



THE QUALITY OF DERIVATIVE INSTRUMENTS DISCLOSURE IN ACCORDANCE WITH THE IFRS 7

KVALITET NAPOMENA O DERIVATIVNIM INSTRUMENTIMA U SKLADU SA MSFI 7

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Abstract:

This paper analyses the importance of financial instruments disclosure and transparency of such information following the global financial crisis, in accordance with the accounting regulatory framework, mainly the IFRS 7: Financial Instruments Disclosure. The authors pointed out that derivative financial instruments are mainly used by the companies with the aim to reduce tax liability and the cost of capital. The accounting standards attempted to establish additional criteria for disclosing the effects of these sophisticated transactions by increasing the volume of information on derivative risks. The main hypothesis in this paper is that despite the fact that the accounting rules are quite rigid in terms of financial derivative disclosures, the investors are not satisfied with their quality as they still cannot cover all the risks to which the company is exposed when entering into derivative transactions.

Key words:

financial instruments, risk measurement, disclosure, transparency.

1. INTRODUCTION

One of the biggest challenges in the area of corporate finance following the world financial crisis in 2007-09 was the recognition and measurement of financial instruments, especially derivative instruments. These instruments were blamed for the crisis, but the accounting procedures for recognition and measurement were also determined to be inadequate in terms of revealing key financial risk information. Although the International Accounting Standards Board (IASB) already passed the regulation known as *IFRS 7 Financial Instruments: disclosure*, in 2005, the effectiveness of this regulation as well as the transparency of information regarding the key financial risks related to derivative instruments was at a very low level and users were not able to recognize the magnitude of financial losses incurred by derivative instruments of the companies during the crisis. The authors attempted to emphasize that the accounting rules regarding the financial instruments are detailed and transparent, and that the main discrepancy exists in the area of what is actually reported by the companies.

In order to deeply and thoroughly investigate this problem, we have divided this article into three main sections. Namely, the first section presents the definition and key characteristics of derivative financial instruments in the area of corporate finance while the second section emphasizes the requirements of IFRS 7 regarding the reports on risks. The third section presents research results about the quality and usefulness of derivative disclosure.

Apstrakt:

U ovom radu se analizira važnost napomena o finansijskim instrumentima, kao i transparentnost tih informacija u periodu nakon globalne finansijske krize, a u skladu sa računovodstvenim okvirom za izveštavanje, MSFI 7 Finansijski instrumenti: Napomene. Autori se bave derivatnim finansijskim instrumentima koje kompanije koriste sa ciljem da smanje svoje poreske obaveze, kao i cenu kapitala. Računovodstveni standardi pokušali su da uspostave dodatne kriterijume za napomene o sofisticiranim transakcijama sa derivatima kroz povećanje broja informacija o rizicima koje derivati proizvode. Osnovna hipoteza u ovom radu je da iako računovodstvena regulativa propisuje prilično rigidne zahteve vezane za napomene o derivatnim instrumentima, korisnici finansijskih izveštaja nisu zadovoljni kvalitetom napomena jer ne mogu da ispravno obuhvate sve rizike kojima je kompanija izložena kada ulazi u derivatne transakcije.

Ključne reči:

finansijski instrumenti, merenje rizika, napomene, transparentnost.

2. DERIVATIVE FINANCIAL INSTRUMENTS AND THEIR RELATIONS WITH THE WORLD OF CORPORATE FINANCE

Financial instruments are intangibles and their typical benefit or value is a claim to future cash (Fabozzi, 2002, p. 1). Financial instruments can be divided into primary (stock, bonds) and derivative instruments (options, futures, forward, swaps, forward rate agreement *etc.*), while primary are further classified into debt and equity. Debt instruments are bonds and the issuer establishes the debt relationship with the bondholder obliging himself to pay interest and return back the original amount of investment to the bondholder. By issuing equity instruments, the company finances its business through establishing the obligation to pay the equity holder amount based on corporate earnings. Derivative instruments, which are in business practice more known as „devil instruments „can be defined (Gupta, 2008, par. 2.1) as contracts that give rise to a financial asset of one entity and financial liability or equity instrument of another entity. Derivative instruments (Gupta, 2008, par. 4.1) are financial instruments that derive their value from the price of underlying assets such as stocks, bonds, currency or commodity; and they require little initial investment and are settled at some future date.

