IAS 39 Financial Instruments: Recognition and Measurement (November 2006)

Testing of hedge effectiveness on a cumulative basis

The IFRIC was asked to consider a situation in which an entity uses regression analysis to assess both retrospective and prospective effectiveness. In measuring hedge effectiveness at the initial stage of the hedging relationship, the entity finds that the actual dollar-to-dollar comparison of the changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk and the changes in the fair value or cash flows of the hedging instrument was outside a range of 80-125 per cent. The issue was whether such a result meant that the entity failed to qualify for hedge accounting in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*

The IFRIC noted that IAS 39 distinguishes the requirement to perform periodic hedge effectiveness tests from the requirement to measure and recognise hedge effectiveness and ineffectiveness. The IFRIC noted that measurement of hedge effectiveness and ineffectiveness requires the comparison of the actual gains or losses on the hedging items and those on the hedged instruments.

However, the IFRIC observed that IAS 39 does not specify a single method for assessing retrospective and prospective hedge effectiveness. Paragraph 88 of IAS 39 requires that an entity should document the method for assessing hedge effectiveness at inception of the hedging relationship and apply the same method consistently over the life of the hedging relationship. The entity should use the documented method to perform the tests. The IFRIC believed that the fact that the dollar-to-dollar comparison of the changes in the fair value or cash flows of the hedged items and the changes in the fair value or cash flows of the hedging instrument falls outside a range of 80-125 per cent does not necessarily result in the entity failing to qualify for hedge accounting, provided that the dollar-to-dollar comparison is not the method documented at inception of the hedge for assessing hedge effectiveness. The IFRIC also noted that, regardless of how hedge effectiveness is assessed, IAS 39 requires any hedge ineffectiveness to be recognised in profit or loss.

The IFRIC noted that specifying how to apply a particular method for assessing hedge effectiveness would require development of application guidance (rather than an Interpretation). The IFRIC, therefore, decided not to take the issue onto the agenda.