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Approval by the Board of IAS 39 issued in December 2003

International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003) was approved for issue by eleven of the fourteen members of the International Accounting Standards Board. Messrs Cope, Leisenring and McGregor dissented. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie

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Patricia L O'Malley

Harry K Schmid

John T Smith

Geoffrey Whittington

Tatsumi Yamada

Approval by the Board of *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Amendments to IAS 39) issued in March 2004

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk (Amendments to IAS 39) was approved for issue by thirteen of the fourteen members of the International Accounting Standards Board. Mr Smith dissented. His dissenting opinion is set out after the Basis for Conclusions.

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John T Smith	
Geoffrey Whittington	
Tatsumi Yamada	

Approval by the Board of *Transition and Initial Recognition of Financial Assets and Financial Liabilities* (Amendments to IAS 39) issued in December 2004

Transition and Initial Recognition of Financial Assets and Financial Liabilities (Amendments to IAS 39) was approved for issue by the fourteen members of the International Accounting Standards Board.

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Geoffrey Whittington

Tatsumi Yamada

Approval by the Board of *Cash Flow Hedge Accounting of Forecast Intragroup Transactions* (Amendments to IAS 39) issued in April 2005

Cash Flow Hedge Accounting of Forecast Intragroup Transactions (Amendments to IAS 39) was approved for issue by the fourteen members of the International Accounting Standards Board.

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Patricia L O'Malley

John T Smith

Geoffrey Whittington

Tatsumi Yamada

Approval by the Board of *The Fair Value Option* (Amendment to IAS 39) issued in June 2005

The Fair Value Option (Amendment to IAS 39) was approved for issue by eleven of the fourteen members of the International Accounting Standards Board. Professor Barth, Mr Garnett and Professor Whittington dissented. Their dissenting opinions are set out after the Basis for Conclusions.

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Gilbert Gélard

James J Leisenring

Warren J McGregor

Patricia L O'Malley

John T Smith

Geoffrey Whittington

Tatsumi Yamada

Approval by the Board of *Financial Guarantee Contracts* (Amendments to IAS 39 and IFRS 4) issued in August 2005

Financial Guarantee Contracts (Amendments to IAS 39) was approved for issue by the fourteen members of the International Accounting Standards Board.

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Gilbert Gélard	
James J Leisenring	
Warren J McGregor	
Patricia L O'Malley	
John T Smith	
Geoffrey Whittington	
Tatsumi Yamada	

Approval by the Board of *Eligible Hedged Items* (Amendment to IAS 39) issued in July 2008

Eligible Hedged Items (Amendment to IAS 39) was approved for issue by the thirteen members of the International Accounting Standards Board.

Sir David Tweedie

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John T Smith

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Wei-Guo Zhang

Approval by the Board of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) issued in October 2008

Reclassification of Financial Assets (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*) was approved for issue by eleven of the thirteen members of the International Accounting Standards Board. Messrs Leisenring and Smith dissented. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie

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John T Smith

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Wei-Guo Zhang

Approval by the Board of *Reclassification of Financial Assets—Effective Date and Transition* (Amendments to IAS 39 and IFRS 7) issued in November 2008

Reclassification of Financial Assets—Effective Date and Transition (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*) was approved for issue by the thirteen members of the International Accounting Standards Board.

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CONTENTS

**BASIS FOR CONCLUSIONS ON
IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT**
from paragraph

BACKGROUND	BC4
SCOPE	BC15
Loan commitments	BC15
Financial guarantee contracts	BC21
Contracts to buy or sell a non-financial item	BC24
Business combination forward contracts	BC24A
DEFINITIONS	BC25
Loans and receivables	BC25
Effective interest rate	BC30
Accounting for a change in estimates	BC36
EMBEDDED DERIVATIVES	BC37
Embedded foreign currency derivatives	BC37
Inability to measure embedded derivatives separately	BC40A
Embedded prepayment penalties	BC40B
RECOGNITION AND DERECOGNITION	BC41
Derecognition of a financial asset	BC41
The original IAS 39	BC41
Exposure draft	BC44
Comments received	BC46
Revisions to IAS 39	BC48
Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients	BC54
Transfers that do not qualify for derecognition	BC65
Continuing involvement in a transferred asset	BC67
MEASUREMENT	BC70A
Definitions	BC70A
Fair value option	BC71
Designation as at fair value through profit or loss eliminates or significantly reduces a measurement or recognition inconsistency	BC75
A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy	BC76
The instrument contains an embedded derivative that meets particular conditions	BC77
The role of prudential supervisors	BC78A
Other matters	BC80
Application of the fair value option to a component or a proportion (rather than the entirety) of a financial asset or a financial liability	BC85
Credit risk of liabilities	BC87
Measurement of financial liabilities with a demand feature	BC93
Reclassification of financial instruments	BC104A
Fair value measurement guidance	BC95
Use of quoted prices in active markets	BC96
No active market	BC102

Impairment and uncollectibility of financial assets	BC105
Impairment of investments in equity instruments	BC105
HEDGING	BC131
Consideration of the shortcut method in SFAS 133	BC132
Hedges of portions of financial assets and financial liabilities	BC135A
Expected effectiveness	BC136
Hedges of portions of non-financial assets and non-financial liabilities for risk other than foreign currency risk	BC137
Loan servicing rights	BC140
Whether to permit hedge accounting using cash instruments	BC144
Whether to treat hedges of forecast transactions as fair value hedges	BC146
Hedges of firm commitments	BC149
Basis adjustments	BC155
Basis adjustments for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability	BC161
Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability	BC162
Hedging using internal contracts	BC165
Eligible hedged items in particular situations	BC172B
Designation of a one-sided risk in a hedged item	BC172D
Designation of inflation in particular situations	BC172G
Fair value hedge accounting for a portfolio hedge of interest rate risk	BC173
Background	BC173
Scope	BC175
The issue: why fair value hedge accounting was difficult to achieve in accordance with previous versions of IAS 39	BC176
Prepayment risk	BC178
Designation of the hedged item and liabilities with a demand feature	BC182
What portion of assets should be designated and the impact on ineffectiveness	BC193
The carrying amount of the hedged item	BC207
Derecognition of amounts included in the separate line items	BC210
The hedging instrument	BC213
Hedge effectiveness for a portfolio hedge of interest rate risk	BC216
Transition to fair value hedge accounting for portfolios of interest rate risk	BC219
ELIMINATION OF SELECTED DIFFERENCES FROM US GAAP	BC221
SUMMARY OF CHANGES FROM THE EXPOSURE DRAFT	BC222
DISSENTING OPINIONS	

Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

This Basis for Conclusions accompanies, but is not part of, IAS 39.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements (as revised in 2007).

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions on revising IAS 39 *Financial Instruments: Recognition and Measurement* in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, with a comment deadline of 14 October 2002. In August 2003 the Board published a further Exposure Draft of Proposed Amendments to IAS 39 on *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003.
- BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and IAS 39, this Basis for Conclusions does not discuss requirements in IAS 39 that the Board has not reconsidered.

Background

- BC4 The original version of IAS 39 became effective for financial statements covering financial years beginning on or after 1 January 2001. It reflected a mixed measurement model in which some financial assets and financial liabilities are measured at fair value and others at cost or amortised cost, depending in part on an entity's intention in holding an instrument.
- BC5 The Board recognises that accounting for financial instruments is a difficult and controversial subject. The Board's predecessor body, the International Accounting Standards Committee (IASC) began its work on the issue some 15 years ago, in 1988. During the next eight years it published two Exposure Drafts, culminating in the issue of IAS 32 on disclosure and presentation in 1995. IASC decided that its initial proposals on recognition and measurement should not be progressed to a Standard, in view of:
- the critical response they had attracted;
 - evolving practices in financial instruments; and
 - the developing thinking by national standard-setters.
- BC6 Accordingly, in 1997 IASC published, jointly with the Canadian Accounting Standards Board, a discussion paper that proposed a different approach, namely that all financial assets and financial liabilities should be measured at fair value. The responses to that paper indicated both widespread unease with some of its proposals and that more work needed to be done before a standard requiring a full fair value approach could be contemplated.
- BC7 In the meantime, IASC concluded that a standard on the recognition and measurement of financial instruments was needed urgently. It noted that although financial instruments were widely held and used throughout the world, few countries apart from the United States had any recognition and measurement standards for them. In addition, IASC had agreed with the International Organization of Securities Commissions (IOSCO) that it would develop a set of 'core' International Accounting Standards that could be endorsed by IOSCO for the purpose of cross-border capital raising and listing in all global markets. Those core standards included one on the recognition and measurement of financial instruments. Accordingly, IASC developed the version of IAS 39 that was issued in 2000.
- BC8 In December 2000 a Financial Instruments Joint Working Group of Standard Setters (JWG), comprising representatives or members of accounting standard-setters and professional organisations from a range of countries, published a Draft Standard and Basis for Conclusions entitled *Financial Instruments and Similar*

Items. That Draft Standard proposed far-reaching changes to accounting for financial instruments and similar items, including the measurement of virtually all financial instruments at fair value. In the light of feedback on the JWG's proposals, it is evident that much more work is needed before a comprehensive fair value accounting model could be introduced.