Definitions of derivatives published in accounting standards point out that „derivative financial instruments create rights and obligations that have the effect of transferring between



the parties to the instrument one or more of the financial risks inherent in underlying primary financial instruments“ (IASB, 2009). IASB definition focuses on the derivatives used for hedging purposes and risk it transfers.

The following segment describes the typology of derivative contracts used by corporate finance managers. There are three basic types of derivative contracts: forward and futures, swaps and options. Forward contracts are Over the counter, OTC, and they are directly negotiated between the contract parties that specify that certain amount of goods or certain security should exchange hands at some future date at the agreed price. Future contract is traded in organized exchange and can be settled without transferring the goods or security to another party. The characteristics of these contracts are almost the same as those for forward contracts while futures are usually marked to market. Participants are also asked to post a margin in order to reduce the default risk of a counterparty. In swap contracts, parties have an obligation to multi-exchange cash flows related to some financial variable (such as an interest rate or a foreign exchange rate). Options are much more different than previous contracts because they require that an initial premium should be paid by the buyer. The buyer has the right but not the obligation to trade in certain goods or variables. There are two types of option contracts in business practice- call and put option. Call option calls for buying the assets at a strike price, while for the put option, the holder has a right to sell the assets at a strike price. This premium paid by the buyer will be the only costs for the buyer if the prediction about some variable is wrong and the buyer decides to terminate the contract without selling or buying the asset at a strike price. Options have specified the date and they should be executed or terminated prior to that date. When option expires, all rights or privileges for the option holder cease to exist.

Derivative instruments are used for hedging or speculative purposes and the magnitude of using derivatives can be supported by the following results (BIS Report, 2014): the total notional amount of all contracts with derivatives traded in organized exchange (futures and options) were approximately 70 trillion US \$, while all derivatives traded on over the counter markets (OTC) were exchanged for 691 trillion US \$ in 2014. The most widely used derivatives in OTC markets were interest rate swaps, interest rate options and forward rate agreements. Financial market investors believe that the interest rate risk has the highest impact on investment assets in their portfolio, which is why interest rate derivatives are mainly used in trading in OTC markets.

According to the above presented figures, conclusions can be drawn that derivative financial instruments serve for two purposes: hedging the item by avoiding the fluctuations of cash flows or prices of underlying variable (price of material, interest rate, index, currency) and speculative purposes (trading with the underlying risk). Nevertheless, derivative potential for hedging purposes is enormous as they are also used for speculative motives or the possibility to create abnormal profit/return. Speculation is not only related to the financial corporate sector. Many non-financial sector companies use speculation as well (eg. Enron). The world of corporate finance uses derivatives to transfer or mitigate risk of financial variables such as interest rate, exchange rates, commodity prices that affect the core business of a company. Derivatives are enormously useful instruments in managing risk. They can be used (Sundaram, 2013) „to hedge an existing market exposure (forwards and futures), obtain downside protection to an exposure even while retaining upside potential (options), transform the nature of an exposure (swaps), and obtain insurance against events such as default (credit derivatives)“.

Finally, for corporations and financial institutions looking to manage exchange-rate risk, input costs, credit risk and market risk explain why we are facing the rapid growth in derivative markets.

