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| Project | Financial Instruments (Replacement of IAS 39) – Hedge Accounting |
| Topic | Hedge Effectiveness – General Approach |

Introduction

Background

1. This is an overview paper that outlines the issues with the current model for assessing and measuring hedge effectiveness and the approach that the staff proposes to follow when developing the new model. The staff will produce separate papers for each issue or group of relevant issues surrounding assessment and measurement of hedge effectiveness.
2. The staff is not requesting any decisions from the Board nor is it making any recommendation. Decisions will be asked in separate papers.

Purpose of the paper

3. The purpose of this paper is to outline the issues with the current methodology for assessing and measuring effectiveness. The paper also outlines areas the Board may consider when developing the effectiveness requirements within the new hedge accounting model.
4. For the purpose of the effectiveness workstream, effectiveness assessment and measurement of ineffectiveness will be dealt with separately. The diagram below explains the approach that the staff proposes to follow:

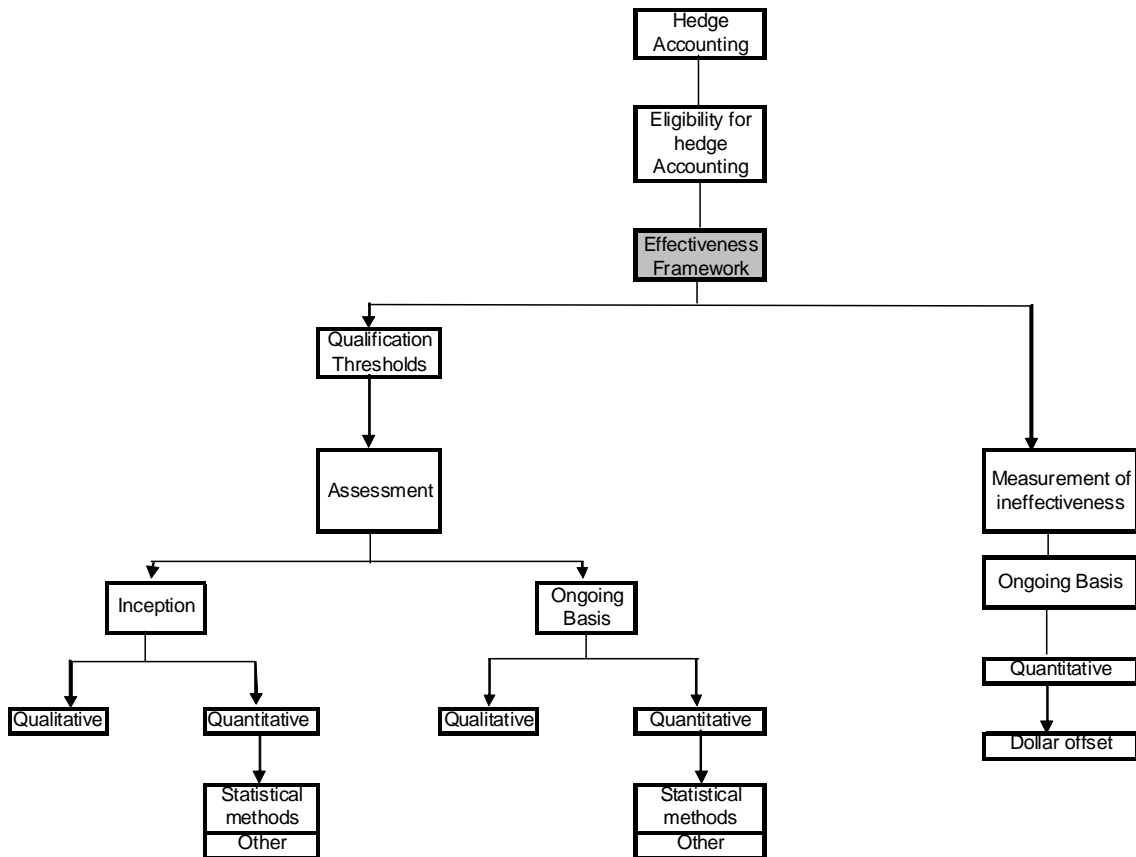
This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

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.

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5. This paper is structured into the following sections:

- (a) Definitions.
- (b) Issues with the existing model.
- (c) Potential areas to be considered by the Board (including any implications of the proposals that the US Financial Accounting Standards Board (FASB) recently issued).¹

Definitions

6. Assessment of effectiveness is the *analysis of the expected behaviour* of a hedging relationship in achieving offsetting changes in the fair value of the hedged item² attributable to the hedged risk.

¹ Appendix A provides an outline of the recently issued FASB proposals.

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7. Measurement of ineffectiveness is the *quantification* of portion of the change in fair value of the hedged item attributable to the hedged risk that has not been offset in a reporting period.

