Project **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic **Measurement of ineffectiveness – Impact of the time value of money**

Introduction

Background

1. This paper is one in a series of papers that addresses specific issues that arise when ***measuring*** hedge ineffectiveness.

Purpose of the paper

2. This paper discusses whether the time value of money should be considered when measuring hedge ineffectiveness.

The issue

3. Should the time value of money be considered when measuring hedge ineffectiveness?

Staff analysis and alternatives

Principles

4. As stated in paper 7 of the July 2010 meeting (Hedge Effectiveness – General Approach), the main objective for the measurement of hedge ineffectiveness is the quantification of the portion of the change in the fair value of the hedging

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

instrument that has not been offset by the change in the fair value of the hedged item attributable to the hedged risk (and vice versa for fair value hedges) in the measurement period.

5. When calculating the ineffective portion of the hedging relationship, entities shall consider the full change in fair value both of the hedged item and of the hedging instrument during a period (subject to the 'lower of' test for cash flow hedges).

6. This is given by a discounted cash flow measure that takes into account not only the time value of money but also the behaviour of the variables influencing the hedging relationship such as changes in the term structure of interest rates or changes to the behaviour of the underlying asset, changes in the basis. Any settlements that occurred during the measurement period shall be treated separately as they do not represent a source of ineffectiveness.

7. The issue of consideration of the time value money has been discussed by the IFRIC[1] in March 2007. The IFRIC was asked whether, when an entity designates an interest rate swap in a cash flow hedge, the entity is allowed to consider only the undiscounted changes in cash flows of the hedging instrument and hedged item in *assessing* hedge effectiveness for hedge qualification purposes.

8. The IFRIC decided not to add the issue to its agenda, on the basis that when an interest rate swap is designated as a hedging instrument, a reason for ineffectiveness is the mismatch of the timing of the interest payment or receipts of the swap and the hedged item. To take into account the timing of the cash flows from interest payments or receipts of the swap and hedged item, entities need to consider the effect of the *time value of money*. The IFRIC rejection notice also states:

> IAS 39 states that ineffectiveness arises when the principal terms of the hedged item do not match perfectly with those of the hedging instrument (see paragraph AG 108 of IAS 39). The IFRIC observed

[1] In 2010 the IFRIC became the IFRS Interpretations Committee.

> that a consequence of a comparison between changes in undiscounted cash flows of the hedged item for assessing hedge effectiveness is that only a portion of the movements in fair value of the swap is taken into account. The IFRIC noted that such a method for assessing hedge effectiveness would not meet the requirements in IAS 39…

9. Despite the overlapping in the IFRIC rejection notice between assessment and measurement of ineffectiveness, the IFRIC rejection notice is based on the principle that measurement of ineffectiveness shall consider the full performance both of the hedged item and the hedging instrument. Such performance can only be measured using present values, and therefore time value of money cannot be ignored.

10. In addition, hedging instruments (derivatives and some FX denominated financial assets and liabilities) are subject to a measurement either at FV or amortised cost that are present values. Hence, whatever (the hedged item) is compared to the changes in the value of these items must be on a present value basis. Moreover, hedge accounting does not change the measurement of the hedging instrument but only where the change in its carrying amount is presented (ie profit or loss or OCI). As a result, the same basis (ie present value) for the hedged item must be used otherwise a mismatch will be created.

Implications for hedge accounting

11. Allowing entities to perform the measurement of ineffectiveness based on undiscounted cash flow measures will not capture the full extent of the performance both of the hedged item and of the hedging instrument, and therefore ineffectiveness will not be recognised in its entirety. Ineffectiveness may arise as a result of the unwinding of the discount, and of changes in the behaviour of the variables affecting the fair value of the hedged item and the fair value of the hedging instrument.

Staff recommendation and question to the board

12. The staff recommend that *time value of money* shall be considered when performing the measurement of ineffectiveness.

Question 1 – Time value of money
Does the Board agree with the staff recommendation as outlined in paragraph 12? If not, what does the Board wish to do, and why?