- BC9 In July 2001 the Board announced that it would undertake a project to improve the existing requirements on the accounting for financial instruments in IAS 32 and IAS 39. The improvements deal with practice issues identified by audit firms, national standard-setters, regulators and others, and issues identified in the IAS 39 implementation guidance process or by IASB staff.
- BC10 In June 2002 the Board published an Exposure Draft of proposed amendments to IAS 32 and IAS 39 for a 116-day comment period. More than 170 comment letters were received.
- BC11 Subsequently, the Board took steps to enable constituents to inform it better about the main issues arising out of the comment process, and to enable the Board to explain its views of the issues and its tentative conclusions. These consultations included:
- (a) discussions with the Standards Advisory Council on the main issues raised in the comment process.
 - (b) nine round-table discussions with constituents during March 2003 conducted in Brussels and London. Over 100 organisations and individuals took part in those discussions.
 - (c) discussions with the Board's liaison standard-setters of the issues raised in the round-table discussions.
 - (d) meetings between members of the Board and its staff and various groups of constituents to explore further issues raised in comment letters and at the round-table discussions.
- BC11A Some of the comment letters on the June 2002 Exposure Draft and participants in the round-tables raised a significant issue for which the June 2003 Exposure Draft had not proposed any changes. This was hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as 'macro hedging') and the related question of the treatment in hedge accounting of deposits with a demand feature (sometimes referred to as 'demand deposits' or 'demandable liabilities'). In particular, some were concerned that it was very difficult to achieve fair value hedge accounting for a macro hedge in accordance with previous versions of IAS 39.
- BC11B In the light of these concerns, the Board decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. This resulted in a further Exposure Draft of Proposed Amendments to IAS 39 that was published in August 2003 and on which more than 120 comment letters were received. The amendments proposed in the Exposure Draft were finalised in March 2004.
- BC11C After those amendments were issued in March 2004 the Board received further comments from constituents calling for further amendments to the Standard. In particular, as a result of continuing discussions with constituents, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. These constituents were concerned that:
- (a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.
 - (b) the use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.
 - (c) if an entity applied the fair value option to financial liabilities, it might result in an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.
- In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option. In March 2005 the Board held a series of round-table meetings to discuss proposals with invited constituents. As a result of this process, the Board issued an amendment to IAS 39 in June 2005 relating to the fair value option.
- BC11D In September 2007, following a request from the International Financial Reporting Interpretations Committee (IFRIC), the Board published *Exposures Qualifying for Hedge Accounting*, an exposure draft of proposed amendments to IAS 39. The Board's objective was to clarify its requirements on exposures qualifying for hedge accounting and to provide additional guidance by specifying eligible risks and portions of cash flows. The Board received 75 responses to the exposure draft. Many respondents raised concerns about the rule-based approach proposed in the exposure draft. Their responses indicated that there was little diversity in practice regarding the designation of hedged items. However, the responses demonstrated that diversity in practice existed, or was likely to occur, in the two situations set out in paragraph BC172C. After considering the responses, the Board decided to focus on those two situations. Rather than specifying

eligible risks and portions as proposed in the exposure draft, the Board decided to address those situations by adding application guidance to illustrate how the principles underlying hedge accounting should be applied. The Board subsequently issued *Eligible Hedged Items* (Amendment to IAS 39) in July 2008. The rationale for the amendment is set out in paragraphs BC172B–BC172J.

- BC11E In October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP (Statements of Financial Accounting Standards No. 115 *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115) and No. 65 *Accounting for Certain Mortgage Banking Activities* (SFAS 65) issued by the US Financial Accounting Standards Board). In response the Board issued *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008. The amendments to IAS 39 permit non-derivative financial assets held for trading and available-for-sale financial assets to be reclassified in particular situations. The rationale for the amendments is set out in paragraphs BC104A–BC104E.
- BC11F Following the issue of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) in October 2008 constituents told the Board that there was uncertainty about the interaction between those amendments and IFRIC 9 regarding the assessment of embedded derivatives. In response the Board issued *Embedded Derivatives* (Amendments to IFRIC 9 and IAS 39) in March 2009. The amendment to IAS 39 clarifies the consequences if the fair value of the embedded derivative that would have to be separated cannot be measured separately.
- BC12 The Board did not reconsider the fundamental approach to accounting for financial instruments contained in IAS 39. Some of the complexity in existing requirements is inevitable in a mixed measurement model based in part on management's intentions for holding financial instruments and given the complexity of finance concepts and fair value estimation issues. The amendments reduce some of the complexity by clarifying the Standard, eliminating internal inconsistencies and incorporating additional guidance into the Standard.
- BC13 The amendments also eliminate or mitigate some differences between IAS 39 and US GAAP related to the measurement of financial instruments. Already, the measurement requirements in IAS 39 are, to a large extent, similar to equivalent requirements in US GAAP, in particular, those in FASB SFAS 114 *Accounting by Creditors for Impairment of a Loan*, SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* and SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*.
- BC14 The Board will continue its consideration of issues related to the accounting for financial instruments. However, it expects that the basic principles in the improved IAS 39 will be in place for a considerable period.

Scope

Loan commitments (paragraphs 2(h) and 4)

- BC15 Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. In the IAS 39 implementation guidance process, the question was raised whether a bank's loan commitments are derivatives accounted for at fair value under IAS 39. This question arises because a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. In effect, it is a written option for the potential borrower to obtain a loan at a specified rate.
- BC16 To simplify the accounting for holders and issuers of loan commitments, the Board decided to exclude particular loan commitments from the scope of IAS 39. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).
- BC17 However, the Board decided that an entity should be permitted to measure a loan commitment at fair value with changes in fair value recognised in profit or loss on the basis of designation at inception of the loan commitment as a financial liability through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis.
- BC18 The Board further decided that a loan commitment should be excluded from the scope of IAS 39 only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is difficult to justify its exclusion from the requirement in IAS 39 to measure at fair value similar instruments that meet the definition of a derivative.

- BC19 Some comments received on the Exposure Draft disagreed with the Board's proposal that an entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IAS 39 to all of its loan commitments. The Board considered this concern and agreed that the words in the Exposure Draft did not reflect the Board's intention. Thus, the Board clarified that if an entity has a past practice of selling the assets resulting from its loan commitments shortly after origination, it applies IAS 39 only to its loan commitments in the same class.
- BC20 Finally, the Board decided that commitments to provide a loan at a below-market interest rate should be initially measured at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. It noted that without such a requirement, liabilities that result from such commitments might not be recognised in the balance sheet, because in many cases no cash consideration is received.
- BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on loan commitments from the scope section of the Standard to the section on subsequent measurement (paragraph 47(d)). The purpose of this change was to rationalise the presentation of this material without making substantive changes.

Financial guarantee contracts (paragraphs 2(e), 9, 47(c), AG4 and AG4A)

- BC21 In finalising IFRS 4 *Insurance Contracts* in early 2004, the Board reached the following conclusions:
- (a) Financial guarantee contracts can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. However, although this difference in legal form may in some cases reflect differences in substance, the accounting for these instruments should not depend on their legal form.
 - (b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39. This was the case before the Board finalised IFRS 4.
 - (c) As required before the Board finalised IFRS 4, if a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if it is an insurance contract, as defined in IFRS 4.
 - (d) Unless (c) applies, the following treatment is appropriate for a financial guarantee contract that meets the definition of an insurance contract:
 - (i) At inception, the issuer of a financial guarantee contract has a recognisable liability and should measure it at fair value. If a financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.
 - (ii) Subsequently, the issuer should measure the contract at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.
- BC22 Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board finalised IFRS 4 in early 2004 without specifying the accounting for these contracts and then published an Exposure Draft *Financial Guarantee Contracts and Credit Insurance* in July 2004 to expose for public comment the conclusion set out in paragraph BC21(d). The Board set a comment deadline of 8 October 2004 and received more than 60 comment letters. Before reviewing the comment letters, the Board held a public education session at which it received briefings from representatives of the International Credit Insurance & Surety Association and of the Association of Financial Guaranty Insurers.
- BC23 Some respondents to the Exposure Draft of July 2004 argued that there were important economic differences between credit insurance contracts and other forms of contract that met the proposed definition of a financial guarantee contract. However, both in developing the Exposure Draft and in subsequently discussing the comments received, the Board was unable to identify differences that would justify differences in accounting treatment.
- BC23A Some respondents to the Exposure Draft of July 2004 noted that some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not address until phase II of its project on insurance contracts. They argued that the Exposure Draft did not give enough guidance to enable them to account for these features. The Board concluded it could not address such

features in the short term. The Board noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the Board was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the Board decided the following:

- (a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.
- (b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39.

BC23B The Board does not regard criteria such as those described in paragraph BC23A(a) as suitable for the long term, because they can lead to different accounting for contracts that have similar economic effects. However, the Board could not find a more compelling approach to resolve its concerns for the short term. Moreover, although the criteria described in paragraph BC23A(a) may appear imprecise, the Board believes that the criteria would provide a clear answer in the vast majority of cases. Paragraph AG4A gives guidance on the application of those criteria.

BC23C The Board considered convergence with US GAAP. In US GAAP, the requirements for financial guarantee contracts (other than those covered by US standards specific to the insurance sector) are in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The recognition and measurement requirements of FIN 45 do not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. Some respondents to the Exposure Draft of July 2004 asked the Board to provide a similar exemption. They argued that the requirement to recognise these financial guarantee contracts in separate or individual financial statements would cause costs disproportionate to the likely benefits, given that intragroup transactions are eliminated on consolidation. However, to avoid the omission of material liabilities from separate or individual financial statements, the Board did not create such an exemption.

BC23D The Board issued the amendments for financial guarantee contracts in August 2005. After those amendments, the recognition and measurement requirements for financial guarantee contracts within the scope of IAS 39 are consistent with FIN 45 in some areas, but differ in others:

- (a) Like FIN 45, IAS 39 requires initial recognition at fair value.
- (b) IAS 39 requires systematic amortisation, in accordance with IAS 18, of the liability recognised initially. This is compatible with FIN 45, though FIN 45 contains less prescriptive requirements on subsequent measurement. Both IAS 39 and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).
- (c) Like FIN 45, IAS 39 permits a different treatment for financial guarantee contracts issued by insurers.
- (d) Unlike FIN 45, IAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control. However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities.

