Project	**Financial Instruments (Replacement of IAS 39)—Hedge Accounting**
Topic	**Effectiveness –assessment—staff recommendations and questions to the Board**

Introduction

Background

1. This paper sets out the staff recommendations and the questions to the Board for papers 1A and 1B. As these papers are interdependent the related decisions need to be considered in contemplation of each other.

<u>Paper 1A</u>

Staff recommendation and question to the Board

2. Considering the feedback received and the analysis in paper 1A, the staff dismiss the following alternatives:

   (a) retaining the 80-125 per cent bright-line test of IAS 39;

   (b) using a 'reasonably effective' threshold; and

   (c) using the umbrella term 'other than accidental offsetting'.

3. Instead, the staff recommend disaggregating the umbrella term 'other than accidental offsetting' and explaining what it entails, ie *directly* referring to the following two criteria[1] that a hedging relationship would have to meet:

   (a) there is an economic relationship between the hedged item and the hedging instrument, and

   (b) the effect of credit risk does not dominate the value changes that result from the economic relationship (ie the effect of the changes in the underlying).

   Those criteria would be added to the main body of the ED and the related application guidance. In addition, the elaboration in the section 'Disaggregating the umbrella term 'other than accidental offsetting'' in paper 1A would be added to the application guidance of the ED.

4. The staff consider that this alternative is consistent with the Board's rationale for the proposals and would also reduce the level of abstractness by explaining the different aspects that the umbrella term comprises thus addressing the primary concern raised by respondents to the ED on this issue. The staff consider this would best address the feedback received on the proposal.

Question—clarification of 'other than accidental offsetting'
Does the Board agree with the staff recommendation as outlined in paragraph 3? If the Board disagrees with the staff recommendation, what would the Board prefer and why?

[1] Criteria that address the requirement that the hedging relationship needs to produce an 'unbiased result' and minimise expected hedge ineffectiveness are addressed in agenda paper 1B.

Paper 1 B

Staff recommendation and question to the Board

5. For the reasons set out in paper 1A the staff dismiss retaining the 80-125 per cent bright-line test of IAS 39.

6. Considering the feedback received and the analysis in paper 1B, the staff dismiss the alternative of retaining the requirement as it was described in the ED (mainly) because:

   (a) the reference to 'unbiased' caused confusion among commentators, in particular it creates the unintended consequence of (at least in terms of perception) restricting or second guessing an entity's commercial decision of which hedging instrument to actually use (which would imply a higher level of effectiveness than actually achieved);

   (b) references to 'minimising' expected hedge ineffectiveness inevitably cause the impression of an accurate mathematical optimisation exercise that is not operational and disconnected from risk management;

   (c) a requirement that 'the entity has no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the changes in value of the hedged item such that they would produce a biased result' would have unintended consequences in situations commonly known as 'late hedges'[2].

7. Instead, the staff recommend to *directly* refer to the following criteria: an entity's designation of the hedging relationship shall be based on:

   (a) the quantity of hedged item that it actually hedges; and

   (b) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item.

[2] These are situations where a derivative is designated as a hedging instrument only after its inception so that it is already in- or out-of-the-money at the time of its designation.

The staff also recommend that it be required that for the purpose of hedge accounting an entity shall not designate a hedging relationship such that it reflects a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) *in order to achieve* an inappropriate accounting outcome (eg in order to avoid recognising hedge ineffectiveness for cash flow hedges or in order to achieve fair value hedge adjustments for more hedged items to increase the use of fair value accounting without offsetting fair value changes of the hedging instrument).

8. Those criteria would be added to the main body of the ED and the related application guidance. In addition, the example regarding the 'lot size issue' (see paragraph 60 of paper 1B) would be added to the application guidance of the ED. Also, the example in paragraph AG107A of IAS 39 *Financial Instruments: Recognition and Measurement* would be included in the application guidance.

9. The staff consider that this alternative is consistent with the Board's rationale for the proposals, in particular further strengthening the link with risk management, but would avoid unintended consequences of using the terms in the ED. The staff consider this would best address the feedback received on the proposal.

Question—meaning of the 'unbiased requirement'—clarification
Does the Board agree with the staff recommendation as outlined in paragraphs 7-8? If the Board disagrees with the staff recommendation, what would the Board prefer instead and why?