IFRS

**IASB Meeting**

Staff Paper

Agenda reference **7A**

Date **Week beginning 19 July 2010**

Project **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic **Hedge Effectiveness – Definition of thresholds in the context of effectiveness assessment**

## Introduction

### *Background*

1. This paper is one in a series of papers that will address the specific issues regarding effectiveness assessment (ie the 'effectiveness test').

### *Purpose of the paper*

2. The purpose of this paper is to discuss whether defining a threshold is appropriate in the context of the assessment of hedge effectiveness. The paper has the following structure:
   (a) Overview of the issue.

   (b) Staff analysis.

   (c) Staff recommendation and question to the Board.

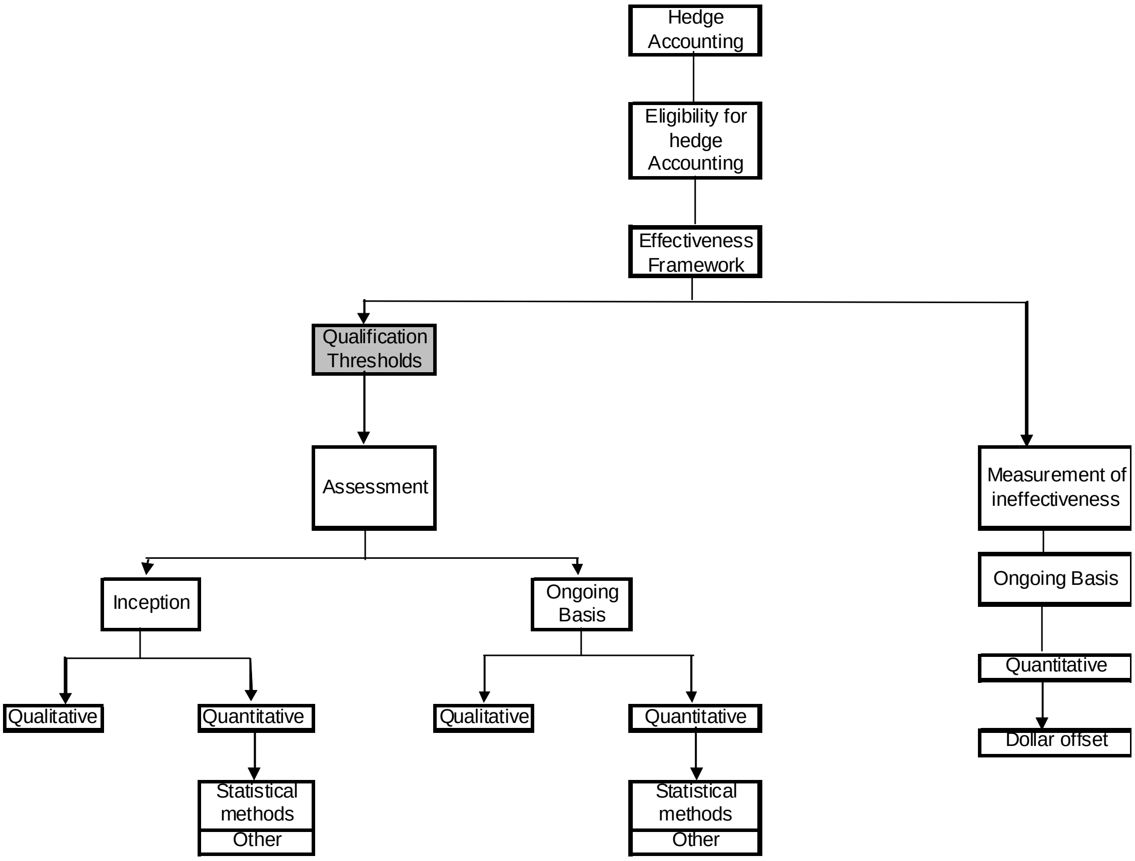
3. This paper aims to address the 'qualification thresholds' stage as stated in the diagram below. Other areas encompassed by the effectiveness assessment workstream will be addressed in separate papers. The paper contains one question to the Board.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.


Hedge Accounting
Eligibility for hedge Accounting
Effectiveness Framework
Qualification Thresholds
Assessment
Measurement of ineffectiveness
Inception
Ongoing Basis
Ongoing Basis
Qualitative
Quantitative
Qualitative
Quantitative
Quantitative
Statistical methods
Other
Statistical methods
Other
Dollar offset

## The issue

4. Should a threshold be considered when assessing hedge effectiveness? If yes, shall it be quantitative or qualitative?

## Staff analysis

### *Objective of effectiveness testing*

5. The staff believes that before considering whether the new hedge effectiveness assessment model should define any thresholds, the Board should agree on the broader o*bjective* for effectiveness assessment.

6. For financial reporting purposes there are at least two potential objectives of an effectiveness assessment :

- **Objective A**: setting a minimum level of how effective a hedge must (or be expected to) be during its term in order to be recognised as a hedge for financial reporting purposes (this could be described as a '*screen in*'); or
- **Objective B**: screening out hedge relationships with *accidental* offsetting of changes between the hedged item and the hedging instrument attributable to the hedged risk (this could be described as a '*screen out*').

