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

Topic **Discontinuation of a hedging relationship**

Introduction

Background

1. This paper discusses the discontinuation of hedge accounting relationships.

Purpose of the paper

2. This paper discusses under what circumstances hedge accounting relationships should be discontinued in the context of the new hedge accounting model.
3. This paper also provides an overview of the issues surrounding the discontinuation of hedge accounting.
4. This paper does not address the issue of new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a business combination. This is a requirement of IFRS 3 *Business Combinations*, which is not within the scope of this project.
5. The staff would like to remind the Board that this paper aims to articulate the issues arising from discontinuation of hedge accounting. Hence, it is a general paper that should be read in conjunction with papers 17B and 17C. Paper 17C contains some illustrative examples on some of the concepts outlined in this paper.
6. This paper has the following structure:
   (a) overview of the issue;

(b) staff analysis; and

(c) staff recommendation and question to the Board.

The issue

7. When a hedge accounting relationship should be discontinued.

Discontinuation versus dedesignation

8. First some terminology.

9. Discontinuation can be distinguished (by type of triggering event) into:

   (a) *mandatory* discontinuation; and

   (b) *dedesignation*, ie voluntary discontinuation.

10. Hence, *discontinuation* of hedge accounting is an umbrella term that includes different causes that result in ending hedge accounting. This means specific requirements for unwinding the accounting effects of the hedge accounting relationship apply.

11. *Mandatory* discontinuation occurs when the hedging relationship ceases to meet the qualifying criteria (including that the entity no longer has the hedging instrument). Hence, hedge accounting *must* be stopped.

12. *Dedesignation* occurs when the entity *chooses* to revoke its hedge designation.

Reasons for dedesignating hedge relationships

13. Dedesignation can occur for various reasons. For example, the hedging relationship needs to be adjusted to reflect changes to its design or to reflect changes in the variables affecting the hedging relationship.

14. Entities with dynamic hedging strategies commonly use dedesignation (and then redesignation) because the hedging instruments and hedged items that make up the hedging relationship frequently change.

15. In other circumstances, entities often use dedesignation proactively to avoid the risk that a hedging relationship will fail the qualifying criteria. Hence, management changes the hedging relationship while it still qualifies for hedging accounting rather than waiting until it may no longer do so.

16. In such situations, the date of discontinuing hedge accounting is clear — the date of dedesignation. This allows the lead time to redesignate the hedging relationship on the same date thus avoiding any time gap for which hedge accounting is not achieved. Hence, in this scenario, hedge accounting ceases but also results in a new hedge accounting relationship (the redesignated one). (In addition, the discontinued hedge accounting occurs to unwind the effects of the original (dedesignated) hedging relationship).

17. In contrast, when failing the effectiveness assessment, the entity has to identify the event or change in circumstances that caused the failure and demonstrate that the hedging relationship qualified until that point in time or else discontinue the hedging relationship from the last date it was demonstrated to be effective.[1] Since hedge relationships cannot be designated retrospectively this would typically mean that for some period (eg a whole quarter) hedge accounting is not achieved (even if redesignation would have been possible at the date of discontinuation).

18. In other situation an entity might choose to dedesignate a hedging relationship and apply discontinued hedge accounting without designating the hedging instrument and hedged item of the original hedging relationship in a new one. This could be for a number of reasons. For example, that management prefers to have fair value changes of the hedging instrument in profit or loss without an offsetting effect from the hedged item or that hedge accounting is considered to have become too onerous or costly.

[1] See IAS 39.AG113.

Problems of the discontinuation approach in IAS 39

19. Lack of guidance on the distinction between discontinuation and dedesignation in IAS 39 raises practical issues, particularly when *parts* of existing relationships are terminated, or cease to meet the qualifying criteria. In such scenarios, preparers have had difficulties understanding whether discontinuation applies to the *entire* hedging relationship or only to *the parts* that have ceased to meet the qualifying criterion or have been subject to change.

20. In addition, because of the lack of alignment between hedge accounting and risk management, dedesignation is an accounting exercise that is inevitably closely linked to the bright-line effectiveness assessment test of 80 to 125%, and to the changes that have not been documented by preparers in the hedge accounting documentation.

