Deloitte.

20 October 2006

Robert Garnett, Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Email: ifric@iasb.org

Dear Bob,

IAS 39 *Financial Instruments: Recognition and Measurement* **– Testing of hedge effectiveness on a cumulative basis**

Deloitte Touche Tohmatsu is pleased to respond to IFRIC's publication in the September 2006 *IFRIC Update* of the tentative decision not to take onto the IFRIC agenda a request for an interpretation of a situation in which an entity uses regression analysis to assess both retrospective and prospective effectiveness but the results of measuring effectiveness on a dollar offset basis fall outside the range of 80-125%.

We support the IFRIC's decision not to take this item onto the agenda as IAS 39 is clear. We believe the rejection wording could be clearer in differentiating between *assessment* of hedge effectiveness (for the purposes of determining whether the hedge is "highly effective" in accordance with IAS 39.88(e)) and *measurement* of effectiveness (for the purposes of determining the amount of hedge ineffectiveness to be recognised in profit or loss). Differentiating between assessment and measurement is the crux of this issue[1]. We have proposed an amendment to the rejection wording included in the Appendix to make this clear.

We also agree that the development of guidance on how to apply a particular method of assessing effectiveness (such as regression analysis) would amount to creating

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[1] We note that the difference between assessment and measurement is well explained in FAS 133 DIG E7 and E8.

application guidance to the standard rather than interpreting it and therefore is not an issue within the IFRIC's remit.

Whilst we agree that hedge effectiveness assessment (which may involve regression analysis or other techniques) and measurement of hedge ineffectiveness (which is always required irrespective of the technique) are different, we do recognise that it is common that the results of a dollar-to-dollar comparison of the changes in the fair value or cash flows of the hedged item and hedging instrument may be used to support the statistical validity of outputs of a regression analysis.

Consider an example where an entity is hedging the interest rate risk of a fixed rate five year bond it has just issued. The entity uses regression to establish a strong statistical relationship between interest rates and bond fair values over the last five years to justify that on a prospective basis the fair value hedge will be highly effective over the life of the bond. At the end of the first reporting period the entity performs a retrospective assessment using regression. The entity adds the most recent actual data into the regression analysis, taking away the oldest data to update the regression analysis at the period end. If the entity continually failed a period to period or cumulative dollar-offset since the start of the hedge relationship this would indicate that the actual data being added is not representative of the past and would call into question whether the statistical relationship is valid. It is important that entities understand the input and outputs of statistical techniques rather than just relying on the results themselves. We are concerned that the IFRIC rejection could lead to entities purposely ignoring dollar-offset and other techniques that are important in supporting the validity of any statistical technique, such as regression. We have proposed an amendment to the rejection wording that is included in the Appendix to make this clear.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

cc: Allan Cook, IFRIC

Appendix:

IAS 39 *Financial Instruments: Recognition and Measurement* **– 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 tests of hedge effectiveness assessment 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. However, if statistical techniques like regression analysis are used entities must include as part of their hedge documentation the techniques they will apply on an ongoing basis to test the quality of the outputs of their regression to ensure the results are statistically valid. 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.