

## STAFF PAPER

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Project	Dynamic Risk Management		
Paper topic	Optional Application and Areas of Focus for Disclosure		
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## Introduction

1. The purpose of this paper is to discuss whether the proposed Dynamic Risk Management (DRM) Accounting model should be optional or mandatory. Also, this paper discusses the areas of focus for the disclosure requirements arising from the DRM accounting model.
2. This paper is structured as follows:
  - (a) Summary of staff recommendations (paragraph 3);
  - (b) Optional or Mandatory (paragraphs 4 – 9); and
  - (c) Principles of Disclosure (paragraphs 10 – 19)

## Summary of staff recommendations

3. In this paper the staff recommend that:
  - (a) the application of the model should be optional; and
  - (b) the aim of disclosures should be to enhance or supplement the information provided in the statement of financial position and the statement of profit or loss. Disclosures should help users:
    - (i) understand and evaluate the merits of the entity's risk management strategy;

- (ii) evaluate the entity's ability to achieve the stated risk management strategy; and
- (iii) understand the impact of an entity's risk management actions on current and future economic resources.

### Optional or Mandatory

4. When considering if the application of the DRM accounting should be optional or mandatory, it is important to highlight that the DRM accounting model proposes an exception to the normal accounting requirements of IFRS Standards whereby derivatives must be measured at fair value through profit or loss. This is similar to the existing hedge accounting requirements of IAS 39 *Financial Instruments: Measurement and Recognition* (IAS 39) and IFRS 9 *Financial Instruments* (IFRS 9). While it is accepted that under certain circumstances, fair value through profit or loss may not provide the most relevant information for derivatives used for risk management purposes, the discipline and qualifying criteria proposed by existing IFRS Standards are intended to ensure that the circumstances are warranted (i.e., that the entity is using derivatives for risk management purposes and has been successful in managing the risks as defined). For similar reasons, the DRM accounting model also includes numerous qualifying criteria and performance requirements.
5. The existence of these requirements, partly intended to ensure disciplined use of the exception, makes mandatory application difficult. For example, in order to qualify for the model, the entity must demonstrate the existence of an economic relationship and demonstrate that it has substantially accomplished the risk management strategy. If the model were mandatory, then entities that fail to demonstrate such a relationship would not qualify regardless and therefore, the staff question the practicability of mandatory application under the current qualification requirements of the model.
6. Furthermore, the DRM accounting model requires a certain degree of sophistication in modelling and risk management systems. Therefore, to make the accounting model mandatory could impose undue cost and effort on institutions that do not have such facilities or need such a process for managing risk.

7. However, if the application of the model is optional, this will reduce comparability as different entities could opt for different accounting alternatives. Consequently, some would argue that the application of the DRM accounting model should be mandatory. However, this would require careful articulation of scope. For the DRM accounting model to be mandatory, dynamic risk management would need to be precisely defined. This could prove difficult because of the diversity in dynamic risk management approaches even among entities within the same industry. Said differently, comparability will always be a challenge regarding risk management and therefore, any attempts to increase comparability will require very careful scoping. For example, certain jurisdictions do not manage risk because it is not possible in that jurisdiction (i.e., there is a lack of available derivative / hedging instruments). The Board has also previously received similar feedback about the difficulties in precisely defining scope during the 2014 Dynamic Risk Management Discussion Paper (“the PRA”).
  
8. Mandatory application could also prove difficult given the wide variety of items considered for the purposes of risk management by different entities. Entities may include certain items in scope of their risk management activities that would conflict with existing IFRS Standards if included in scope of the DRM accounting model. The staff question if such a result would provide useful information in the aggregate.

*Preliminary Staff View*

9. The staff are of the preliminary view that the application of the model should be optional for the reasons outlined above.

**Question for the Board**

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- 1) Does the Board agree with the preliminary staff view in paragraph 9?

## Disclosure

10. As discussed at the November 2017 Board meeting<sup>1</sup>, the objective of the DRM model is to improve information provided regarding risk management and how risk management activities affect a financial institution's current and future economic resources. The DRM model aims to address several challenges, some of which were identified during the November 2017 Board meeting. One of the identified challenges was transparency and more specifically, the model aims at better communication about the entity's risk management strategy and actions. While to date, the model has focused on the information to be presented in the statement of profit or loss and the statement of financial position, the staff recognise it is impracticable, and sometimes impossible, to communicate certain information through measurement. For example, the impact of misalignment on future economic resources if the "lower of test" applies cannot be communicated through recognition and measurement. In addition, while the recognition and measurement aspects of the model have increased transparency in some regards, (for example, the decision to present the aligned portion on a separate line close to interest revenue and interest expense), this information could be enhanced through supplemental disclosures that provide additional context.
11. Therefore, the aim of disclosures will be to enhance or supplement the information provided in the statement of financial position and the statement of profit or loss. In the following paragraphs, this paper discusses what information should be communicated to users of financial reporting through disclosures. The paper however only focuses on the areas that should be covered through such disclosures rather than the details of specific disclosure requirements.