3. THEORY UNDERLINING DERIVATIVE USAGE

Derivative usage has shown rapid increase since 1970. Many researchers have tried to establish certain theories that point out benefits of using derivatives. First, researchers in this area pointed out that those derivatives are used because of reducing taxes (Myers, 1993). If we face convex tax function, they can reduce their tax liability provided that volatility of profit is reduced. In that specific case, the company can predict its future tax liability which provides the opportunity to plan their future operations more effectively. The other researchers found out that the use of derivatives can help reducing the financial distress costs or bankruptcy costs (Smith & Stulz, 1985). By entering the derivative transactions, companies can reduce the risks of doing business and stabilize their profit level and lower the financial distress costs. According to these theories, companies with high leverage ratio, enormous growth opportunities and lower liquidity tend to use derivatives much more than firms without these characteristics. Derivatives can also be used to enhance the company's value, especially when the costs of raising capital are high and the companies tend to optimize their debt to equity ratio (Bartram *et al.*, 2009). Derivatives can be used to increase shareholder value in terms of increasing the possibility for using internal funds and finances such as retained earnings. In conclusion, the evidence regarding the motives of using derivative transactions are various, but the most significant are those related to reducing financial leverage, cost of capital and tax burdens.

4. DISCLOSURE OF DERIVATIVE TRANSACTIONS IN ACCORDANCE WITH IFRS 7

IFRS 7 Financial instruments: Disclosure was published in 2005 and came into effect in 2007. Before the financial crisis hit the economy, it was obvious that the magnitude of derivative transactions was extremely high to be measured in trillion US \$, and that investors need a response about these transactions from the accounting regulatory bodies. IASB decided to publish the IFRS 7 that replaced the IAS 32 Financial instruments: Presentation and disclosure. The main purpose of publishing *IFRS 7* was to enhance information quality of financial instruments and help the users to evaluate the financial risks of the company. Disclosure requirements come in two areas: significance of financial instruments for financial position and results of operations and risk disclosure. Both of these areas of disclosure will be explained in the following sections.

Financial instruments are measured at fair value, and IFRS 7 requires (IFRS 7, par. 7.6) that the information regarding fair value should be disclosed as well as the method and relevant assumptions for calculating fair value. If an instrument is designated for speculation or hedging purposes, IFRS 7 requires that managers classify each derivative instrument in accordance with these two classes. Hedge accounting requirements vary in respect whether the derivatives are used in cash flow hedging or fair value hedging. Fair value measurement is used for all types of derivative instruments with different accounting treatment of gains and losses incurred in subsequent measurement. For instance, all gains and losses on speculative transactions are recognized in profit and loss account, while for derivatives used



for hedging of a cash flow, these gains and losses are recognized in specific section of capital. IFRS 7 par. 7.22-7.24 requires the company to disclose for all types of hedging information regarding the total amount of hedged item, total notional amount of derivative instrument and the type of risk for which hedging is used (currency risk, interest rate risk *etc.*).

IFRS 7 requires that qualitative and quantitative data regarding the nature and risk of derivatives should be recognized in accounting footnotes. In qualitative disclosure requirements exposure to risk is published, as well as objectives, policies and processes for managing risk. Quantitative data comprise specific information related to three types of risks: liquidity, credit and market risk. Liquidity risk refers to derivative instruments requiring cash settlement, and risk related to the counterparty that will not have money to satisfy its derivative position. This risk can be decreased if the company uses futures instead of forwards (because futures require margin to be placed when entering the contract). This risk is evident in other contracts and should be disclosed. Market risk comprises risk that the fair value or future cash flows of financial instruments will fluctuate due to the changes in interest rate or exchange rates or prices of goods. In accordance with the IFRS 7, sensitivity analysis should be performed for each type of market risk showing the impact on profit and loss. Credit risk to which derivatives are exposed refers to the fact that the counterparty in the derivative will cause a financial loss to the contract holder by failing to meet the obligations arising from the contract.

5. THE RESULTS OF RESEARCH ABOUT INVESTOR SATISFACTION REGARDING DERIVATIVE DISCLOSURE

Research was based on the fact that “investors can easily be blindsided regarding the purpose and loss potential of derivative instruments due to uninformative disclosures” (CFA Institute, 2013). The scope of the study conducted by CFA Institute was limited to the derivative instruments only and the research sample comprised 133 investor answers regarding the quality of disclosure. The users are divided into two groups: CFA members and sell side analysts that are included in trading with the derivative instruments. Survey questions were concentrated around (CFA Institute, 2013):

- general usefulness of IFRS 7 disclosure,
- relative usefulness of components of disclosure,
- relative importance with specific categories of disclosures and
- specific use and application of information.