21. These issues demonstrate essentially form-driven nature of the current requirements which does not allow adjustments that were not envisaged (documented) at the inception of the hedge to be treated as adjustments to an existing hedging relationship, but rather as a full discontinuation and restart.

22. In summary, the current model does not include a notion of continuation of an existing hedge in the context of a dedesignation and redesignation.

Staff analysis

23. The table below illustrates the scenarios of discontinuation of hedge accounting.

Rebalancing
(= continuation of hedge accounting)

Link to risk management and effectiveness testing

Discontinued Hedge Accounting	Voluntary	Mandatory
Ceased Hedge Accounting ➔ Only Unwind	Dedesignation (no choice scenario) – (1)	Automatic Discontinuation (2)
Discontinue and Retry	Dedesignation and redesignation - (4)	Automatic discontinuation and 'restart'(3)

Dedesignation—when should it be allowed?

24. Dedesignation might be viewed as a risk management issue rather than as an accounting issue. In this context, dedesignation accommodates situations where as part of the risk management activities entities adjust the hedging relationships to ensure that they achieve the purpose for which they have been designed or to improve their effectiveness (for example, because of changes in the basis).

25. Alternatively, you could view dedesignation as purely an accounting issue. It arises when preparers have to assess the extent of the changes that would create a need for dedesignation and redesignation from an accounting perspective. As noted previously, historically this is driven by the effectiveness assessment bright line of 80 to 125% that forced entities to proactively dedesignate hedging relationships if they believe that the existing hedges might fail the effectiveness test.

26. This contrasts with the risk management view described in paragraph 23 whereby entities use and adjust hedging relationships when they feel that there is the need for hedging a risk exposure, or alternatively entities cease hedging when the hedging relationship no longer achieves the objective for which it was initially designed.

27. The hedge accounting model being developed in this project seeks to better align hedging accounting with risk management. For example, the effectiveness testing that requires an unbiased design of the hedging relationship draws on information from risk management to determine whether the relationship qualifies for hedge accounting or not.

28. The staff believe one way of explaining the relationship between the risk management view and the accounting view described above is by understanding the circumstances where scenarios 1 to 4 outlined in the table above would apply.

Scenario 1—Dedesignation solely for accounting purposes

29. In this scenario, management voluntarily stops hedge accounting solely for accounting purposes (ie there is no redesignation). By taking this action, management changes the accounting for items in the hedging relationship back to the default accounting treatment of the items involved.[2]

30. If the risk management in relation to this hedging relationship has not changed then the dedesignation (without redesignation) creates an accounting mismatch that was previously mitigated by applying hedge accounting (see paragraph 18). This is an arbitrary accounting choice that does not improve but actually impairs the usefulness of the information.

31. The staff note that dedesignation has been widely used under the current hedge accounting model in the context of proactive dedesignation to avoid failing the qualifying criteria particularly the 80 to 125 % bright line or in the context of more dynamic hedging strategies (refer to paragraph 13 above). However, the staff believe that there is a difference to arbitrary dedesignation.

32. Scenarios in which management proactively dedesignates the hedging relationship because it *expects* to fail the qualifying criteria dedesignation will

[2] Notwithstanding the specific requirements for unwinding the hedging gains and losses that were recognised as part of fair value or cash flow hedge accounting before (see IAS 39.91-91 and 101).

normally be followed by a redesignation as the risk management objective remains the same. In these cases dedesignation is used as a means to adjust the hedging relationship in order to qualify under the expected circumstances.

33. The staff believe that allowing entities to arbitrarily dedesignate hedging relationships is inconsistent with the objective of hedge accounting. When the risk management objective and the other qualifying criteria (particularly the effectiveness testing) and are still met the rationale that justified hedge accounting at inception of the hedging relationship would still apply. Thus, changing the accounting even though it could be continued is inconsistent with the original decision to seek hedge accounting.

34. Therefore, the staff believe that dedesignation in such circumstance (ie when it is arbitrary) should not be permitted.

Scenario 2—Automatic discontinuation

35. Automatic discontinuation of hedge accounting occurs because a hedging relationship ceases to meet the qualifying criteria. In this scenario hedge accounting ceases prospectively from the moment the qualifying criteria are no longer met.

36. The staff notes that automatic discontinuation differs from dedesignation because the former results from failing the qualifying criteria while dedesignation is a voluntary consequence of management's intent.

