

IAS 39 Financial Instruments: Recognition and Measurement (March 2007)

Assessing hedge effectiveness of an interest rate swap in a cash flow hedge

The IFRIC was asked whether, when an entity designates an interest rate swap as a hedging instrument in a cash flow hedge, the entity is allowed to consider only the undiscounted changes in cash flows of the hedging instrument and the hedged item in assessing hedge effectiveness for hedge qualification purposes.

The IFRIC noted that when an interest rate swap is designated as a hedging instrument, a reason for ineffectiveness is the mismatch of the timing of interest payments or receipts of the swap and the hedged item. To take into account the timing of cash flows from interest payments or receipts in assessing hedge effectiveness, entities need also to take into account the time value of money.

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 AG108 of IAS 39). The IFRIC observed that a consequence of a comparison between changes in undiscounted cash flows of an interest rate swap and 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. IAS 39 paragraph 74 does not allow the bifurcation of the fair value of a derivative hedging instrument for hedge designation purposes, unless the derivative hedging instrument is an option or a forward contract. The only exceptions permitted in IAS 39 paragraph 74 are separating the intrinsic value and time value of an option and separating the interest element and the spot price of a forward contract.

In the light of the above requirements in IFRSs, the IFRIC did not expect significant diversity in practice in the application of those requirements. The IFRIC, therefore, decided not to take the issue onto the agenda.