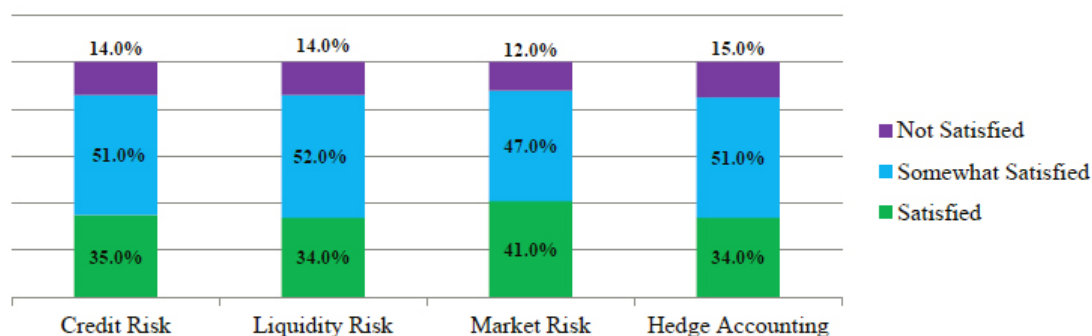
The Graph 1 shows that approximately 51% of the respondents to the questionnaire were satisfied with credit risk, liquidity risk and hedging activities disclosure, while 47% were satisfied with market risk. There is a room to improve the disclosure satisfaction of users in all of these areas. It is noted that disclosures should be in accordance with the IFRS 7, but derivative transactions are so sophisticated that managers are called by this standard to reduce the complexity of derivative information in the footnotes. Footnotes should be tailored to match the average user knowledge about derivative transactions. The limited usefulness of hedge accounting disclosure arises due to these reasons.

After investigation of user satisfaction, CFA constructed the Disclosure Quality Index. The disclosure quality index is not a new methodology in accounting research, as it was previously used by many researchers (see: Zimmerman, 1977). The index that CFA Institute uses comprises the following criteria: desirable presentation, mandatory disclosure, voluntary disclosure with 22 disclosure dimensions.

The extracts of these results are presented in the following table:

	DQI banks	DQI non-banks
Understandability of disclosure		
Sufficient tabular presentation	80%	90%
Ease of use	58%	70%
Notional amount disaggregated by risk and type	83%	30%
Adequately disaggregated quantitative risk exposure	53%	45%
Disaggregation of derivatives accounting by hedge category	85%	85%
Quantitative and qualitative disclosure adequately describing hedging strategies	28%	60%
Disclosure of sources of ineffectiveness	0	0

Table 1. Disclosure Quality Index about derivatives
Source: CFA Institute (2013, pp. 44-45)



Graph 1. Satisfaction of users with disclosure requirement regarding derivatives, risks and hedge accounting

Source: CFA Institute (2013, p. 29)



Table 1 shows the answers of the respondents regarding their satisfaction with derivative disclosure in banking and non-banking sector. The results are published as percentages of their satisfaction while the criteria used are elements of disclosure quality index. We intentionally chose only the elements that we found informative. Users are satisfied with tabular presentation of derivatives in both samples and their satisfaction ranges from 80-90%. In non-banking sector, the users can easily use derivative information (70% were satisfied), while due to the complexity in banking sector they are less satisfied (around 58%). Banks present more information about derivative notional amount according to the type and risk for which derivative is used (83% satisfied). Only 30% of users were satisfied with the notional amount published by non-banking sector companies. Less than 50% in both sectors were satisfied with the quantitative disclosure about risk exposure. Users are generally satisfied with the hedging information published in footnotes in both sectors (85%). It is obvious from the above-given table that the banking sector users are not satisfied with the hedging strategies explained by banks (28%). No satisfaction exists with the disclosure regarding hedge ineffectiveness (0%).