BC23E Some respondents to the Exposure Draft of July 2004 asked for guidance on the treatment of financial guarantee contracts by the holder. However, this was beyond the limited scope of the project.

Contracts to buy or sell a non-financial item (paragraphs 5–7 and AG10)

BC24 Before the amendments, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The Board concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative when it (i) can be settled net or by exchanging financial instruments and (ii) is not held for the purpose of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale). In addition, the Board concluded that the notion of when a contract can be settled net should include contracts:

- (a) where the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments;

- (b) for which the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (c) in which the non-financial item that is the subject of the contract is readily convertible to cash.

Because practices of settling net or taking delivery of the underlying and selling it within a short period after delivery also indicate that the contracts are not 'normal' purchases or sales, such contracts are within the scope of IAS 39 and are accounted for as derivatives. The Board also decided to clarify that a written option that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of the Standard and cannot qualify as a 'normal' purchase or sale.

Business combination forward contracts

- BC24A The Board was advised that there was diversity in practice regarding the application of the exemption in paragraph 2(g) of IAS 39. Paragraph 2(g) applies to particular contracts associated with a business combination and results in those contracts not being accounted for as derivatives while, for example, necessary regulatory and legal processes are being completed.
- BC24B As part of the *Improvements to IFRSs* issued in April 2009, the Board concluded that paragraph 2(g) should be restricted to forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree in a business combination at a future acquisition date and should not apply to option contracts, whether or not currently exercisable, that on exercise will result in control of an entity.
- BC24C The Board concluded that paragraph 2(g) is to exempt contracts for business combinations that are firmly committed to be completed from the provisions of this Standard. Once the business combination is consummated, the entity follows the requirements of IFRS 3. Paragraph 2(g) applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time is required). Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.
- BC24D Several respondents to the exposure draft expressed the view that the proposed amendment also should apply to contracts to acquire investments in associates referring to paragraph 20 of IAS 28. However, the acquisition of an interest in an associate represents the acquisition of a financial instrument. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures. The Board concluded that paragraph 2(g) should not be applied by analogy to contracts to acquire investments in associates and similar transactions. This conclusion is consistent with the conclusion the Board reached regarding impairment losses in investments in associates as noted in the *Improvements to IFRSs* issued in May 2008 and stated in BC27 of IAS 28.
- BC24E Some respondents to the exposure draft raised concerns about the proposed requirement to apply the amendment prospectively. The Board noted that determining the fair value of a currently outstanding contract when its inception was prior to the effective date of this amendment would require the use of hindsight and may not achieve comparability. Accordingly, the Board decided not to require retrospective application. The Board also rejected applying the amendment prospectively only to new contracts entered into after the effective date because that would create a lack of comparability between contracts outstanding as of the effective date and contracts entered into after the effective date. Therefore, the Board concluded that the amendment to paragraph 2(g) should be applied prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010.

Definitions

Loans and receivables (paragraphs 9, 46(a) and AG26)

- BC25 The principal difference between loans and receivables and other financial assets is that loans and receivables are not subject to the tainting provisions that apply to held-to-maturity investments. Loans and receivables that are not held for trading may be measured at amortised cost even if an entity does not have the positive intention and ability to hold the loan asset until maturity.
- BC26 The Board decided that the ability to measure a financial asset at amortised cost without consideration of the entity's intention and ability to hold the asset until maturity is most appropriate when there is no liquid market for the asset. It is less appropriate to extend the category to debt instruments traded in liquid

markets. The distinction for measurement purposes between liquid debt instruments that are acquired upon issue and liquid debt instruments that are acquired shortly afterwards is difficult to justify on conceptual grounds. Why should a liquid debt instrument that is purchased on the day of issue be treated differently from a liquid debt instrument that is purchased one week after issue? Why should it not be possible to classify a liquid debt instrument that is acquired directly from the issuer as available for sale, with fair value gains and losses recognised in equity? Why should a liquid debt instrument that is bought shortly after it is issued be subject to tainting provisions, if a liquid debt instrument that is bought at the time of issue is not subject to tainting provisions?

- BC27 The Board therefore decided to add a condition to the definition of a loan or receivable. More specifically, an entity should not be permitted to classify as a loan or receivable an investment in a debt instrument that is quoted in an active market. For such an investment, an entity should be required to demonstrate its positive intention and ability to hold the investment until maturity to be permitted to measure the investment at amortised cost by classifying it as held to maturity.
- BC28 The Board considered comments received on the proposal in the Exposure Draft (which was unchanged from the requirement in the original IAS 39) that ‘loans and receivables’ must be originated (rather than purchased) to meet that classification. Such comments suggested that purchased loans should be eligible for classification as loans and receivables, for example, if an entity buys a loan portfolio, and the purchased loans meet the definition other than the fact that they were purchased. Such comments also noted that (a) some entities typically manage purchased and originated loans together, and (b) there are systems problems of segregating purchased loans from originated loans given that a distinction between them is likely to be made only for accounting purposes. In the light of these concerns, the Board decided to remove the requirement that loans or receivables must be originated by the entity to meet the definition of ‘loans and receivables’.
- BC29 However, the Board was concerned that removing this requirement might result in some instruments that should be measured at fair value meeting the definition of loans and receivables and thus being measured at amortised cost. In particular, the Board was concerned that this would be the case for a debt instrument in which the purchaser may not recover its investment, for example a fixed rate interest-only strip created in a securitisation and subject to prepayment risk. The Board therefore decided to exclude from the definition of loans and receivables instruments for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration. Such assets are accounted for as available for sale or at fair value through profit or loss.

Effective interest rate (paragraphs 9 and AG5–AG8)

- BC30 The Board considered whether the effective interest rate for all financial instruments should be calculated on the basis of estimated cash flows (consistently with the original IAS 39) or whether the use of estimated cash flows should be restricted to groups of financial instruments with contractual cash flows being used for individual financial instruments. The Board agreed to reconfirm the position in the original IAS 39 because it achieves consistent application of the effective interest method throughout the Standard.
- BC31 The Board noted that future cash flows and the expected life can be reliably estimated for most financial assets and financial liabilities, in particular for a group of similar financial assets or similar financial liabilities. However, the Board acknowledged that in some rare cases it might not be possible to estimate the timing or amount of future cash flows reliably. It therefore decided to require that if it is not possible to estimate reliably the future cash flows or the expected life of a financial instrument, the entity should use contractual cash flows over the full contractual term of the financial instrument.
- BC32 The Board also decided to clarify that expected future defaults should not be included in estimates of cash flows because this would be a departure from the incurred loss model for impairment recognition. At the same time, the Board noted that in some cases, for example, when a financial asset is acquired at a deep discount, credit losses have occurred and are reflected in the price. If an entity does not take into account such credit losses in the calculation of the effective interest rate, the entity would recognise a higher interest income than that inherent in the price paid. The Board therefore decided to clarify that such credit losses are included in the estimated cash flows when computing the effective interest rate.
- BC33 The revised IAS 39 refers to all fees ‘that are an integral part of the effective interest rate’. The Board included this reference to clarify that IAS 39 relates only to those fees that are determined to be an integral part of the effective interest rate in accordance with IAS 18.
- BC34 Some commentators noted that it was not always clear how to interpret the requirement in the original IAS 39 that the effective interest rate must be based on discounting cash flows through maturity or the next market-based repricing date. In particular, it was not always clear whether fees, transaction costs and other premiums or discounts included in the calculation of the effective interest rate should be amortised over the period until maturity or the period to the next market-based repricing date.

- BC35 For consistency with the estimated cash flows approach, the Board decided to clarify that the effective interest rate is calculated over the expected life of the instrument or, when applicable, a shorter period. A shorter period is used when the variable (eg interest rates) to which the fee, transaction costs, discount or premium relates is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date.
- BC35A The Board identified an apparent inconsistency in the guidance in the revised IAS 39. It related to whether the revised or the original effective interest rate of a debt instrument should be applied when remeasuring the instrument's carrying amount on the cessation of fair value hedge accounting. A revised effective interest rate is calculated when fair value hedge accounting ceases. The Board removed this inconsistency as part of *Improvements to IFRSs* issued in May 2008 by clarifying that the remeasurement of an instrument in accordance with paragraph AG8 is based on the revised effective interest rate calculated in accordance with paragraph 92, when applicable, rather than the original effective interest rate.

Accounting for a change in estimates

- BC36 The Board considered the accounting for a change in the estimates used in calculating the effective interest rate. The Board agreed that if an entity revises its estimates of payments or receipts, it should adjust the carrying amount of the financial instrument to reflect actual and revised estimated cash flows. The adjustment is recognised as income or expense in profit or loss. The entity recalculates the carrying amount by computing the present value of remaining cash flows at the original effective interest rate of the financial instrument. The Board noted that this approach has the practical advantage that it does not require recalculation of the effective interest rate, ie the entity simply recognises the remaining cash flows at the original rate.

As a result, this approach avoids a possible conflict with the requirement when assessing impairment to discount estimated cash flows using the original effective interest rate.