37. In the context of the proposed model, automatic discontinuation will arise when the hedging relationship fails the effectiveness assessment test or where the hedged item and hedging instrument fail to meet the other qualifying criteria.

38. The effectiveness assessment test, as developed, has a strong link with risk management, particularly when assessing whether the hedging relationship still achieves the objective underlying the qualifying criterion.

39. The Board tentatively decided at the 24 August meeting the objective for the effectiveness assessment testing. That decision can be summarised as follows:

(a) The objective of the effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected ineffectiveness. Thus, for accounting purposes hedging relationships should not reflect a deliberate mismatch between the weightings of the hedged item and of the hedging instrument within the hedging relationship.

(b) In addition to that objective, hedging relationships are expected to achieve offsetting of changes between the hedged item and the hedging instrument that are attributable to the hedged risk (other than accidental offsetting).

40. Both (a) and (b) use information prepared for risk management purposes as the main source to determine what is the hedging relationship that achieves an unbiased result and minimises ineffectiveness. Similarly, the screen-out that excludes from the scope of hedge accounting hedging relationships that only achieve accidental offsetting uses information prepared by risk management.

41. Hence, information prepared for risk management purposes is used to assess whether the hedging relationship is eligible for hedge accounting (both at inception and on an ongoing basis).

42. This contrasts with the current model where discontinuation is automatic if the hedge effectiveness is not within the bright line of 80 to 125 %.

43. Therefore, the staff believe that automatic discontinuation would still apply under the proposed model. However, the qualifying criteria triggering automatic discontinuation will not involve a bright line but the new objective-based effectiveness test. This is expected to result in fewer automatic discontinuations of hedge accounting compared to today (ie under IAS 39). In addition, the new hedge accounting model might involve rebalancing of a hedging relationship (see papers 17B and 17C), which is an adjustment to the hedging relationship without discontinuing it.

Scenario 3—Automatic discontinuation and restart

44. This is the scenario in which the hedge accounting relationship is discontinued because it fails to meet the qualifying criteria. However, there is also a risk management decision to re-establish hedge accounting relationship to (again) achieve hedge accounting given the entity continues hedging the risk (this can be described as discontinue and restart).

45. This scenario differs from scenario 2 because management decides to try to again achieve hedge accounting for the hedging relationship. That hedging relationship may for example be a new one with a change in the design of the hedging relationship (for example replacement of the hedging instrument).

46. As explained under Scenario 2, the staff believe that automatic discontinuation would still apply under the proposed model but occur less frequently (see paragraph 43).

Scenario 4—Voluntary dedesignation and redesignation (De and Re)

47. This is the scenario where risk management proactively adjusts a hedging relationship because it expects it to fail the qualifying criteria (see paragraphs 31 and 13-17).

What changes to a hedging relationship should be allowed without resulting in its discontinuation?

48. The main question to be answered is which changes to a hedging relationship:

    (a) can be regarded as an adjustment to a hedging relationship (ie that hedging relationship would continue); or

    (b) result in a new hedge (ie the previous hedging relationship is discontinued)?

49. The staff believe that there are three issues to be considered when assessing changes to a hedging relationship:

    (a) whether proactive dedesignation and redesignation is the result of a change to the hedged item or hedging instrument within the hedging relationship, or alternatively whether is the result of a change due to unexpected sources of ineffectiveness;

(b) whether there is a change in objective from a risk management perspective; and

(c) whether changes to the hedging relationship are such that discontinuation and restarting is required (refer to scenario 3 above).

50. To operationalise the analysis of the issues outlined above, the staff believe that there are two notions to be considered:

(a) **Notion 1—***Expected* ineffectiveness. This is the level of ineffectiveness that risk management expects at the inception of the hedge. It results from the analysis of the sources of ineffectiveness that are known to risk management and therefore the hedging relationship continues to meet the qualifying criteria.

(b) **Notion 2—**Design change. A design change involves a modification to the hedging relationship. Such a modification may result from *unexpected* levels of ineffectiveness, changes in the quantity of the hedged item or changes to the hedging instrument. It may also arise from a change in the risk management objective and therefore be linked to a discontinuation and restart.