## Areas of Focus

12. In developing the areas of focus regarding disclosure for the DRM accounting model, the staff considered overall user needs relating to dynamic risk management and then considered which needs may not be satisfied through the

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<sup>1</sup> For further information, refer to paragraph 13 of Agenda Paper 4 *Outline of proposed DRM accounting model and next steps*.

measurement and recognition aspects of the DRM accounting model alone. Also considering feedback received during the PRA, the staff think user needs that would be most effectively be satisfied through disclosures are as follows:

- (a) understand and evaluate the merits of the entity’s risk management strategy;
  - (b) evaluate the entity’s ability to achieve the stated risk management strategy; and
  - (c) understand the impact of an entity’s risk management actions on its current and future economic resources.
13. As an overarching comment, the staff think that any disclosures must consider the changing nature of portfolios and that point in time information, while useful, may have inherent limitations. Therefore, where applicable, disclosures should focus on relevant information throughout the period in question.

*Understand and Evaluate the Risk Management Strategy*

14. To evaluate the merits of the risk management strategy and factor the strategy in their projections of future earnings and future cash flows, users would need to first understand the strategy. While the information in the statement of profit or loss can provide some indication of management’s strategy, this information would need to be accumulated over multiple periods to establish a trend and would also require users to make some inferences or assumptions. Therefore, entities should disclose information that would enable users to clearly understand and evaluate the risk management strategy. While qualitatively describing the risk management strategy would provide users with some information, the staff think that a combination of qualitative and quantitative disclosures would provide better information for users of financial statements. The staff think these disclosures should focus on the target profile, explaining why the target profile is as defined and what that implies for the future earnings and cash flows.

*Evaluate the entity’s ability to achieve its stated risk management strategy*

15. The information provided in the statement of profit or loss provide users with some information to evaluate the entity’s ability to achieve their risk management strategy, however, users also want to evaluate an entity’s ability to achieve a

stated risk management strategy. In order to do this, users need more information than is available through recognition and measurement alone. Therefore, the staff think disclosures should clearly communicate management’s historical ability to align. Such a disclosure could be affected in a number of ways but likely should be quantitative in nature and focus on the entity’s ability to align the asset and target profiles throughout the period in question, not just as at the reporting date, considering the dynamic nature of portfolios.

*Understand the impact of an entity’s risk management actions on its current and future economic resources*

16. While disclosures about the entity’s ability to achieve the risk management strategy would provide valuable information about management’s ability to achieve a strategy, such disclosures may not necessarily quantify the impact (or potential impact) on current and future economic resources from misalignment. The staff think providing quantitative disclosures that compare the designated derivatives with the benchmark derivative throughout the period could provide such detail. For example, the entity could disclose a comparison of the change in fair value of both the benchmark and designated derivatives, or disclosure a comparison of the amounts reclassified to the statement of profit or loss (i.e, the aligned portion) with the amounts implied by the benchmark derivative, or both. Such disclosures should allow users to understand the impact on future periods but also on the current period.

*Next Steps*

17. The staff think the areas of focus for disclosure for the DRM accounting model should be as described in paragraphs 12 – 16.
18. Prior to finalising the DRM accounting model, a more detailed set of disclosure requirements are necessary. However, the question arises as to whether they are necessary as part of the core model given the areas of focus will provide a good starting point for discussion with stakeholders regarding disclosures.
19. While a more detailed set of disclosure requirements would provide more specificity for users and preparers on which to comment, it also implies additional time and effort. Furthermore, prior to finalising the DRM accounting model, additional items will have to be discussed in Phase II (eg Equity Model Book) and

the staff think these scope related discussions will have an impact on the specific disclosure requirements. Therefore, it is not clear whether it would be more efficient and effective to develop a partial set of detailed disclosures requirements at this stage of the project or conduct outreach with users on the areas of focus first and then further develop the detailed requirements.

### Question for the Board

#### Question for the Board

- 2) Does the Board agree with the areas of focus as described in paragraph 12 – 16?
- 3) Does the Board have a preference regarding the development of a detailed set of disclosure requirements at this stage of the project?