Embedded derivatives

Embedded foreign currency derivatives (paragraphs 10 and AG33(d))

- BC37 A rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, a commodity forward in a debt instrument. To achieve consistency in accounting for such embedded derivatives, all derivatives embedded in financial instruments that are not measured at fair value with gains and losses recognised in profit or loss ought to be accounted for separately as derivatives. However, as a practical expedient IAS 39 provides that an embedded derivative need not be separated if it is regarded as closely related to its host contract. When the embedded derivative bears a close economic relationship to the host contract, such as a cap or a floor on the interest rate on a loan, it is less likely that the derivative was embedded to achieve a desired accounting result.
- BC38 The original IAS 39 specified that a foreign currency derivative embedded in a non-financial host contract (such as a supply contract denominated in a foreign currency) was not separated if it required payments denominated in the currency of the primary economic environment in which any substantial party to the contract operates (their functional currencies) or the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (such as the US dollar for crude oil transactions). Such foreign currency derivatives are regarded as bearing such a close economic relationship to their host contracts that they do not have to be separated.
- BC39 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) rather than the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.
- BC40 In revising IAS 39, the Board concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency

derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place. A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperinflationary Economies*).

Inability to measure an embedded derivative separately (paragraph 12)

- BC40A As described in paragraph BC11F, the Board also considered another issue related to a reclassification of a hybrid (combined) financial asset out of the fair value through profit or loss category. If the fair value of the embedded derivative that would have to be separated cannot be measured separately, the Board decided to clarify that the hybrid (combined) financial asset in its entirety should remain in the fair value through profit or loss category. The Board noted that the clarification to paragraph 12 would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates, and hence avoid a requirement to reclassify the hybrid (combined) financial asset back into the fair value through profit or loss category at the end of the financial reporting period. The amendments were issued in March 2009.

Embedded prepayment penalties (paragraph AG30(g))

- BC40B The Board identified an apparent inconsistency in the guidance in IAS 39. The inconsistency related to embedded prepayment options in which the exercise price represented a penalty for early repayment (ie prepayment) of the loan. The inconsistency related to whether these are considered closely related to the loan.
- BC40C The Board decided to remove this inconsistency by amending paragraph AG30(g). The amendment makes an exception to the examples in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise prices of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.

Recognition and derecognition

Derecognition of a financial asset (paragraphs 15–37)

The original IAS 39

- BC41 Under the original IAS 39, several concepts governed when a financial asset should be derecognised. It was not always clear when and in what order to apply these concepts. As a result, the derecognition requirements in the original IAS 39 were not applied consistently in practice.
- BC42 As an example, the original IAS 39 was unclear about the extent to which risks and rewards of a transferred asset should be considered for the purpose of determining whether derecognition is appropriate and how risks and rewards should be assessed. In some cases (eg transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (eg credit guarantees) it was unclear. Also, some questioned whether the assessment should focus on risks and rewards or only risks and how different risks and rewards should be aggregated and weighed.
- BC43 To illustrate, assume an entity sells a portfolio of short-term receivables of CU100¹ and provides a guarantee to the buyer for credit losses up to a specified amount (say CU20) that is less than the total amount of the receivables, but higher than the amount of expected losses (say CU5). In this case, should (a) the entire portfolio continue to be recognised, (b) the portion that is guaranteed continue to be recognised or (c) the portfolio be derecognised in full and a guarantee be recognised as a financial liability? The original IAS 39 did not give a clear answer and the IAS 39 Implementation Guidance Committee—a group set up by the Board's predecessor body to resolve interpretative issues raised in practice—was unable to reach an agreement on how IAS 39 should be applied in this case. In developing proposals for improvements to

¹ In this Basis for Conclusions, monetary amounts are denominated in 'currency units' (CU).

IAS 39, the Board concluded that it was important that IAS 39 should provide clear and consistent guidance on how to account for such a transaction.

Exposure draft

- BC44 To resolve the problems, the Exposure Draft proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash settled option).
- BC45 The purpose of the approach proposed in the Exposure Draft was to facilitate consistent implementation and application of IAS 39 by eliminating conflicting concepts and establishing an unambiguous, more internally consistent and workable approach to derecognition. The main benefits of the proposed approach were that it would greatly clarify IAS 39 and provide transparency on the face of the balance sheet about any continuing involvement in a transferred asset.

Comments received

- BC46 Many respondents agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the continuing involvement approach proposed in the Exposure Draft. Respondents expressed conceptual and practical concerns, including:
- (a) any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems;
 - (b) the proposed approach was a fundamental change from that in the original IAS 39;
 - (c) the proposal did not achieve convergence with US GAAP;
 - (d) the proposal was untested; and
 - (e) the proposal was not consistent with the *Framework*.
- BC47 Many respondents expressed the view that the basic approach in the original IAS 39 should be retained in the revised Standard and the inconsistencies removed. The reasons included: (a) the existing IAS 39 was proven to be reasonable in concept and operational in practice and (b) the approach should not be changed until the Board developed an alternative comprehensive approach.

Revisions to IAS 39

- BC48 In response to the comments received, the Board decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied. In particular, the Board decided that an evaluation of the transfer of risks and rewards should precede an evaluation of the transfer of control for all types of transactions.
- BC49 Although the structure and wording of the derecognition requirements have been substantially amended, the Board concluded that the requirements in the revised IAS 39 are not substantially different from those in the original IAS 39. In support of this conclusion, it noted that the application of the requirements in the revised IAS 39 generally results in answers that could have been obtained under the original IAS 39. In addition, although there will be a need to apply judgement to evaluate whether substantially all risks and rewards have been retained, this type of judgement is not new compared with the original IAS 39. However, the revised requirements clarify the application of the concepts in circumstances in which it was previously unclear how IAS 39 should be applied. The Board concluded that it would be inappropriate to revert to the original IAS 39 without such clarifications.
- BC50 The Board also decided to include guidance in the Standard that clarifies how to evaluate the concepts of risks and rewards and of control. The Board regards such guidance as important to provide a framework for applying the concepts in IAS 39. Although judgement is still necessary to apply the concepts in practice, the guidance should increase consistency in how the concepts are applied.
- BC51 More specifically, the Board decided that the transfer of risks and rewards should be evaluated by comparing the entity's exposure before and after the transfer to the variability in the amounts and timing of the net cash flows of the transferred asset. If the entity's exposure, on a present value basis, has not changed significantly, the entity would conclude that it has retained substantially all risks and rewards. In this case, the Board concluded that the asset should continue to be recognised. This accounting treatment is consistent with the treatment of repurchase transactions and some assets subject to deep in-the-money options under

the original IAS 39. It is also consistent with how some interpreted the original IAS 39 when an entity sells a portfolio of short-term receivables but retains all substantive risks through the issue of a guarantee to compensate for all expected credit losses (see the example in paragraph BC43).

- BC52 The Board decided that control should be evaluated by looking to whether the transferee has the practical ability to sell the asset. If the transferee can sell the asset (eg because the asset is readily obtainable in the market and the transferee can obtain a replacement asset should it need to return the asset to the transferor), the transferor has not retained control because the transferor does not control the transferee's use of the asset. If the transferee cannot sell the asset (eg because the transferor has a call option and the asset is not readily obtainable in the market, so that the transferee cannot obtain a replacement asset), the transferor has retained control because the transferee is not free to use the asset as its own.
- BC53 The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue. It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset is considered for derecognition only if it comprises:
- (a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);
 - (b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or
 - (c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

In all other cases the derecognition principles are applied to the financial asset in its entirety.

Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 19)

- BC54 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a 'pass-through arrangement'). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.
- BC55 To illustrate the issue using a simple example, assume the following. Entity A makes a five-year interest-bearing loan (the 'original asset') of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?²
- BC56 To address these issues, the Exposure Draft of proposed amendments to IAS 39 included guidance to clarify under which conditions pass-through arrangements can be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the *Framework*,³ when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for derecognition even though the entity may

² SIC-12 *Consolidation—Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

³ References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.
- BC57 Respondents to the Exposure Draft were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC-12 *Consolidation—Special Purpose Entities*). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.
- BC58 Considering these and other comments, the Board decided to proceed with its proposals to issue guidance on pass-through arrangements and to clarify that guidance in finalising the revised IAS 39.
- BC59 The Board concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:
- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.
 - (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.
- BC60 These conditions follow from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).
- BC61 The Board decided that the derecognition tests that apply to other transfers of financial assets (ie the tests of transferring substantially all the risks and rewards and control) should also apply to arrangements to pass through cash flows that meet the three conditions but do not involve a fully proportional share of all or specifically identified cash flows. Thus, if the three conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BC55) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, in the example in paragraph BC55, Entity A would report a loan asset of CU10 and derecognise CU90. Similarly, if an entity enters into an arrangement that meets the three conditions above, but the arrangement is not on a fully proportionate basis, the contractual arrangement would have to meet the general derecognition conditions to qualify for derecognition. This ensures consistency in the application of the derecognition model, whether a transaction is structured as a transfer of the contractual right to receive the cash flows of a financial asset or as an arrangement to pass through cash flows.
- BC62 To illustrate a disproportionate arrangement using a simple example, assume the following. Entity A originates a portfolio of five-year interest-bearing loans of CU10,000. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A retains rights to the last CU1,000 (plus interest), ie it retains a subordinated residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000 because some debtors default, Entity A would pass on to Entity C all of the CU8,000 collected and Entity A keeps nothing of the CU8,000 collected. If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500. In this case, if Entity A retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows, the loans continue to be recognised in their entirety even if the three pass-through conditions are met.
- BC63 The Board recognises that many securitisations may fail to qualify for derecognition either because one or more of the three conditions in paragraph 19 are not met or because the entity has retained substantially all the risks and rewards of ownership.
- BC64 Whether a transfer of a financial asset qualifies for derecognition does not differ depending on whether the transfer is direct to investors or through a consolidated SPE or trust that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors.