51. The staff believe that applying the two notions above is a better way of assessing whether the hedging relationship should be discontinued and restarted or rebalanced. This is because the two notions above are likely to be the way entities would assess whether in the context of hedge accounting proactive dedesignation or discontinuation and restart would be appropriate.

52. If there are changes to the hedging relationship resulting from *unexpected* sources of ineffectiveness or as a result of changes to the hedged transaction (for example, taking away a layer of a hedged forecasted transaction or a steep increase or decrease in the basis), there should be analysis on a case by case basis to determine whether an adjustment as part of a continuing hedging relationship is appropriate or conversely discontinuation and restart is the most

appropriate way to reflect the changes to the hedging relationship. This will inevitably involve judgement.

53. The staff's view is that if the original objective of the hedging relationship remains the same and the hedging instrument does not default (and is replaced), discontinuing and restarting is not appropriate. The hedging relationship might (will) need to be adjusted to reflect the changes made. However, this should occur as a continuation of the existing hedge.

54. This is a change when compared to the current requirements in IAS 39. However, it would result in a much closer alignment to risk management and address some practice issues that arise today.

55. An example (this forms the basis for all the examples set out in paper 17C which illustrate application of the proposed approach). A cash flow hedge of a highly probable forecast transaction to buy 100 Units of Commodity A using a forward contract to buy 90 tonnes of the benchmark is established at T0. At T1 the quantity is revised to 90 tonnes. The original objective of the hedge remains the same (ie hedging of a future purchase of commodity A). However the issue arises because the entity will need to determine whether this change means that the revised hedging relationship is a continuation of the existing hedge or is a discontinuation event and restart with a new hedging relationship.

56. As noted in paragraph 54, answering this question involves a trade-off. This is because hedge accounting provides information about the hedging relationships in a way that reflects risk management. (In the example, showing that the hedged item is the remaining layers that have been hedged with a proportion of the derivative established at the outset).

57. Other arguments that might be taken into account when trying to answer to this question are:

   (a) Hedging involves a cost. Therefore entities normally refrain from hedging more than their exposure. This represents a natural barrier to hedge more than what the exposure is expected to be and helps limiting the scenarios like the one described above to forecasting errors.

(b) All the ineffectiveness is recognised in profit or loss prior to the dedesignation and redesignation of the hedge. If the hedging relationship is instead discontinued and restarted, some of the future ineffectiveness will be artificial. This is because the hedging derivative will be an out or in-the-money derivative while the measurement of the value changes of the hedged item starts from zero (eg when using a hypothetical derivative it will be at the money upon resetting). The comparison of the changes in the fair value of the hedging instrument and the hedged item will generate artificial ineffectiveness.

(c) Discontinuation could also result in portraying all or part of the hedging relationship as a new one or the hedging instrument as 'trading' (eg because hedge accounting is not achieved again after discontinuing the original hedging relationship). This would be inconsistent with the objective of what hedge accounting should aim to represent (the results of risk management) if hedging for risk management purposes *continues* (but hedge accounting would *not* or only as a *new* hedging relationship).

58. Based on the arguments outlined above we believe that the new hedge accounting model should include a mechanism for adjustments to a hedging relationship as part of a continuing hedging relationship (refer to papers 17B and 17C on rebalancing). The discipline around this mechanism comes from the fact that entities have to prove that the risk management objective remains the same as for the original hedging relationship and all the ineffectiveness is recognised prior to the adjustments. By doing this, the staff believe that the outcome of the hedging relationship will be better reflected in the financial statements

59. If this approach is followed, the accounting for the revised hedging relationship will be consistent with what risk management aims to achieve.

60. In the example above, accounting as a continuing hedging relationship would apply to the revised quantity of 90 tonnes if the entity (partially) discontinues only the portion of the hedging relationship that related to the forecast transaction that is no longer highly probable to occur (10 tonnes). This means:

(a) the dedesignated portion of the hedging instrument is treated as non-designated derivative if not closed out or used for hedging purposes in a different hedging relationship;

(b) all the ineffectiveness is recognised in profit or loss prior to the partial dedesignation; and

(c) the documentation supporting the hedging relationship is updated.

FASB proposed model

61. The model currently being proposed by the FASB's draft Accounting Standards Update (ASU)[3] states that:

(a) 'an entity shall not remove the designation of an effective fair value or cash flow hedging relationship after it has been established at inception.

