

HEDGING STRATEGIES IN MANAGING UNCERTAINTY: THE ROLE IN UZBEKISTAN'S TRANSITION TO IFRS

Master's Degree Marupov Abdushukurbek Alijonovich

Undergraduate Student Kamoliddinov Sherzodbek
Affiliation: Department of Accounting and Audit of the
Andijan Institute of Agriculture and Agro Technologies

Abstract

This article examines the role of hedging strategies in managing uncertainties during Uzbekistan's transition to International Financial Reporting Standards (IFRS), as mandated by Presidential Decree No. 4611 on February 24, 2020. The decree emphasizes the importance of adopting IFRS to provide transparent financial information and enhance access to international financial markets. The article explores how hedging strategies contribute to financial stability and transparency during this transition.

Keywords: IFRS Transition, Hedging Strategies, Financial Reporting, Uzbekistan, Forward Contracts, Options, Futures Contracts, Swaps, Financial Stability, Risk Management, Presidential Decree No. 4611.

Introduction

Following its independence, Uzbekistan initiated a shift towards a market economy, moving away from Soviet accounting methods and adopting globally accepted financial reporting principles. Legislative efforts were made to align national accounting standards with international practices, fostering education and certification systems for accountants. Despite these efforts, the transition to IFRS has been prolonged, partly due to Uzbekistan's historical economic isolation until 2016. This isolation resulted in an accounting system focused on tax reporting rather than providing relevant information to external investors and internal stakeholders.

The Challenges of Transitioning to IFRS

Transitioning to IFRS presents several challenges for Uzbekistan's financial reporting system. The existing system prioritizes tax compliance, leading to financial reports that emphasize tax liabilities over an accurate representation of an organization's financial health. For example, tax authorities are interested in maximizing taxable income, while investors seek accurate information about an organization's net income and asset values. This divergence necessitates a dual accounting system: one for tax purposes and another for financial reporting, which must be harmonized under IFRS to ensure transparency and reduce potential tax and penalty risks.



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Examples from the Tax Code of Uzbekistan illustrate these challenges:

- **Depreciation Rules:** According to Article 298 of the Tax Code, the depreciation of assets and other property is strictly regulated, often leading to lower recorded expenses compared to financial reporting standards. This results in higher taxable income and can differ significantly from IFRS-compliant depreciation (Article 298, Tax Code of Uzbekistan).
- **Tax Deductions:** Certain expenses that are allowable under IFRS may not be deductible for tax purposes. For instance, Article 270 specifies that some expenses related to intangible assets and long-term investments are subject to adjustments, which can create discrepancies between tax and financial reports (Article 270, Tax Code of Uzbekistan).
- **Wear and Tear Norms:** The Tax Code strictly sets the boundaries for depreciation expenses, often encouraging lower write-offs (Tax Code, Article 306).
- **Total Income Calculation:** The Tax Code outlines comprehensive guidelines for determining total income, which might exclude certain expenses recognized under IFRS (Tax Code, Article 53, Chapter on Total Income).

The tax collector is primarily interested in maximizing tax revenue, thus requiring the organization to reflect higher income in their reports, whereas investors are more concerned with the real net income and true value of assets (IAS 12 "Income Taxes" and Uzbekistan's National Accounting Standard 2 "Income from Main Economic Activity").

Hedging Strategies: A Solution to Financial Uncertainties

Presidential Decree No. 4611 mandates that companies adopt IFRS by January 1, 2021, aligning their accounting practices and financial reporting with international standards. This shift, however, introduces financial risks and uncertainties. Efficient hedging strategies, including the use of derivatives such as forwards, futures, options, and swaps, play a crucial role in mitigating these risks. These strategies help stabilize cash flows, maintain favorable exchange rates, and protect against adverse market movements, thereby enhancing financial predictability and stability during the IFRS transition.

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IFRS Standards Related to Hedging

Several IFRS standards are specifically relevant to hedging activities:

- **IFRS 9: Financial Instruments:** This standard covers the classification, measurement, and recognition of financial assets and liabilities. It includes guidelines for hedge accounting, which aligns the accounting treatment of hedging instruments with risk management activities. IFRS 9 allows for three types of hedge accounting: fair value hedges, cash flow hedges, and hedges of net investments in foreign operations.
- **IFRS 7: Financial Instruments: Disclosures:** This standard requires disclosures about the significance of financial instruments for an entity's financial position and performance, including information about the nature and extent of risks arising from financial instruments and how those risks are managed.
- **IFRS 13: Fair Value Measurement:** This standard defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurements. It applies to IFRS that require or permit fair value measurements or disclosures.

Practical Application of Hedging Strategies

The application of various hedging tools can significantly aid Uzbek companies in navigating the uncertainties of transitioning to IFRS:

Forward Contracts: These contracts involve agreements to buy or sell assets at a future date for a predetermined price, protecting companies from currency exchange fluctuations.

Options: Options give the holder the right, but not the obligation, to buy or sell an asset at a predetermined price within a specific period, helping mitigate potential financial risks from volatile asset prices or interest rates.

Futures Contracts: Similar to forward contracts but standardized and traded on exchanges, these contracts can help companies safeguard against commodity price or currency rate volatility.

Swaps: These involve exchanging cash flows or assets between two parties based on pre-agreed terms, providing protection against interest rate changes or currency risks.

Empirical Data on Hedging Strategy Adoption

Survey data from Uzbek enterprises indicate a high adoption rate of hedging strategies to manage financial risks associated with IFRS transition. Approximately 75% of respondents reported using forward contracts to stabilize financial reports against currency exchange fluctuations. Around 60% utilized options to protect against uncertain commodity prices and interest rate changes, while 80% emphasized the use of futures contracts. Almost all 43 enterprises and companies that participated in the survey consider swap to be a novelty.

Conclusion

The adoption of IFRS in Uzbekistan is a significant step towards integrating with the global financial system. However, it introduces complexities and uncertainties that require robust risk



management strategies. Hedging provides an effective means to mitigate these risks, ensuring financial stability and transparency. As Uzbekistan continues to refine its accounting practices in line with international standards, the role of hedging strategies will remain pivotal in navigating the transitional challenges and achieving long-term economic stability.

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