7. Objective A reflects a view that there is a *particular* level of effectiveness that separates appropriate from inappropriate hedges and that this level can be adequately defined. Implicitly, this results in a verdict of what kind of risk management strategy is appropriate and which is not. The challenges of this approach are to identify an adequate threshold that achieves this objective and that the accounting standard setter inevitably ends up (at least by appearance) telling management how to manage risks (ie what are acceptable or 'good' hedges that are 'rewarded' with hedge accounting and which are not).

8. Objective B reflects a view that there is *no* particular level of effectiveness that that separates appropriate from inappropriate hedges. Instead, this objective reflects a view that hedge accounting is based on that part of risk management that involves the notion of offset. Hence, the objective is to provide a screen against those instances where offset is accidental to ensure instruments with little or no offsetting risks are not treated as a hedging transaction in the financial statements.

9. Traditionally, accounting standards setters have set very high thresholds to qualify a hedging relationship as an effective hedge within the scope of hedge accounting. This was due to the fact that most of the standards have evolved in an environment where risk management and accounting practices were not developed enough, particularly in the context of accounting models that do not require recognising ineffectiveness if the hedging was within the range defined for accounting purposes.

10. This created a disconnection between accounting and risk management as accounting for hedging activities became arbitrary, too rules based and difficult to explain to the users of the financial statements.

11. As outlined in the overview paper, constituents feel that the current model has too many arbitrary bright lines and has little or no link to risk management practice. Constituents also noted that hedge accounting should be the mechanism whereby the performance of entities' risk management is reflected in the financial statements and ultimately communicated to their users.

12. Effectiveness assessment aims to detect accidental offsetting by looking at the possible behaviour of the hedging relationship during its term and ascertain whether it can be expected to meet the objective for which it has been initially designed. This objective for which the hedge has been initially designed has its foundation in entities' risk management practice.

13. After discussing the objective for the effectiveness assessment under the new hedge accounting model, one of the first considerations to be taken into account is whether effectiveness assessment shall place full reliance on risk management or whether it should consider thresholds (either quantitative or qualitative).

14. Defining a threshold (either quantitative or qualitative) is a mechanism for limiting the application of hedge accounting.

15. If a threshold is defined, only hedging relationships that meet that threshold would be eligible for hedge accounting.

### *Advantages of defining a threshold*

16. Some argue that defining a threshold increases comparability of information reported in the financial statements as it sets minimum requirements for preparers to be eligible for hedge accounting and all preparers follow the same guideline.

17. In their view a threshold increases discipline and avoids transactions only achieving accidental offsetting or transactions below the threshold from qualifying for hedge accounting.

18. Effectiveness testing against a threshold has forced some entities to look more thoroughly at risk management and helped embed it into their organisations

because it became an important factor for key management personnel to consider.

19. Guidance on a threshold can provide a fallback position for entities with a less developed risk management. This is particularly relevant as the quality, stage of development of risk management and the capability of producing reliable information for the purpose of the financial statements on a regular basis varies among entities.

### *Disadvantages of defining a threshold*

20. Conversely to paragraph 16 above, some argue that defining quantitative thresholds provides an arbitrary bright line with no link to risk management. The outcome of applying a quantitative threshold often undermines comparability because economically same situations get different results (eg because of the testing method used, insignificant ineffectiveness in absolute terms in a given period), which distorts the 'big picture'. Therefore, its usefulness is questionable.

21. Any mere accounting threshold poses a danger of turning into an arbitrary bright line that will disconnect financial reporting and risk management and be seen as too rigid.

22. Depending on the type of threshold, it is an indication of a rules-based approach rather than principles-based approach.

23. The strengths and weaknesses of risk management will not be fully recognised in the financial statements if a threshold is set. Hence, the analysis of the impact of hedge accounting will be linked to the threshold rather than to the quality of risk management.

### *Types of thresholds*

24. Thresholds can be of two types: quantitative or qualitative.

25. Quantitative thresholds rely on a set 'hurdle' or range within which a hedging relationship is considered to be effective, eg the 80 to 125% threshold within the

hedge accounting model in IAS 39 *Financial Instruments: Recognition and Measurement*.

26. Qualitative thresholds rely on a consideration that is subject to professional judgement, eg the 'reasonably effective' threshold in the recently issued FASB proposals.

