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International
Accounting Standards
Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: September 2006, London

Project: IAS 39 *Financial Instruments: Recognition and Measurement* –
Hedge Effectiveness on a Cumulative Basis (Agenda Paper 8(i))

SUMMARY OF THE ISSUE

1. The IFRIC has received a submission relating to assessment of hedge effectiveness.
2. Consider the following example:
 - Entity A designated a hedge on 25 June 20X1. Assume that the hedging relationship was a cash flow hedge.
 - Entity A needed to prepare its interim financial report for the six months ended 30 June 20X1.
 - At inception of the hedging relationship, Entity A documented that it would use regression analysis on an on-going basis to assess both retrospective and prospective hedge effectiveness.
 - The actual changes in cash flows of the hedging instrument and hedged item for the five-day period ended 30 June 20X1 were CU 75 and CU 100 respectively (i.e. the dollar-to-dollar comparison between the change in

cash flows of the hedging instrument and that of the hedged item was beyond a range of 80-125%).

- On 30 June 20X1, the hedge was expected to be highly effective over the life of the hedging instrument.

3. The issue is:

- When Entity A uses regression analysis to perform its retrospective and prospective hedge effectiveness tests on 30 June 20X1, whether the fact that the actual dollar-to-dollar comparison between the change in cash flows of the hedging instrument and that of the hedged item falls beyond a range of 80-125% over the initial five-day period necessarily means that Entity A fails to qualify for hedge accounting.

4. In order to qualify for hedge accounting, entities must pass both retrospective and prospective hedge effectiveness tests in accordance with AG 105 of IAS 39. Entities are required to perform retrospective and prospective hedge effectiveness tests at their annual or interim financial reporting dates in accordance with IAS 39¹.

5. Although illustrated in the context of a cash flow hedging relationship in the above example, the above-mentioned issue applies equally to a fair value hedging relationship.

6. The purpose of this agenda paper is not to address the recognition and measurement of the effective and ineffective portions. IAS 39 distinguishes the requirement to perform hedge effectiveness tests for hedge accounting qualification purposes from the requirement to measure hedge effectiveness and ineffectiveness for accounting recording purposes. Whether or not an entity can use hedge accounting depends on whether it meets the “highly effective” criteria in IAS 39. If an entity passes both the hedge effectiveness tests (including both retrospective and prospective tests set out in AG 105 of IAS 39), it can continue using hedge accounting. It should then measure the hedge ineffectiveness and recognise it immediately in its profit or loss. On the other hand, if an entity fails

¹ AG 106 of IAS 39 requires entities to perform hedge effectiveness tests, as a minimum, at the time when they prepare their annual or interim financial statements. In addition, IAS 39 requires that, in order to qualify for hedge accounting, both retrospective and prospective hedge effectiveness tests must be passed (see IAS 39.88(b), (e) and AG 105 of IAS 39).

one of the hedge effectiveness tests, it should discontinue hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated in accordance with IAS 39. And, the fair value movement of the hedging instrument since then should be recognised in profit or loss.

PREVIOUS AGENDA COMMITTEE DISCUSSION (JULY 2006)

7. The Agenda Committee agreed with the staff that the issue should not be taken onto the agenda.
8. The Agenda Committee noted that IAS 39 does not provide any specific guidance on how effectiveness tests are performed. [Remainder of paragraph omitted from observer note.]

STAFF ANALYSIS AND RECOMMENDATION

9. The submission to the IFRIC notes that F.4.2 of IAS 39 states: “expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship.” The paragraph continues with an example: “an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is UK base rate plus a margin. The UK base rate changes, perhaps once each quarter or less, in increments of 25-50 basis points, while LIBOR changes daily. Over a period of 1-2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.”
10. The submission interprets F.4.2 of IAS 39 as permitting an entity to use hedge accounting even if, at one particular reporting date, the results of the actual hedge effectiveness falls outside a range of 80-125%, provided that the hedging relationship on a cumulative basis is highly effective.
11. The staff believes that F.4.2 of IAS 39, which deals with whether expected hedge effectiveness can be assessed separately for each period or cumulatively over the life of the hedging relationship, focuses on prospective tests only. The staff agrees

that if an entity expects that the hedge will not be highly effective in a particular period in the future but still expects that the hedge is highly effective over the remaining life of the hedging relationship, it does not necessarily mean that the entity fails the prospective test. As mentioned above, in order to qualify for hedge accounting, both retrospective and prospective hedge effectiveness tests must be passed. The staff does not believe that F.4.2 is very helpful to solve the issue in this agenda paper, which is whether Entity A fails hedge effectiveness tests for hedge accounting qualification purposes if it uses regression analysis.

12. IAS 39 requires that all conditions set out in IAS 39.88 should be satisfied in order for an entity to qualify for hedge accounting. In particular, IAS 39.88 states the following:
 - At the inception of the hedge there is formal designation and documentation of the hedging relationship. That documentation shall include how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
 - The hedge is expected to be highly effective (see Appendix A paragraphs AG 105 – AG 113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
13. IAS 39 does not provide specific guidance on how hedge effectiveness tests for hedge qualification purposes should be performed. As required by IAS 39.88, entities should document their own methods at inception of the hedge and apply the same method consistently over the life of the hedging relationship.
14. IAS 39 does not preclude an entity from using regression analysis as long as the method is properly documented at inception of the hedge. AG 100 of IAS 39 headed *Designation of non-financial items as hedged items* states that: 'For example, a regression analysis could be performed to establish a statistical relationship between the hedged item and the hedging relationship. If there is a valid statistical relationship between the two variables, the slope of the regression line can be used to establish the hedge ratio that will maximise hedge effectiveness.'

15. BC 136B of IAS 39 states that: ‘the Board decided to amend the Standard to clarify that an expectation of high effectiveness may be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value of cash flows of the hedged items and those of the hedging instrument. The Board noted that the entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG 100.’
16. F.4.4 of IAS 39 headed *Hedge effectiveness: effectiveness tests* reaffirms the principles in IAS 39 by saying that:
- IAS 39 does not provide specific guidance about how effectiveness tests are performed.
 - Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, and statistical measurement techniques such as regression analysis.
 - The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used.
 - The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified.
 - If regression analysis is used, the entity’s documented policies for assessing hedge effectiveness must specify how the results of the regression will be assessed.
17. In the staff’s view, IAS 39 provides an entity with flexibility as to what methods can be used to determine whether criteria for hedge accounting are met in order to reflect its own risk management strategy, as long as the chosen method is properly documented at inception of the hedge. Throughout the life of the hedging relationship, entities should use the documented method to determine whether criteria for hedge accounting are met.
18. The staff believes that an entity should distinguish the requirement to perform hedge effectiveness tests for the hedge accounting qualification purposes from the

requirement to measure hedge ineffectiveness. [Remainder of paragraph omitted from observer note.]

19. [Paragraphs 19 – 22 omitted from observer note.]

APPENDIX – PROPOSED “REJECTION” WORDING [Omitted from observer note.]