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**International Accounting Standards Board**

*This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.*

*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:** **January 2007, London**

**Project:** **IAS 39 *Financial Instruments: Recognition and Measurement* - Assessing Hedge Effectiveness of an Interest Rate Swap in a Cash Flow Hedge (Agenda Paper 14(v))**

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## BACKGROUD INFORMATION

1. The IFRIC has been asked to consider a situation in which an interest rate swap with a non-zero fair value is designated as a hedging instrument in a cash flow hedge.

2. The submission states that ineffectiveness arises for hedge qualification purposes if an interest rate swap with a non-zero fair value is designated as a hedging instrument, and hedge effectiveness is assessed based on the changes in the fair value of cash flows of the hedging instrument and the hedged item (even though changes in the undiscounted cash flows of the hedging instrument may match perfectly with changes in the undiscounted cash flows of the hedged item). An example set out in Appendix 1 to this agenda paper illustrates why hedge ineffectiveness arises. In the staff's view, regardless of whether the time value of money is taken into account in assessing hedge effectiveness, hedge ineffectiveness arises (see Appendix 1).

**SUMMARY OF THE ISSUE**

3. The issue is, in the context of an interest rate swap being designated as a hedging instrument in a cash flow hedge, whether an entity is allowed to consider only changes in the undiscounted cash flows of the hedged item and the hedging instrument (i.e. no consideration of the time value of money) in assessing hedge effectiveness for hedge qualification purposes. Though the issue raised in the submission is in the context of an interest rate swap with a non-zero fair value at inception of the hedging instrument, the same issue arises in situations in which the fair value of the swap at inception is equal to zero.

4. A cash flow hedge is defined as a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or highly probable forecast transaction and (ii) could affect profit or loss (see IAS 39.86(b).

5. A number of paragraphs in IAS 39 state that the level of hedge effectiveness depends on the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. For example:

- IAS 39.9 defines hedge effectiveness as the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

- IAS 39.88(b) states: 'The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows, consistently with the originally documented risk management strategy for that particular hedging relationship.'

- AG 105 of IAS 39 states: 'At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.'

6. Some suggest, taking together the above paragraphs, that entities are allowed to assess hedge effectiveness based on a comparison between changes in the undiscounted cash flows of the hedging instrument and changes in the undiscounted cash flows of the hedged item (i.e. no consideration of the time value of money).

7. However, F.5.5 of the Guidance on Implementing IAS 39 states:

> *'It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IAS 39 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IAS 39.74). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.'*

**PURPOSE OF THIS AGENDA PAPER**

8. IAS 39 distinguishes the requirement to assess hedge effectiveness for hedge qualification purposes from the requirement to measure hedge effectiveness and ineffectiveness. Hedge ineffectiveness is required to be recognised in profit or loss in accordance with IAS 39.

9. IAS 39 paragraph 96 requires that, for cash flow hedges, the separate component of equity associated with the hedged item is adjusted to the lesser of (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge.

10. Therefore, in measuring hedge effectiveness and hedge ineffectiveness, entities inevitably need to consider the time value of money in order to be comparable with the gain or loss on the hedging instrument.

11. However, this agenda paper does not address how hedge effectiveness is measured for the purpose of recognising any ineffectiveness in profit or loss. Instead, this agenda paper focuses on the assessment of hedge effectiveness for hedge qualification purposes (see IAS 39.88(b) and AG 105 of IAS 39).

**SUMMARY OF THE STAFF RECOMMENDATION**

12. The staff believes that, when an interest rate swap is designated as a hedging instrument in a cash flow hedge, the time value of money should be considered in order to take into account the timing of interest payments or receipts.

13. Furthermore, IAS 39.74 does not allow the bifurcation of a single fair value of an interest rate swap for hedge designation purposes, unless the hedging instrument designated is an option or a forward contract. IAS 39.74 reasons that the factors that cause changes in fair value of a derivative hedging instrument are co-dependent. Consequently, the staff does not believe that an entity is allowed to consider only part of the fair value of the derivative hedging instrument in assessing hedge effectiveness for hedge qualification purposes (i.e. only considering the changes in undiscounted cash flows of the derivative hedging instrument).

14. For the above reasons, the staff recommends that the issue should not be taken onto the agenda. Proposed 'rejection' wording is set out in paragraph 27 of this agenda paper.

**STAFF ANALYSIS**

15. AG 108 of IAS 39 states:

> *'If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value or cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item.'*

16. AG 108 of IAS 39 suggests that a hedge is likely to be highly effective, if the principal terms of the hedging instrument and those of the hedged item are the same. In the context of an interest rate swap in a cash flow hedge, one of the principal terms relates to dates of interest payments or receipts. If the timing of interest payments or receipts of an interest rate swap does not match with that of the hedged item, the interest rate swap is less likely to be highly effective. For example, if interest payments of a floating rate borrowing are due on 31 December each year, whereas interest payments or receipts of an interest rate swap are exchanged on 31 January each year, ineffectiveness arises even though other principal terms (e.g. the notional and principal amounts, basis for measuring interest rates) perfectly match.

17. To reflect the mismatch of the timing of interest payments or receipts, the staff believes that an entity should take into account the time value of money.

18. Consistent with the above analysis, AG 112 of IAS 39 states:

> *'In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.'*

19. Furthermore, the staff notes that IAS 39.74 requires designation of a hedging instrument in its entirety for a hedging relationship, except if the hedging instrument designated is an option or a forward.

20. IAS 39.74 states:

> *'There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:*
>
> *(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and*
>
> *(b) separating the interest element and the spot price of a forward contract.'*

21. Since IAS 39.74 does not permit an entity to bifurcate the fair value of an interest rate swap for hedge designation purposes, it is difficult for the staff to justify why the entity might assess hedge effectiveness based on a portion of the fair value of the swap (i.e. mere consideration of the undiscounted changes in cash flows of the swap).

***F.5.5 of the Guidance on Implementing IAS 39***

22. F.5.5 of the Guidance on Implementing IAS 39 states:

> *'It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IAS 39 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IAS 39.74). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.'*

23. The staff believes that the above statement in F.5.5 of IAS 39 is a clarification of IAS 39.74, suggesting that the bifurcation of the fair value of a derivative hedging instrument is not allowed. However, the staff does not believe that it specifically addresses whether the time value of money should be considered in assessing hedge effectiveness for hedge qualification purposes.

***AG 107 of IAS 39***

24. AG 107 of IAS 39 states:

> *'This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing hedge effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value of money is excluded.'*

25. Some suggest that AG 107 of IAS 39 could be read as allowing entities to choose whether or not to include the time value of money in assessing hedge

effectiveness, as long as the chosen method is properly documented at inception of the hedge.

26. AG 107 of IAS 39 allows entities to choose an appropriate method for assessing hedge effectiveness that fits their risk management strategies. However, AG 107 of IAS 39 does not address whether the time value of money should be included in assessing hedge effectiveness. Instead, AG 107 of IAS 39 only requires the hedge documentation to state clearly whether the time value of money is included in assessing hedge effectiveness.

**PROPOSED 'REJECTION' WORDING**

27. [This paragraph omitted from the observer note.]

**APPENDIX 1: EXAMPLE**

[This example omitted from the observer note.]