Transfers that do not qualify for derecognition (paragraph 29)

- BC65 The original IAS 39 did not provide guidance about how to account for a transfer of a financial asset that does not qualify for derecognition. The amendments include such guidance. To ensure that the accounting reflects the rights and obligations that the transferor has in relation to the transferred asset, there is a need to consider the accounting for the asset as well as the accounting for the associated liability.
- BC66 When an entity retains substantially all the risks and rewards of the asset (eg in a repurchase transaction), there are generally no special accounting considerations because the entity retains upside and downside exposure to gains and losses resulting from the transferred asset. Therefore, the asset continues to be recognised in its entirety and the proceeds received are recognised as a liability. Similarly, the entity continues to recognise any income from the asset along with any expense incurred on the associated liability.

Continuing involvement in a transferred asset (paragraphs 30–35)

- BC67 The Board decided that if the entity determines that it has neither retained nor transferred substantially all of the risks and rewards of an asset and that it has retained control, the entity should continue to recognise the asset to the extent of its continuing involvement. This is to reflect the transferor's continuing exposure to the risks and rewards of the asset and that this exposure is not related to the entire asset, but is limited in amount. The Board noted that precluding derecognition to the extent of the continuing involvement is useful to users of financial statements in such cases, because it reflects the entity's retained exposure to the risks and rewards of the financial asset better than full derecognition.
- BC68 When the entity transfers some significant risks and rewards and retains others and derecognition is precluded because the entity retains control of the transferred asset, the entity no longer retains all the upside and downside exposure to gains and losses resulting from the transferred asset. Therefore, the revised IAS 39 requires the asset and the associated liability to be measured in a way that ensures that any changes in value of the transferred asset that are not attributed to the entity are not recognised by the entity.
- BC69 For example, special measurement and income recognition issues arise if derecognition is precluded because the transferor has retained a call option or written a put option and the asset is measured at fair value. In those situations, in the absence of additional guidance, application of the general measurement and income recognition requirements for financial assets and financial liabilities in IAS 39 may result in accounting that does not represent the transferor's rights and obligations related to the transfer.
- BC70 As another example, if the transferor retains a call option on a transferred available-for-sale financial asset and the fair value of the asset decreases below the exercise price, the transferor does not suffer a loss because it has no obligation to exercise the call option. In that case, the Board decided that it is appropriate to adjust the measurement of the liability to reflect that the transferor has no exposure to decreases in the fair value of the asset below the option exercise price. Similarly, if a transferor writes a put option and the fair value of the asset exceeds the exercise price, the transferee need not exercise the put. Because the transferor has no right to increases in the fair value of the asset above the option exercise price, it is appropriate to measure the asset at the lower of (a) the option exercise price and (b) the fair value of the asset.

Measurement

Definitions (paragraph 9)

- BC70A The definition of a financial asset or financial liability at fair value through profit or loss excludes derivatives that are designated and effective hedging instruments. Paragraph 50 of IAS 39 prohibits the reclassification of financial instruments into or out of the fair value through profit or loss category after initial recognition. The Board noted that the prohibition on reclassification in paragraph 50 might be read as preventing a derivative financial instrument that becomes a designated and effective hedging instrument from being excluded from the fair value through profit or loss category in accordance with the definition. Similarly, it might be read as preventing a derivative that ceases to be a designated and effective hedging instrument from being accounted for at fair value through profit or loss.
- BC70B The Board decided that the prohibition on reclassification in paragraph 50 should not prevent a derivative from being accounted for at fair value through profit or loss when it does not qualify for hedge accounting and vice versa. Therefore, in *Improvements to IFRSs* issued in May 2008, the Board amended the definitions in paragraph 9(a) and added paragraph 50A to address this point.

Fair value option (paragraph 9)

- BC71 The Board concluded that it could simplify the application of IAS 39 (as revised in 2000) for some entities by permitting the use of fair value measurement for any financial instrument. With one exception (see paragraph 9), this greater use of fair value is optional. The fair value measurement option does not require entities to measure more financial instruments at fair value.
- BC72 IAS 39 (as revised in 2000) did not permit an entity to measure particular categories of financial instruments at fair value with changes in fair value recognised in profit or loss. Examples included:
- (a) originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading in paragraph 9.
 - (b) financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available-for-sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading in paragraph 9.
 - (c) non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.
- BC73 The Board decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss ('fair value through profit or loss'). To impose discipline on this approach, the Board decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. The Board noted that the requirement to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to 'cherry pick' in this way. This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.
- BC73A Following the issue of IAS 39 (as revised in 2003), as a result of continuing discussions with constituents on the fair value option, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately (as discussed in paragraph BC11C). In response to those concerns, the Board published in April 2004 an Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003). After discussing comments received from constituents and a series of public round-table meetings, the Board issued an amendment to IAS 39 in June 2005 permitting entities to designate irrevocably on initial recognition financial instruments that meet one of three conditions (see paragraphs 9(b)(i), 9(b)(ii) and 11A) as ones to be measured at fair value through profit or loss.
- BC74 In the amendment to the fair value option, the Board identified three situations in which permitting designation at fair value through profit or loss either results in more relevant information (cases (a) and (b) below) or is justified on the grounds of reducing complexity or increasing measurement reliability (case (c) below). These are:
- (a) when such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise (paragraphs BC75–BC75B);
 - (b) when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraphs BC76–BC76B); and
 - (c) when an instrument contains an embedded derivative that meets particular conditions (paragraphs BC77–BC78).
- BC74A The ability for entities to use the fair value option simplifies the application of IAS 39 by mitigating some anomalies that result from the different measurement attributes in the Standard. In particular, for financial instruments designated in this way:
- (a) it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analysing hedge effectiveness.
 - (b) it eliminates the burden of separating embedded derivatives.
 - (c) it eliminates problems arising from a mixed measurement model when financial assets are measured at fair value and related financial liabilities are measured at amortised cost. In particular, it

eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently.

- (d) the option to recognise unrealised gains and losses on available-for-sale financial assets in profit or loss is no longer necessary.
- (e) it de-emphasises interpretative issues around what constitutes trading.

Designation as at fair value through profit or loss eliminates or significantly reduces a measurement or recognition inconsistency (paragraph 9(b)(i))

BC75 IAS 39, like comparable standards in some national jurisdictions, imposes a mixed-attribute measurement model. It requires some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It requires some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity.⁴ This combination of measurement and recognition requirements can result in inconsistencies, which some refer to as ‘accounting mismatches’, between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.

BC75A Some entities can overcome measurement or recognition inconsistencies by using hedge accounting or, in the case of insurers, shadow accounting. However, the Board recognises that those techniques are complex and do not address all situations. In developing the amendment to the fair value option, the Board considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.

BC75B The Board concluded that accounting mismatches arise in a wide variety of circumstances. In the Board’s view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the Board concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. Hence, the Board decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option. Rather, the Board decided to require disclosures in IAS 32⁵ about:

- the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss
- how the entity satisfies the conditions in this Standard for such designation
- the nature of the assets and liabilities so designated
- the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability’s credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.

A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraph 9(b)(ii))

BC76 The Standard requires financial instruments to be measured at fair value through profit or loss in only two situations, namely when an instrument is held for trading or when it contains an embedded derivative that the entity is unable to measure separately. However, the Board recognised that some entities manage and evaluate the performance of financial instruments on a fair value basis in other situations. Furthermore, for

⁴ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 these other gains and losses are recognised in other comprehensive income.

⁵ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

instruments managed and evaluated in this way, users of financial statements may regard fair value measurement as providing more relevant information. Finally, it is established practice in some industries in some jurisdictions to recognise all financial assets at fair value through profit or loss. (This practice was permitted for many assets in IAS 39 (as revised in 2000) as an accounting policy choice in accordance with which gains and losses on all available-for-sale financial assets were reported in profit or loss.)

- BC76A In the amendment to IAS 39 relating to the fair value option issued in June 2005, the Board decided to permit financial instruments managed and evaluated on a fair value basis to be measured at fair value through profit or loss. The Board also decided to introduce two requirements to make this category operational. These requirements are that the financial instruments are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and that information about the financial instruments is provided internally on that basis to the entity's key management personnel.
- BC76B In looking to an entity's documented risk management or investment strategy, the Board makes no judgement on what an entity's strategy should be. However, the Board noted that users, in making economic decisions, would find useful both a description of the chosen strategy and how designation at fair value through profit or loss is consistent with it. Accordingly, IAS 32⁶ requires such disclosures. The Board also noted that the required documentation of the entity's strategy need not be on an item-by-item basis, nor need it be in the level of detail required for hedge accounting. However, it should be sufficient to demonstrate that using the fair value option is consistent with the entity's risk management or investment strategy. In many cases, the entity's existing documentation, as approved by its key management personnel, should be sufficient for this purpose.