In conclusion, we can add that more should be done by financial statement preparators in order to increase the quality of information regarding derivative transactions. Companies should explain the nature and purpose of derivative instruments used, outlining the difference between the derivatives used for hedging or for speculative purposes. They should also clearly explain hedging strategies being used, cost of hedging, hedging and risk management policies and reduce the complexity of hedging information in the footnotes.

6. DERIVATIVE TRANSACTIONS AND THEIR DISCLOSURE IN SERBIA

Derivative financial instruments can be traded in organized and OTC market by Serbian banks and other non-banking sector companies according to the articles of the Stock Exchange Act (Official Gazette of the Republic of Serbia, 31/ 2011, article 2, par. 6). Although this Act permits the trade, only banks trade in certain quasi derivative instruments (Marinković & Skakavac, 2010), which points out that domestic banks offer private contracts, notably forward and swaps. The National Bank of Serbia also introduces currency swap contract, as a package of offsetting spot and forward transactions. Swap is used by banks to help them manage the currency risk. Also, quasi currency forward contracts exist in the Serbian market. It is a mix of typical terminal agreement and deposit contract (Marinković & Skakavac, 2010). According to the result of the research (Marinković & Skakavac, 2010), questionnaire was sent to bank officials, who answered that they are merely informed about the derivatives, and that they have positive attitude.

The next section presents the disclosure regarding derivatives published by Erste bank, Serbia.

Image 1 presents qualitative disclosure about derivative instruments used by Erste bank in Serbia. In this specific case, derivatives are related to the credit risk and the bank manages this risk by limiting the maximum exposure in derivative portfolio.

Image 2 shows quantitative data about derivatives published by Erste bank in 2013. According to this example, we can conclude that derivatives were used in 2012 and their value was

Derivative Financial Instruments

Derivative financial instruments lead to the Bank's exposure to credit risk in case their fair value is positive.

Such credit risk is limited by determining the maximum fair value of the total derivatives' portfolio, as well as determination of the maximum positive fair value of each individual transaction, having in mind their type, maturity and credit quality of clients.

Image 1. Footnotes regarding derivative instruments in footnotes for the year 2013. published by Erste bank, Serbia

Source: www.erstebank.rs

	2013 RSD thousand	2012 RSD thousand
Funds managed on behalf of third parties (a)	755,714	780,975
Guarantees and other irrevocable commitments (b)	12,941,471	9,730,334
Derivatives (c)	-	792,810
Other off-balance sheet items (d)	18,611,102	19,294,339
Balance as at 31 December	32,308,287	30,598,458

13. LOSSES FROM CHANGES IN VALUE OF ASSETS AND LIABILITIES

	RSD thousands	
	2013	2012
Losses from changes in value of placements and receivables	2,354,971	3,110,820
Losses from changes in value of securities	7,458	20,045
Losses from changes in value of liabilities	163,856	312,125
Losses from changes in value of derivatives	7,680	147,431
Total	2,533,965	3,590,421

Image 2. Quantitative disclosure about derivatives in disclosures of Erste bank for the year 2013.

Source: www.erstebank.rs



792,810 thousand RSD. In 2013, this bank did not enter into the derivative transactions. In footnote number 13, Erste bank recognized in both years losses from changes in value of derivatives in the amount of 147,431 thousand RSD in 2012, which decreased to 7,680 thousand RSD in 2013. Obviously, entering into derivative transaction was not a successful strategy of the bank, because the portfolio has lost 18,5% (147,431/792,810) of its value since the inception of this contract.

Serbian banks attempt to make footnotes regarding financial derivative instruments in accordance with the IFRS 7 requirements. This specific bank presents quantitative and qualitative data in line with the IFRS 7. Information is easily understood because derivative transactions were not sophisticated. Also, we would like to mention that such disclosures can be improved in terms of describing derivative contracts and aggregating them according to the type of risk being managed. This would further contribute to increasing the usefulness of information for the users.

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