Issues with the existing model

8. The staff conducted various outreach activities and specifically covered the issues of effectiveness assessment and measurement of ineffectiveness (refer to paragraphs 6 and 7 above). These activities involved preparers, users and auditors. A summary of the main comments raised by these constituents is outlined below.

Preparers*Effectiveness Assessment*

9. In relation to effectiveness assessment, preparers find the current provisions on hedge effectiveness arbitrary, onerous and difficult to apply because:
 - (a) Many entities (particularly smaller non-financial institutions) do not have the skill-set to document hedge accounting relationships and perform hedge accounting effectiveness tests.
 - (b) The model is too rules-based and contains too many arbitrary bright lines, particularly the highly effective threshold of 80 to 125 per cent.
 - (c) The effectiveness test is too onerous as it is required to be done prospectively and retrospectively at each reporting date.
 - (d) The fact that, if a hedging relationship fails during one period, hedge accounting would be precluded is arbitrary and difficult to justify.
 - (e) The concept of assessing effectiveness based on a percentage is highly questionable. This often results in effectiveness ratios that might not be commensurate with the economics of the hedge or its predicted

² The term 'hedged item' is used in lieu of fair value or cash flows attributable to the hedged risk to avoid the misinterpretation of this wording in IAS 39. The term hedged item refers both to the hedging of changes in fair value and cash flows.

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statistical behaviour. One of the root causes of this issue are insignificant but not identical changes in the fair value of the hedged item and hedging instrument that may cause a relationship to fail the effectiveness test.

- (f) There is little or no link between hedge accounting and the risk management strategy. This is largely caused by the approach and arbitrary thresholds used by the current model.

Measurement of Ineffectiveness

- 10. Regarding measurement of ineffectiveness preparers raised the following concerns:
 - (a) The current hedge accounting model places a disproportionate emphasis on ineffectiveness compared to recognising the merits of economically effective hedges in the financial statements.
 - (b) The use of exchange traded contracts that rarely match the terms of the hedged item makes hedge accounting difficult to apply as it leads to ineffectiveness even though credit risk is avoided.
 - (c) The treatment of option premiums as ineffectiveness (or like freestanding derivatives) distorts the effectiveness of hedging strategies and has a prohibitive effect (ie creates a bias against using option-based derivatives).

Auditors

Effectiveness Assessment

- 11. Specifically in relation to effectiveness assessment, auditors raised the following issues:
 - (a) Hedge accounting is not allowed outside the 80 to 125 per cent range, which makes it difficult to understand in the context of the risk management strategy – despite the numerous references in IAS 39 to risk management strategy (!).

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- (b) There is divergence in methods for assessing and measuring effectiveness between US GAAP and IFRSs, for example: the change in the variable cash flows method, which compares the floating rate cash flows of the hedged item with the floating rate cash flows of the hedging derivative, is not allowed under IFRSs but is under US GAAP when the hedging derivative has a fair value of zero or close to zero at inception.
- (c) In order to get hedge accounting under IAS 39, entities need to perform two tests³ for each hedge. The retrospective test is the one that determines that the hedging relationship has been effective in the reporting period. The prospective test supports the expectation that the hedge relationship will be effective in the future.
- (d) There is lack of guidance when applying the hypothetical derivative method to assess and measure effectiveness.

Measurement of Ineffectiveness

- 12. Regarding measurement of ineffectiveness auditors raised the following concerns:
 - (a) Hedge ineffectiveness is sometimes caused by ‘technical reasons’ such as: i) the reset of the hypothetical derivative, ii) the requirement to perform the effectiveness test even when all the terms in the relationship match or iii) the use of different types of contracts that in substance hedge the same risk (for example futures and forwards where the former has maturities that do not match the ones of the hedged item) is difficult to explain.

Users

- 13. Users raised the following concerns:

³ However, an entity can use one test for both prospective and retrospective hedge effectiveness testing purposes.

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- (a) Users generally find the current hedge accounting model difficult to reconcile to the economic reality of the companies being analysed as it has no link with risk management and the entity's business model.
- (b) Users would like to see a model with a focus on the activities that entities perform to manage their risks. Additionally, the merits and weaknesses of those activities should be recognised in the financial statements.
- (c) Adjustments arising from fair value hedge accounting, particularly the adjustment to the fair value attributable to the hedged risk in debt instruments measured at amortised cost, are normally removed from the financial statements as analysts believe they distort the carrying amount.
- (d) Users also believe that the volatility created by economic hedges (accounted for as if they were trading activities) does not represent the economic substance of the transactions that have been entered into by the entities being analysed. Therefore, this effect is backed out for analysis purposes.
- (e) Accounting ineffectiveness is difficult to understand due to the arbitrary bright-lines in the current model. Most users find that ineffectiveness has little or no economic meaning and when separately disclosed it is often ignored or backed out for analysis purposes. Users are particularly concerned that today's requirements do not allow achieving hedge accounting for hedging strategies they consider valid. They are more interested in the 'big picture' than the intricacies of ineffectiveness (that can disallow hedge accounting). Many consider the usefulness of hedge ineffectiveness information in developing forecasts fairly limited.
- (f) Hedge accounting makes comparability between entities difficult as two entities having similar hedging policies and instruments may present substantially different balance sheets and income statements.