The instrument contains an embedded derivative that meets particular conditions (paragraph 11A)

- BC77 The Standard requires virtually all derivative financial instruments to be measured at fair value. This requirement extends to derivatives that are *embedded* in an instrument that also includes a non-derivative host contract if the embedded derivative meets the conditions in paragraph 11. Conversely, if the embedded derivative does not meet those conditions, separate accounting with measurement of the embedded derivative at fair value is prohibited. Therefore, to satisfy these requirements, the entity must:
- (a) identify whether the instrument contains one or more embedded derivatives,
 - (b) determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and
 - (c) if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.
- BC77A For some embedded derivatives, like the prepayment option in an ordinary residential mortgage, this process is fairly simple. However, entities with more complex instruments have reported that the search for and analysis of embedded derivatives (steps (a) and (b) in paragraph BC77) significantly increase the cost of complying with the Standard. They report that this cost could be eliminated if they had the option to fair value the combined contract.
- BC77B Other entities report that one of the most common uses of the fair value option is likely to be for structured products that contain several embedded derivatives. Those structured products will typically be hedged with derivatives that offset all (or nearly all) of the risks they contain, whether or not the embedded derivatives that give rise to those risks are separated for accounting purposes. Hence, the simplest way to account for such products is to apply the fair value option so that the combined contract (as well as the derivatives that hedge it) is measured at fair value through profit or loss. Furthermore, for these more complex instruments, the fair value of the combined contract may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that IAS 39 requires to be separated.
- BC78 The Board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions of this Standard and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The Board determined that allowing the fair value option to be used for *any* instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. Therefore, the Board decided to specify situations in which an entity cannot justify using the fair value option in place of assessing embedded derivatives—when the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or is

⁶ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments Disclosures*.

one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

The role of prudential supervisors

- BC78A The Board considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The Board recognised that regulated financial institutions are extensive holders and issuers of financial instruments and so are likely to be among the largest potential users of the fair value option. However, the Board noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.
- BC79 The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.
- BC79A The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the Board agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the Board decided to require an entity to disclose how it has satisfied the conditions in paragraphs 9(b), 11A and 12 for using the fair value option, including, for instruments within paragraph 9(b)(ii), a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Other matters

- BC80 IAS 39 (as revised in 2000) contained an accounting policy choice for the recognition of gains and losses on available-for-sale financial assets—such gains and losses could be recognised either in equity or in profit or loss. The Board concluded that the fair value option removed the need for such an accounting policy choice. An entity can achieve recognition of gains and losses on such assets in profit or loss in appropriate cases by using the fair value option. Accordingly, the Board decided that the choice that was in IAS 39 (as revised in 2000) should be removed and that gains and losses on available-for-sale financial assets should be recognised in equity when IAS 39 was revised in 2003.
- BC80A The fair value option permits (but does not require) entities to measure financial instruments at fair value with changes in fair value recognised in profit or loss. Accordingly, it does not restrict an entity's ability to use other accounting methods (such as amortised cost). Some respondents to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 would have preferred more pervasive changes to expand the use of fair values and limit the choices available to entities, such as the elimination of the held-to-maturity category or the cash flow hedge accounting approach. Although such changes have the potential to make the principles in IAS 39 more coherent and less complex, the Board did not consider such changes as part of the project to improve IAS 39.
- BC81 Comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 also questioned the proposal that all items measured at fair value through profit or loss should have the descriptor 'held for trading'. Some comments noted that 'held for trading' is commonly used with a narrower meaning, and it may be confusing for users if instruments designated at fair value through profit or loss are also called 'held for trading'. Therefore, the Board considered using a fifth category of financial instruments—'fair value through profit or loss'—to distinguish those instruments to which the fair value option was applied from those classified as held for trading. The Board rejected this possibility because it believed adding a fifth category of financial instruments would unnecessarily complicate the Standard. Rather, the Board concluded that 'fair value through profit or loss' should be used to describe a category that encompasses financial instruments classified as held for trading and those to which the fair value option is applied.
- BC82 In addition, the Board decided to include a requirement for an entity to classify a financial liability as held for trading if it is incurred principally for the purpose of repurchasing it in the near term or it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a

recent pattern of short-term profit-taking. In these circumstances, the absence of a requirement to measure such financial liabilities at fair value permits cherry-picking of unrealised gains or losses. For example, if an entity wishes to recognise a gain, it can repurchase a fixed rate debt instrument that was issued in an environment where interest rates were lower than in the reporting period and if it wishes to recognise a loss, it can repurchase an issued debt instrument that was issued in an environment in which interest rates were higher than in the reporting period. However, a financial liability is not classified as held for trading merely because it funds assets that are held for trading.

- BC83 The Board decided to include in revised IAS 32⁷ a requirement to disclose the settlement amount repayable at maturity of a liability that is designated as at fair value through profit or loss. This gives users of financial statements information about the amount owed by the entity to its creditors in the event of its liquidation.
- BC84 The Board also decided to include in IAS 39 (as revised in 2003) the ability for entities to designate a loan or receivable as available for sale (see paragraph 9). The Board decided that, in the context of the existing mixed measurement model, there are no reasons to limit to any particular type of asset the ability to designate an asset as available for sale.

Application of the fair value option to a component or a proportion (rather than the entirety) of a financial asset or a financial liability

- BC85 Some comments received on the Exposure Draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value option should be extended so that it could also be applied to a component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).
- BC86 The Board concluded that IAS 39 should not extend the fair value option to components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the component because of ordering issues and joint effects (ie if the component is affected by more than one risk, it may be difficult to isolate accurately and measure the component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value adjustment for a component may move the carrying amount of an instrument away from its fair value. In finalising the 2003 amendments to IAS 39, the Board separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC145).
- BC86A Other comments received on the April 2004 Exposure Draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The Board was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, CU10 million specified certificates, the first (or last) CU10 million certificates to be redeemed, or on some other basis? The Board was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to 'cherry pick' (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the Board decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability. However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency, as explained in paragraph AG4G). Thus, in the above example, the entity could designate CU10 million specified certificates if to do so would meet one of the three criteria in paragraph BC74.

Credit risk of liabilities

- BC87 The Board discussed the issue of including changes in the credit risk of a financial liability in its fair value measurement. It considered responses to the Exposure Draft of proposed amendments to IAS 39 published in June 2002 that expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the Board concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in the Standard (as revised in 2003) because to do so would negate some of the benefits of the fair value option set out in paragraph BC74A.

⁷ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

- BC88 The Board considered comments on the Exposure Draft that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and a loan expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when a liability's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in the instrument's credit risk.
- BC89 However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability⁸ reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:
- (a) entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;
 - (b) changes in credit risk affect the observed market price of a financial liability and hence its fair value;
 - (c) it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and
 - (d) the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.
- BC90 The Board also considered whether the component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that whilst separately presenting or disclosing such changes might be difficult in practice, disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided to include in IAS 32⁹ a disclosure to help identify the changes in the fair value of a financial liability that arise from changes in the liability's credit risk. The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.
- BC91 The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity. The Board noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.¹⁰
- BC92 The Board also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.
- BC92A IFRS 13, issued in May 2011, includes requirements for measuring the fair value of a liability issued with an inseparable third-party credit enhancement from the issuer's perspective.

Measurement of financial liabilities with a demand feature¹¹

BC93–BC94 [Deleted]

Fair value measurement guidance (paragraphs AG69–AG82)¹²

- BC95 The Board decided to include in the revised IAS 39 expanded guidance about how to determine fair values, in particular for financial instruments for which no quoted market price is available (Appendix A paragraphs AG74–AG82).¹³ The Board decided that it is desirable to provide clear and reasonably detailed

⁸ IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

⁹ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

¹⁰ IFRS 13, issued in May 2011, describes the objective of a fair value measurement of a liability.

¹¹ IFRS 13, issued in May 2011, resulted in the relocation of paragraphs BC93 and BC94 of IAS 39 to paragraphs BCZ102 and BCZ103 of IFRS 13. As a consequence minor necessary edits have been made to that material.

¹² IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

¹³ IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence in Appendix A of IAS 39 paragraphs AG69–AG75, AG76A–AG79 and AG82 have been deleted and paragraphs AG76, AG80 and AG81 have been amended.

guidance about the objective and use of valuation techniques to achieve reliable and comparable fair value estimates when financial instruments are measured at fair value.

Use of quoted prices in active markets (paragraphs AG71–AG73)

- BC96 The Board considered comments received that disagreed with the proposal in the Exposure Draft that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market. Some respondents argued that (a) valuation techniques are more appropriate for measuring fair value than a quoted price in an active market (eg for derivatives) and (b) valuation models are consistent with industry best practice, and are justified because of their acceptance for regulatory capital purposes.
- BC97 However, the Board confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value as defined¹⁴ in the Standard does not depend on entity-specific factors. The Board further clarified that a quoted price includes market-quoted rates as well as prices.

Entities that have access to more than one active market (paragraph AG71)

- BC98 The Board considered situations in which entities operate in different markets. An example is a trader that originates a derivative with a corporate in an active corporate retail market and offsets the derivative by taking out a derivative with a dealer in an active dealers' wholesale market. The Board decided to clarify that the objective of fair value measurement is to arrive at the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market¹⁵ to which an entity has immediate access. Thus, if a dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers' market, the entity recognises a profit on initial recognition of the derivative instrument. However, the entity adjusts the price observed in the dealer market for any differences in counterparty credit risk between the derivative instrument with the corporate and that with the dealers' market.

Bid-ask spreads in active markets (paragraph AG72)

- BC99 The Board confirmed the proposal in the Exposure Draft that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price.¹⁶ It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising up-front gains or losses for the difference between the bid-ask price and the mid-market price.
- BC100 The Board discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.¹⁷
- BC101 Comments received on the Exposure Draft revealed that some interpret the term 'bid-ask spread' differently from others and from the Board. Thus, IAS 39 clarifies that the spread represents only transaction costs.

¹⁴ IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

¹⁵ IFRS 13, issued in May 2011, states that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market, or in the absence of a principal market, the most advantageous market for the asset or liability.

¹⁶ IFRS 13, issued in May 2011, states that fair value is measured using the price within the bid-ask spread that is most representative of fair value in the circumstances.

¹⁷ IFRS 13, issued in May 2011, permits an exception to the fair value measurement requirements when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or the credit risk of a particular counterparty, allowing the entity to measure the fair value of its financial instruments on the basis of the entity's net exposure to either of those risks.

