Project	**Financial Instruments (Replacement of IAS 39) – Hedge Accounting**
Topic	**Measurement of Ineffectiveness – Principles (Cover Paper)**

Introduction

Background

1. This paper is one in a series of papers that address the ***measurement*** of hedge ineffectiveness.

Purpose of the paper and background

2. This paper proposes a principle and guidance supporting that principle when ***measuring*** hedge ineffectiveness.

3. At the 24 August 2010 meeting, the Board tentatively decided on an approach for hedge effectiveness ***assessment***, which was summarised in the IASB Update as follows:

   (a) The objective of the effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected ineffectiveness. Thus, for accounting purposes hedging relationships should not reflect a deliberate mismatch between the weightings of the hedged item and of the hedging instrument within the hedging relationship.

   (b) In addition, hedging relationships are expected to achieve offsetting of changes between the hedged item and the hedging instrument that are attributable to the hedged risk (other than accidental offsetting).

(c) The assessment is forward looking and is performed at inception and on an ongoing basis.

(d) The type of assessment (quantitative or qualitative) depends on the relevant characteristics of the hedging relationship and on the potential sources of ineffectiveness. The main source of information to perform the effectiveness assessment is entities' risk management.

(e) No particular methods for assessing hedge effectiveness are prescribed. However, the method used should be robust enough to capture the relevant characteristics of the hedging relationship including the sources of ineffectiveness.

(f) Changes in the method for assessing effectiveness are mandatory if there are unexpected sources of ineffectiveness (ie new sources not initially anticipated), or if, upon a rebalancing in the hedging relationship, the method previously used is no longer capable of capturing the sources of ineffectiveness and is therefore now not capable of demonstrating whether the hedge produces an unbiased result and minimises ineffectiveness.

4. This approach requires entities to design hedging relationships in such way that these will minimise ineffectiveness. In addition, this approach was developed based on the principle that any actual ineffectiveness must be recognised in the reporting period and (if earlier) prior to a rebalancing of the hedging relationship.

5. This paper is the overview paper that aims to outline the principles that entities should follow when UUU***measuring*** hedge ineffectiveness. Separate papers will be produced to address specific issues surrounding the measurement of hedge ineffectiveness.

Staff analysis

Objective

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

Principle and guidance

7. Taking the objective described in paragraph 6 above, the staff believes that measurement of hedge ineffectiveness should follow a 'dollar-offset' approach and be recognised at the end of the reporting period or upon a rebalancing of the hedging relationship (whichever happens first). The more detailed guidance supporting the principle that actual hedge ineffectiveness shall be recognised are outlined in the paragraphs below:

   (a) Entities shall calculate hedge ineffectiveness using the ratio between the change in the fair value of hedging instrument and the change in the fair value of the hedged item (otherwise known as the *dollar-offset*).

   (b) Measurement of hedge ineffectiveness shall be based on the actual performance of the hedged item and hedging instrument[1] .

   (c) Recognition of hedge ineffectiveness will differ depending on whether the hedging relationship is a fair value hedge or a cash flow hedge. This is due to the use of the '*lower of*' test for cash flow hedges whereby the amount of the effective portion to be recognised in Other Comprehensive Income (OCI) is the lower of:

[1] In some circumstances the clean price would suffice to capture all the ineffectiveness (eg. in a hedging relationship involving a fully match IRS), in others the dirty price might need to be used.

(i) the cumulative change in fair value of the hedging instrument; and

(ii) the cumulative change in fair value of the expected future cash flows of the hedged item[2].

8. For cash flow hedges, because of the '*lower of*' test, no hedge ineffectiveness is recognised in the income statement if the cumulative change in the fair value of the hedging instrument is lower than the cumulative change in the fair value of the expected future cash flows from the hedged item (refer to (c) above).

9. For fair value hedges, measurement of hedge ineffectiveness will be recognised in the income statement as a 'recycling' entry from OCI. (The Board tentatively decided to recognise in OCI both the adjustment to the hedged item attributable to hedged risk and the change in the value of the hedging instrument.) Ineffectiveness will arise if those amounts do not fully offset each other and therefore, ineffectiveness is the recycling entry to achieve full offsetting in OCI[3].

10. If a hedging relationship is subject to rebalancing of the hedge ratio, hedge ineffectiveness shall be recognised prior to the rebalancing. This means that prior to a change in the hedging relationship impacting the hedge ratio all the hedge ineffectiveness is recognised. It also avoids abusive accounting resulting from incorporating hedge ineffectiveness into the new hedge ratio.

[2] See October 2009 AP 11 for further details.
[3] See September 2009 AP 15 (application of cash flow hedge mechanics to fair value hedge) and July 2010 AP 8A for accounting for fair value hedges.

Question 1 – Measurement of ineffectiveness - Principles
Does the Board agree with the objective, principle and guidance outlined in paragraphs 7 to 10? If the Board disagrees, what do you propose, and why?