

THE 80/125 PROBLEM

Ira Kawaller explains why the most common effectiveness test is statistically incorrect.



The authorities at the Financial Accounting Standards Board have not been eager to lay down specific guidance for assessing hedge effectiveness—a critical prerequisite for special hedge accounting treatment. In most cases, they want to leave it up to the people performing and auditing the test to determine what makes sense for them. As a result, there will likely be a variety of approaches that will be used, and auditors will have to evaluate each new method on a case-by-case basis.

And that raises cause for concern.

The basic idea behind the standard is that gains or losses in derivatives should offset changes in fair values or cash flows. The problem, however, comes when it's time to assess whether a particular hedge is effective. Although it's never explicitly stated in the documentation, there's a widespread assumption that a hedge should pass if it can satisfy an "80/125 test." According to this criterion, the measure of the results of the derivative relative to the gain or loss on the hedged item ideally should be 1 to 1, but a range from 0.80 to 1.25 is acceptable.

While that standard may seem to be reasonably generous, it tends to break down quite easily; as a result, even well performing hedges can quickly fall out of hedge effectiveness and thus be denied hedge accounting.

Let's take, for example, a situation where the value a \$1 million item changes by \$5 dollars, but the value of the offsetting hedge changes by \$10. The price changes are negligible, but the dollar-offset ratio—five divided by

ten—falls well beyond the 80–125 band. Denial of hedge accounting in the current period makes little difference, in that the price effects are negligible, but suppose we get kicked out of hedge accounting and *next* period a significant price change occurs. *Then* we're in trouble.

There is a way out of this conundrum. If you fall out of the 80–125 range, FASB will still permit hedge accounting, provided you redo the effectiveness test using some statistical analysis and methodology. How the test should be constructed, however, is not specified, although FASB does offer some guidance in an example of a firm seeking to hedge an exposure to natural gas prices.

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In the example, the "hedged item" is natural gas located in West Texas, and a derivative used to hedge the exposure is based on a price at the Henry Hub. To validate the "highly effective expectation," all that is required (according to the discussion in FAS 133, paragraph 75) is showing that the two respective prices (in this case, the price in West Texas and the price at the Henry Hub) are highly correlated.

What's tricky is that showing that two price *levels* are highly correlated offers no statistically valid information

about future prices *changes*. That is, even though price levels may be highly correlated, price changes may not be; hence, after doing this analysis on price levels, we really don't have a clue about whether the price *changes* will perform in an acceptable way. In fact, even though price levels may be highly correlated *ex ante*, people should be prepared for the fact that, *ex post*, the 80–125 rule will likely be violated quite often—perhaps as much as 50 percent of the time.

There does seem to be a consensus among those with statistical expertise that correlating price levels is a flawed methodology, given that the assessment of hedge effectiveness is supposed to be indicative of the way

derivatives results will offset *changes* in cash flows or fair values. As a consequence, it's not clear that audit firms will qualify this analysis. Some may, but others may not. Essentially, the audit firms are in the same bind as their clients. And it's a bind that FASB seems unwilling to resolve.

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