No active market (paragraphs AG74–AG82)

- BC102 The Exposure Draft proposed a three-tier fair value measurement hierarchy as follows:
- (a) For instruments traded in active markets, use a quoted price.
 - (b) For instruments for which there is not an active market, use a recent market transaction.
 - (c) For instruments for which there is neither an active market nor a recent market transaction, use a valuation technique.
- BC103 The Board decided to simplify the proposed fair value measurement hierarchy¹⁸ by requiring the fair value of financial instruments for which there is not an active market to be determined on the basis of valuation techniques, including the use of recent market transactions between knowledgeable, willing parties in an arm's length transaction.
- BC104 The Board also considered constituents' comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising up-front gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value¹⁹. The Board also noted that its decision achieved convergence with US GAAP.²⁰

Reclassification of financial instruments (paragraphs 50–54)

- BC104A As described in paragraph BC11E, in October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP. SFAS 115 permits a security to be reclassified out of the trading category in rare situations. SFAS 65 permits a loan to be reclassified out of the Held for Sale category if the entity has the intention and ability to hold the loan for the foreseeable future or until maturity. IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held-for-trading category as is permitted by SFAS 115 and SFAS 65.
- BC104B The Board noted that allowing reclassification, even in limited circumstances, could allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets.
- BC104C The Board was also informed that, in practice under US GAAP, reclassification out of the trading category of SFAS 115 is extremely rare. However, the Board noted that the possibility of reclassification of securities and loans under US GAAP is available and that entities applying IFRSs do not have that possibility.
- BC104D The Board therefore decided to permit non-derivative financial assets to be reclassified out of the held-for-trading category in the same circumstances as are permitted in SFAS 115 and SFAS 65. The Board also noted that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term. In addition, the Board decided that a financial asset that would have met the definition of loans and receivables (if it had not been designated as available for sale) should be permitted to be transferred from the available-for-sale category to loans and receivables, if the entity intends to hold the loan or receivable for the foreseeable future or until maturity. The Board decided that this substantially aligns the accounting for reclassifications of loans and receivables with that permitted under US GAAP.
- BC104E The Board normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, given the requests to address this issue urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to proceed directly to issuing the amendments. In taking this exceptional step the Board noted that the amendments to IAS 39 relaxed the existing requirements to provide short-term relief for some entities. The

¹⁸ IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value.

¹⁹ IFRS 13, issued in May 2011, describes when a transaction price might not represent the fair value of an asset or a liability at initial recognition.

²⁰ FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) superseded EITF Issue No. 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Involved in Energy Trading and Risk Management Activities* (Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*[®] codified SFAS 157). As a result, IFRSs and US GAAP have different requirements for when an entity may recognise a gain or loss when there is a difference between fair value and the transaction price at initial recognition.

Board also noted that the amendments were a short-term response to the requests and therefore the Board decided to restrict the scope of the amendments. Shortly afterwards, in response to representations from some interested parties, the Board issued a further amendment, clarifying the effective date of the amendments to IAS 39.

Impairment and uncollectibility of financial assets

Impairment of investments in equity instruments (paragraph 61)

- BC105 Under IAS 39, investments in equity instruments that are classified as available for sale and investments in unquoted equity instruments²¹ whose fair value cannot be reliably measured are subject to an impairment assessment. The original IAS 39 did not include guidance about impairment indicators that are specific to investments in equity instruments. Questions were raised about when in practice such investments become impaired.
- BC106 The Board agreed that for marketable investments in equity instruments any impairment trigger other than a decline in fair value below cost is likely to be arbitrary to some extent. If markets are reasonably efficient, today's market price is the best estimate of the discounted value of the future market price. However, the Board also concluded that it is important to provide guidance to address the questions raised in practice.
- BC107 The revised IAS 39 includes impairment triggers that the Board concluded were reasonable in the case of investments in equity instruments (paragraph 61). They apply in addition to those specified in paragraph 59, which focus on the assessment of impairment in debt instruments.

Incurred versus expected losses

- BC108 Some respondents to the Exposure Draft were confused about whether the Exposure Draft reflected an 'incurred loss' model or an 'expected loss' model. Others expressed concern about the extent to which 'future losses' could be recognised as impairment losses. They suggested that losses should be recognised only when they are incurred (ie a deterioration in the credit quality of an asset or a group of assets after their initial recognition). Other respondents favoured the use of an expected loss approach. They suggested that expected future losses should be considered in the determination of the impairment loss for a group of assets even if the credit quality of a group of assets has not deteriorated from original expectations.
- BC109 In considering these comments, the Board decided that impairment losses should be recognised only if they have been incurred. The Board reasoned that it was inconsistent with an amortised cost model to recognise impairment on the basis of expected future transactions and events. The Board also decided that guidance should be provided about what 'incurred' means when assessing whether impairment exists in a group of financial assets. The Board was concerned that, in the absence of such guidance, there could be a range of interpretations about when a loss is incurred or what events cause a loss to be incurred in a group of assets.
- BC110 Therefore, the Board included guidance in IAS 39 that specifies that for a loss to be incurred, an event that provides objective evidence of impairment must have occurred after the initial recognition of the financial asset, and IAS 39 now identifies types of such events. Possible or expected future trends that may lead to a loss in the future (eg an expectation that unemployment will rise or a recession will occur) do not provide objective evidence of impairment. In addition, the loss event must have a reliably measurable effect on the present value of estimated future cash flows and be supported by current observable data.

Assets assessed individually and found not to be impaired (paragraphs 59(f) and 64)

- BC111 It was not clear in the original IAS 39 whether loans and receivables and some other financial assets, when reviewed for impairment and determined not to be impaired, could or should subsequently be included in the assessment of impairment for a group of financial assets with similar characteristics.
- BC112 The Exposure Draft proposed that a loan asset or other financial asset that is measured at amortised cost and has been individually assessed for impairment and found not to be impaired should be included in a collective assessment of impairment. The Exposure Draft also included proposed guidance about how to evaluate impairment inherent in a group of financial assets.

²¹ IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

- BC113 The comment letters received on the Exposure Draft indicated considerable support for the proposal to include in a collective evaluation of impairment an individually assessed financial asset that is found not to be impaired.
- BC114 The Board noted the following arguments in favour of an additional portfolio assessment for individually assessed assets that are found not to be impaired.
- (a) Impairment that cannot be identified with an individual loan may be identifiable on a portfolio basis. The *Framework* states that for a large population of receivables, some degree of non-payment is normally regarded as probable. In that case, an expense representing the expected reduction in economic benefits is recognised (*Framework*, paragraph 85).²² For example, a lender may have some concerns about identified loans with similar characteristics, but not have sufficient evidence to conclude that an impairment loss has occurred on any of those loans on the basis of an individual assessment. Experience may indicate that some of those loans are impaired even though an individual assessment may not reveal this. The amount of loss in a large population of items can be estimated on the basis of experience and other factors by weighing all possible outcomes by their associated probabilities.
 - (b) Some time may elapse between an event that affects the ability of a borrower to repay a loan and actual default of the borrower. For example, if the market forward price for wheat decreases by 10 per cent, experience may indicate that the estimated payments from borrowers that are wheat farmers will decrease by 1 per cent over a one-year period. When the forward price decreases, there may be no objective evidence that any individual wheat farmer will default on an individually significant loan. On a portfolio basis, however, the decrease in the forward price may provide objective evidence that the estimated future cash flows on loans to wheat farmers have decreased by 1 per cent over a one-year period.
 - (c) Under IAS 39, impairment of loans is measured on the basis of the present value of estimated future cash flows. Estimations of future cash flows may change because of economic factors affecting a group of loans, such as country and industry factors, even if there is no objective evidence of impairment of an individual loan. For example, if unemployment increases by 10 per cent in a quarter in a particular region, the estimated future cash flows from loans to borrowers in that region for the next quarters may have decreased even though no objective evidence of impairment exists that is based on an individual assessment of loans to borrowers in that region. In that case, objective evidence of impairment exists for the group of financial assets, even though it does not exist for an individual asset. A requirement for objective evidence to exist to recognise and measure impairment in individually significant loans might result in delayed recognition of loan impairment that has already occurred.
 - (d) Accepted accounting practice in some countries is to establish a provision to cover impairment losses that, although not specifically identified to individual assets, are known from experience to exist in a loan portfolio as of the balance sheet date.
 - (e) If assets that are individually not significant are collectively assessed for impairment and assets that are individually significant are not, assets will not be measured on a consistent basis because impairment losses are more difficult to identify asset by asset.
 - (f) What is an individually significant loan that is assessed on its own will differ from one entity to another. Thus, identical exposures will be evaluated on different bases (individually or collectively), depending on their significance to the entity holding them. If a collective evaluation were not to be required, an entity that wishes to minimise its recognised impairment losses could elect to assess all loans individually. Requiring a collective assessment of impairment for all exposures judged not to be impaired individually enhances consistency between entities rather than reduces it.
- BC115 Arguments against an additional portfolio assessment for individually assessed loans that are found not to be impaired are as follows.
- (a) It appears illogical to make an impairment provision on a group of loans that have been assessed for impairment on an individual basis and have been found not to be impaired.
 - (b) The measurement of impairment should not depend on whether a lender has only one loan or a group of similar loans. If the measurement of impairment is affected by whether the lender has groups of similar loans, identical loans may be measured differently by different lenders. To ensure consistent measurement of identical loans, impairment in individually significant financial assets should be recognised and measured asset by asset.

