exposures relating to uncertain future prices (most likely, but not necessarily, cash flow hedges), an improved disclosure would segment exposures into appropriate risk horizons and detail the portion of risks being hedged by existing derivative positions. For example, a company that manages prospective foreign currency purchases or sales may hedge (and disclose that it is hedging) approximately 35% to 50% of purchases anticipated in the most immediate six-month horizon, and 20% to 30% of such exposures for the subsequent 18-month period. Some lack of precision in these proportions should be expected, however, because the volume of forecasted business activity will generally not be known with certainty. As a consequence, a given hedge could end up hedging a higher or lower portion of prospective transactions, depending upon whether the volume of those transactions rises or falls from some initial estimate.

An analogous volumetric uncertainty does not arise for hedges of existing price risk (normally fair value hedges, but not necessarily). In these cases, the risk is associated with recognized assets or liabilities, or with firm commitments. The portion of these risks being hedged should be more readily and more precisely discernible. For such hedges, disclosures would be improved by detailing the portion of any balance sheet price risk that is currently hedged with derivatives.

**Best Practices**

Besides disclosing the percentage of hedge coverage in identified exposure areas, reporting entities should also offer greater detail about the types of derivatives they use—those with symmetric payoff functions (e.g., futures, forwards, swaps), where gains or losses accrue in magnitudes consistent with price changes in either direction, or those with asymmetric payoffs (e.g., options, caps, floors, combinations of each), where payoffs are constrained in some fashion. A company that enters into an interest rate swap has a much different character from one that enters into an interest rate cap. Depending on the extent of the hedging activities, these distinctions could have material effects that would be relevant to discerning analysts.

The “check the box” approach that satisfies FASB’s disclosure requirements for derivatives serves readers of financial statements poorly, especially in light of current disclosure rules that require virtually no directives relating to the portion of exposures being hedged. Businesses could—and should—do better.

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