(b) A hedging relationship shall be discontinued only if either of the following criteria are met:

(i) The qualifying criteria for hedging relationship are no longer met, such as if the hedging relationship no longer is expected to be reasonably effective in achieving offsetting changes in fair values or cash flows.

(ii) The hedging instrument is expired or is sold, terminated or exercised.'

62. The proposed FASB approach states that the hedging instrument can be considered in effect terminated when an offsetting derivative is entered into. The model requires entities to prepare concurrent documentation of this in substance termination.

63. The offsetting derivatives cannot be designated in future hedging relationships.

[3] Refer to proposed FASB's ASU paragraphs 119 to 121.

64. The model also allows entities to modify the hedging instrument by adding a derivative to that hedging relationship. This derivative would not offset fully the existing hedging derivative, and would not reduce the effectiveness of the hedging relationship. Such a modification would not result in the termination of the hedging relationship, although the documentation would need to be updated.

Staff's overall conclusion

65. Based on the above analysis, the staff conclusion is as follows:

    (a) Dedesignation and mandatory discontinuation are two different issues in the context of hedge accounting. Mandatory discontinuation relates to scenarios where the qualifying criteria cease to be met and therefore hedge accounting must be stopped. In contrast, dedesignation is a voluntary discontinuation of a hedge accounting relationship.

    (b) The new hedge accounting model should include a mechanism for adjusting a continuing hedging relationship. If there are changes to the hedging relationship other than in its objective such changes should not require immediate discontinuing and restarting. Specific facts and circumstances should be considered before regarding changes as so significant that they require discontinuation and restarting.

    (c) If the objective of the hedging relationship changes then discontinuing and restarting is the appropriate accounting outcome.

    (d) Arbitrary dedesignation solely based on management's intention (ie when none of the qualifying criteria is breach) should be forbidden.

66. To assist Board members with the staff recommendation we present a table below that aims to summarise what is kept consistent with the current provisions in IAS 39 and what represents a change.

Risk management	**Still valid**	**Changed (becomes**

(original objective)			**N/A)**
	Dedesignation not allowed	Adjustment instead of restart (rebalance)	Mandatory discontinuation
Other qualifying criteria	Fulfilled	Failed	Fulfilled

(grey)	Change to existing requirements in IAS 39
(green)	Consistent with IAS 39

Implications for hedge accounting

67. Creating a mechanism that allows adjusting a continuing hedging relationship will allow entities to better reflect the results of their risk management in the financial statements.

68. Not allowing arbitrary dedesignation will mean that entities will not be able to dedesignate hedging relationships solely to achieve an accounting outcome that does not reflect risk management.

69. Not requiring discontinuing and restarting upon changes in the hedge ratio or adjustments to the hedging relationship will eliminate the practice issues that preparers face with the current model (such as the recognition of artificial ineffectiveness).

Staff recommendation and question to the Board

70. Based on the analysis above, the staff propose[4] that the Board should make a clear distinction between discontinuation and adjustments to a continuing hedging relationship as follows:

[4] The requirements of how to unwind a discontinued hedging relationship in IAS 39 will be retained. Board members should note that the proposals in this paper are about when the requirements to unwind a hedging relationship would apply and the articulation of the new mechanism for adjusting a continuing hedging relationship. This latter is described in more detail in papers 17A and 17B.

(a) Mandatory discontinuation occurs when the hedging relationship ceases to meet the qualifying criteria. However, entities can start a new hedging relationship using the items that previously were part of the discontinued hedging relationship.

(b) Adjustments to the hedging relationship shall only require a discontinuation and restart if there is a change in the risk management objective of the hedging relationship.

(c) Adjusting a continuing hedging relationship should only be allowed when the risk management objective remains the same but other qualifying criteria have failed or are about to fail (for example the effectiveness testing). Specific facts and circumstances should be considered when distinguishing mandatory discontinuation from dedesignation and redesignation.

(d) Arbitrary dedesignation shall not be permitted on the basis no qualifying criteria have failed.

(e) Documentation supporting the hedging relationship must be updated to reflect changes to the hedging relationship irrespective of the type of scenario.

Question - Discontinuation of hedge accounting
Does the Board agree with the staff recommendation as outlined in paragraph 70? If the Board disagrees with the staff recommendation, what would the Board recommend and why?