27. The table below summarises the advantages of defining a quantitative or qualitative threshold.

| **Types of Threshold** | **Advantages** | **Disadvantages** |
|---|---|---|
| **Quantitative** | • Specific and unambiguous;<br>• Make the decision of qualifying for hedge accounting binary (on the basis of a bright line);<br>• Easy to apply;<br>• Increase comparability of information? (see section above) | • Rigid;<br>• Unable to accommodate professional judgment;<br>• Unable to accommodate negligible differences if those mean that the predefined threshold is violated. As a result preparers are unable to apply materiality judgements;<br>• Unable to take into account entities' risk management. |
| **Qualitative** | • More flexible;<br>• Allow entities to apply professional judgment, internal thresholds or accepted financial reporting practice;<br>• Provide a better link to the entity's risk management;<br>• Can rely on the | • More ambiguous and difficult to interpret;<br>• Decision-making is not a binary process (on the basis of a bright line);<br>• Reduce the comparability of information? (see section above)<br>• May create other |

| Types of Threshold | Advantages | Disadvantages |
|---|---|---|
|  | information provided to key management personnel for decision making (i.e. when to hedge and how to hedge) and ongoing monitoring of effectiveness;<br>• Provide a better link to the economics of the hedging relationship. | arbitrary bright lines based on the generally accepted interpretation of the qualitative consideration (e.g. reasonably effective can easily be associated with a 50% qualitative threshold) |

28. An alternative approach to the use of a qualitative threshold is combining the use of a qualitative threshold with minimum requirements within risk management that must be met in order to be eligible for hedge accounting. This option will place reliance on the entities' implementation of the qualitative threshold while it sets some requirements for risk management to ensure the main aspects impacting the effectiveness assessment are considered. These may include:

(a) Decision-making criteria including the entity's interpretation of the qualitative thresholds to qualify for hedge accounting at inception and on an ongoing basis.

(b) Methodology for assessing hedge effectiveness on a qualitative and quantitative basis (if needed).

(c) Criteria for discontinuation of hedge accounting (to be discussed at a later stage in the project).

(d) Minimum information to be produced by the risk management on effectiveness assessment for accounting purposes.

29. This alternative approach not only has the advantages associated with the use of a qualitative threshold but recognises the stage of development and robustness of risk management. Under this approach, entities that do not have a risk management developed enough to include the provisions described in the paragraph above, shall for financial reporting purposes make an assessment as to

whether their hedging relationships can be assessed qualitatively both at inception and on an ongoing basis. If it is determined that there is a degree of uncertainty that would preclude a qualitative assessment, entities it will be required to perform a quantitative assessment to qualify for hedge accounting. In other words, there must be a quantitative back-up for the effectiveness test if the qualitative assessment is insufficient (either because of the complexity of the hedge or the lack of risk management to draw on). Further details on this issue will be discussed on paper 7B.

30. This alternative approach prevents the inappropriate use of hedge accounting when entities do not have robust risk management or are unable to produce reliable information on the effectiveness of the hedges while it still allows entities with less sophisticated risk management to apply hedge accounting.

31. When combined with appropriate disclosures on entities risk management, it can improve the relationship between accounting and risk management, increase transparency and hence improve the usefulness of information to users of the financial statements.

### *Conclusion*

32. The staff believes that by defining a qualitative threshold, or relying on a model based on a combination of a qualitative threshold supplemented by minimum requirements for risk management, as an eligibility criterion for hedge accounting, the model would strengthen the relationship with risk management practice. Moreover, entities will be allowed to apply their own judgements, define their own materiality thresholds and will ultimately report in the financial statements what is being used for managing hedging activities.

33. Small and medium-sized entities and entities with less developed risk management will not be precluded from applying hedge accounting as the model includes an alternative (refer to paragraph 29) based on the complexity and level of uncertainty embedded in their hedging relationships.

34. Based on the above the staff believes the Board has four alternatives:

(a) **Alternative 1 –** require a quantitative threshold to qualify for hedge accounting.

(b) **Alternative 2 –** require a qualitative threshold to qualify for hedge accounting.

(c) **Alternative 3 –** neither require a qualitative nor a qualitative threshold, and therefore fully rely on the risk management policy.

(d) **Alternative 4 –** combine the use of qualitative thresholds with minimum requirements within risk management or supplementary tests to be eligible for hedge accounting.

## Implications for hedge accounting

35. Defining a qualitative threshold or opting for a mixed model will:

(a) Rely on the way entities perform and interpret their effectiveness assessment and take decisions of entering into hedging transactions. Consideration of the entities interpretation of the qualitative threshold to achieve hedge accounting will be a main decision factor when analysing hedging relationships.

(b) Result in better alignment between accounting and risk management.

36. Defining a quantitative threshold will keep the inflexibility of the current model and will not resolve the issues raised by constituents (refer to agenda paper 7).

## Staff recommendations and questions to the board

37. The staff recommends **Alternative 4.**

## Rationale for the staff recommendation

38. By choosing Alternative 4, the staff believes the model will allow entities to apply their own judgements particularly allowing the use of entities’ more

developed mechanisms for assessing effectiveness. This alternative, while not excluding entities with less developed risk management practice from using hedge accounting, will efficiently use relevant information that already exists (for risk management purposes) and also encourage some entities to strengthen their risk management. Further details on the principles for assessing hedge effectiveness are discussed in paper 7B.

**Question 1 – Definition of thresholds in the context of assessing hedge effectiveness**

Does the Board agree with the staff recommendation as outlined in paragraph 37?

If not, which alternative does the Board prefer, and why?