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Feedback implications

14. The main outcome from the observations outlined above is that the current provisions for effectiveness assessment and measurement of ineffectiveness do not facilitate entities reflecting their risk management in the financial statements. Additionally, they do not allow entities to reflect how effective the hedging relationships are if they are outside the acceptable effectiveness range and, therefore, the economic substance of the transactions may not be shown in the financial statements.
15. It is clear that constituents would like the Board to consider substantial changes to the way effectiveness is assessed and measured. Some of the most relevant potential changes to be considered in this project are the following:
 - (a) Develop a model for effectiveness testing that is principles-based.
 - (b) Create a clear link between hedge effectiveness and risk management by increasing the focus on the information provided to the key management personnel when entering into and monitoring hedging activities (ie focus on decision making).
 - (c) Define the meaning of effectiveness and ineffectiveness and develop a set of principles on whether and (if so) how should they be assessed both on a prospective and retrospective basis.
16. The staff believes that the three main areas to be considered by the Board are:
 - (a) Effectiveness assessment.
 - (b) Measurement of hedge ineffectiveness.
 - (c) Implications of the recently issued FASB proposals.
17. Each one of these areas will be addressed by the staff in separate papers.

Effectiveness assessment

18. For this workstream the staff analysis will be focused on the following main areas:

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- (a) whether defining qualification thresholds in the context of the new hedge accounting would be appropriate ?
- (b) which principles should be considered when developing an effectiveness assessment model ?
- (c) which methods (if any) shall be prescribed to perform the effectiveness assessment ?
- (d) papers addressing specific issues raised by constituents on effectiveness assessment.

Measurement of hedge ineffectiveness

19. For this workstream the staff analysis will be focused on the following main areas:

- (a) which principles should be considered when measuring hedge ineffectiveness ?
- (b) which methods shall be prescribed to perform the measurement of ineffectiveness?
- (c) papers addressing specific issues raised by constituents on effectiveness assessment.

Implications of the recently issued FASB proposals

20. The staff will consider the recently issued FASB proposals when developing the new approach to assessing hedge effectiveness.

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Appendix A

Overview of the recently issued FASB proposals regarding hedge effectiveness

A1. The model for hedge accounting currently outlined in the FASB's exposure draft proposes a less onerous approach to hedge effectiveness (assessment and measurement) and aims to address some of the concerns raised in the section above. The main features of the proposed model are as follows:

- (a) The model requires that at inception and on an ongoing basis the hedging relationship is expected to be reasonably effective in achieving offsetting changes in the fair value or cash flows attributable to the hedged risk.
- (b) An entity shall document the risk management objective expected to be achieved by the hedging relationship and how the hedging instrument is expected to mitigate the risk or risks inherent in the hedged item or forecasted transaction.
- (c) A qualitative assessment might be used to demonstrate that the hedging relationship is reasonably effective; an entity cannot assume that there will never be any ineffectiveness during the period of the hedge.
- (d) As a consequence of the above the shortcut method and the critical terms matching are eliminated and therefore shall not be used to assume that the hedging relationship is completely effective and no ineffectiveness should be recognised.⁴
- (e) After inception of the hedging relationship a hedging relationship shall be qualitatively (or quantitatively if necessary) reassessed.

⁴ However, that is not tantamount to an approach that measures and recognises all hedge ineffectiveness, eg see paragraph (h) below.

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- (f) A hedging relationship shall be discontinued if the criteria for designating a hedging relationship are no longer met, particularly if the hedging relationship no longer is expected to be reasonably effective in achieving offsetting changes in the fair value or cash flows attributable to the hedged risks or the hedging instrument expires, is sold, terminated or exercised.
- (g) Measurement of ineffectiveness for cash flow hedges shall be based on the comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in the expected future cash flows of the hedged transaction. The hypothetical derivative method is suggested as a possible method for assessing ineffectiveness.
- (h) As a practical expedient, the model allows entities to consider that the hypothetical derivative has the same credit risk as the hedging derivative.
- (i) The model does not have the concept of the 'lower of test' for cash flow hedges. Therefore, other comprehensive income (OCI) associated with the hedged transaction shall be adjusted to a balance that reflects the amount necessary to offset the present value of the cumulative change in the expected cash flows on the hedged item less the amount previously reclassified from OCI to net income, if any. This will ensure that ineffectiveness will be recognised for both 'overhedges' and 'underhedges'.
- (j) If a purchased option is used as a hedging instrument in a cash flow hedge of a one sided risk, entities have the option to choose designating either the intrinsic value of the option or the total changes in the value of the option. If the latter is chosen, entities shall reclassify from other comprehensive income to net income the amount that adjusts net income for the amortisation of the cost of the option.