²² now paragraph 4.40 of the *Conceptual Framework*

- (c) The *Framework* specifies that financial statements are prepared on the accrual basis of accounting, according to which the effects of transactions and events are recognised when they occur and are recognised in the financial statements in the periods to which they relate. Financial statements should reflect the outcome of events that took place before the balance sheet date and should not reflect events that have not yet occurred. If an impairment loss cannot be attributed to a specifically identified financial asset or a group of financial assets that are not individually significant, it is questionable whether an event has occurred that justifies the recognition of impairment. Even though the risk of loss may have increased, a loss has not yet materialised.
 - (d) The *Framework*, paragraph 94²³, requires an expense to be recognised only if it can be measured reliably. The process of estimating impairment in a group of loans that have been individually assessed for impairment but found not to be impaired may involve a significant degree of subjectivity. There may be a wide range of reasonable estimates of impairment. In practice, the establishment of general loan loss provisions is sometimes viewed as more of an art than a science. This portfolio approach should be applied only if it is necessary on practical grounds and not to override an assessment made on an individual loan, which must provide a better determination of whether an allowance is necessary.
 - (e) IAS 39 requires impairment to be measured on a present value basis using the original effective interest rate. Mechanically, it may not be obvious how to do this for a group of loans with similar characteristics that have different effective interest rates. In addition, measurement of impairment in a group of loans based on the present value of estimated cash flows discounted using the original effective interest rate may result in double-counting of losses that were expected on a portfolio basis when the loans were originated because the lender included compensation for those losses in the contractual interest rate charged. As a result, a portfolio assessment of impairment may result in the recognition of a loss almost as soon as a loan is issued. (This question arises also in measuring impairment on a portfolio basis for loans that are not individually assessed for impairment under IAS 39.)
- BC116 The Board was persuaded by the arguments in favour of a portfolio assessment for individually assessed assets that are found not to be impaired and decided to confirm that a loan or other financial asset measured at amortised cost that is individually assessed for impairment and found not to be impaired should be included in a group of similar financial assets that are assessed for impairment on a portfolio basis. This is to reflect that, in the light of the law of large numbers, impairment may be evident in a group of assets, but not yet meet the threshold for recognition when any individual asset in that group is assessed. The Board also confirmed that it is important to provide guidance about how to assess impairment on a portfolio basis to introduce discipline into a portfolio assessment. Such guidance promotes consistency in practice and comparability of information across entities. It should also mitigate concerns that collective assessments of impairment should not be used to conceal changes in asset values or as a cushion for potential future losses.
- BC117 Some respondents expressed concerns about some of the detailed guidance proposed in the Exposure Draft, such as the guidance about adjusting the discount rate for expected losses. Many entities indicated that they do not have the data and systems necessary to implement the proposed approach. The Board decided to eliminate some of the detailed application guidance (eg whether to make an adjustment of the discount rate for originally expected losses and an illustration of the application of the guidance).

Assets that are assessed individually and found to be impaired (paragraph 64)

- BC118 In making a portfolio assessment of impairment, one issue that arises is whether the collective assessment should include assets that have been individually evaluated and identified as impaired.
- BC119 One view is that methods used to estimate impairment losses on a portfolio basis are equally valid whether or not an asset has been specifically identified as impaired. Those who support this view note that the law of large numbers applies equally whether or not an asset has been individually identified as impaired and that a portfolio assessment may enable a more accurate prediction to be made of estimated future cash flows.
- BC120 Another view is that there should be no need to complement an individual assessment of impairment for an asset that is specifically identified as impaired by an additional portfolio assessment, because objective evidence of impairment exists on an individual basis and expectations of losses can be incorporated in the measurement of impairment for the individual assets. Double-counting of losses in terms of estimated future cash flows should not be permitted. Moreover, recognition of impairment losses for groups of assets should not be a substitute for the recognition of impairment losses on individual assets.
- BC121 The Board decided that assets that are individually assessed for impairment and identified as impaired should be excluded from a portfolio assessment of impairment. Excluding assets that are individually

²³ now paragraph 4.49 of the *Conceptual Framework*

identified as impaired from a portfolio assessment of impairment is consistent with the view that collective evaluation of impairment is an interim step pending the identification of impairment losses on individual assets. A collective evaluation identifies losses that have been incurred on a group basis as of the balance sheet date, but cannot yet be identified with individual assets. As soon as information is available to identify losses on individually impaired assets, those assets are removed from the group that is collectively assessed for impairment.

Grouping of assets that are collectively evaluated for impairment (paragraphs 64 and AG87)

- BC122 The Board considered how assets that are collectively assessed for impairment should be grouped for the purpose of assessing impairment on a portfolio basis. In practice, different methods are conceivable for grouping assets for the purposes of assessing impairment and computing historical and expected loss rates. For example, assets may be grouped on the basis of one or more of the following characteristics: (a) estimated default probabilities or credit risk grades; (b) type (for example, mortgage loans or credit card loans); (c) geographical location; (d) collateral type; (e) counterparty type (for example, consumer, commercial or sovereign); (f) past-due status; and (g) maturity. More sophisticated credit risk models or methodologies for estimating expected future cash flows may combine several factors, for example, a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status, and other relevant characteristics of the assets being evaluated and associated loss data.
- BC123 The Board decided that for the purpose of assessing impairment on a portfolio basis, the method employed for grouping assets should, as a minimum, ensure that individual assets are allocated to groups of assets that share similar credit risk characteristics. It also decided to clarify that when assets that are assessed individually and found not to be impaired are grouped with assets with similar credit risk characteristics that are assessed only on a collective basis, the loss probabilities and other loss statistics differ between the two types of asset with the result that a different amount of impairment may be required.

Estimates of future cash flows in groups (paragraphs AG89–AG92)

- BC124 The Board decided that to promote consistency in the estimation of impairment on groups of financial assets that are collectively evaluated for impairment, guidance should be provided about the process for estimating future cash flows in such groups. It identified the following elements as critical to an adequate process:
- (a) Historical loss experience should provide the basis for estimating future cash flows in a group of financial assets that are collectively assessed for impairment.
 - (b) Entities that have no loss experience of their own or insufficient experience should use peer group experience for comparable groups of financial assets.
 - (c) Historical loss experience should be adjusted, on the basis of observable data, to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.
 - (d) Changes in estimates of future cash flows should be directionally consistent with changes in underlying observable data.
 - (e) Estimation methods should be adjusted to reduce differences between estimates of future cash flows and actual cash flows.

Impairment of investments in available-for-sale financial assets (paragraphs 67–70)

- BC125 In the Exposure Draft, the Board proposed that impairment losses on debt and equity instruments classified as available for sale should not be reversed through profit or loss if conditions changed after the recognition of the impairment loss. The Board arrived at this decision because of the difficulties in determining objectively when impairment losses on debt and equity instruments classified as available-for-sale have been recovered and hence of distinguishing a reversal of an impairment (recognised in profit or loss) from other increases in value (recognised in equity). Accordingly, the Board proposed that any increase in the fair value of an available-for-sale financial asset would be recognised directly in equity even though the entity had previously recognised an impairment loss on that asset. The Board noted that this was consistent with the recognition of changes in the fair value of available-for-sale financial assets directly in equity²⁴ (see paragraph 55(b)).

²⁴ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such changes are recognised in other comprehensive income.

- BC126 The Board considered the comments received on its proposal to preclude reversals of impairment on available-for-sale financial assets. It concluded that available-for-sale debt instruments and available-for-sale equity instruments should be treated differently.

Reversals of impairment on available-for-sale debt instruments (paragraph 70)

- BC127 For available-for-sale debt instruments, the Board decided that impairment should be reversed through profit or loss when fair value increases and the increase can be objectively related to an event occurring after the loss was recognised.
- BC128 The Board noted that (a) other Standards require the reversal of impairment losses if circumstances change (eg IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*); (b) the decision provides consistency with the requirement to reverse impairment losses on loans and receivables, and on assets classified as held to maturity; and (c) reversals of impairment in debt instruments (ie determining an increase in fair value attributable to an improvement in credit standing) are more objectively determinable than those in equity instruments.

Reversals of impairment on available-for-sale equity instruments (paragraph 69)

- BC129 For available-for-sale equity instruments, the Board concluded that if impairment is recognised, and the fair value subsequently increases, the increase in value should be recognised in equity (and not as a reversal of the impairment loss through profit or loss).
- BC130 The Board could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value. Therefore, it decided that precluding reversals of impairment on available-for-sale equity instruments was the only appropriate solution. In its deliberations, the Board considered:
- (a) limiting reversals to those cases in which specific facts that caused the original impairment reverse. However, the Board questioned the operationality of applying this approach (ie how to decide whether the same event that caused the impairment caused the reversal).
 - (b) recognising all changes in fair value below cost as impairments and reversals of impairment through profit or loss, ie all changes in fair value below cost would be recognised in profit or loss, and all changes above cost would be recognised in equity. Although this approach achieves consistency with IAS 16 and IAS 38, and eliminates any subjectivity involved in determining what constitutes impairment or reversal of impairment, the Board noted that it would significantly change the notion of 'available for sale' in practice. The Board believed that introducing such a change to the available-for-sale category was not appropriate at this time.

Hedging

- BC131 The Exposure Draft proposed few changes to the hedge accounting guidance in the original IAS 39. The comments on the Exposure Draft raised several issues in the area of hedge accounting suggesting that the Board should consider these issues in the revised IAS 39. The Board's decisions with regard to these issues are presented in the following paragraphs.

Consideration of the shortcut method in SFAS 133

- BC132 SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* issued by the FASB allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method').
- BC133 The original IAS 39 and the Exposure Draft precluded the use of the shortcut method. Many comments received on the Exposure Draft argued that IAS 39 should permit use of the shortcut method. The Board considered the issue in developing the Exposure Draft, and discussed it in the round-table discussions that were held in the process of finalising IAS 39.
- BC134 The Board noted that, if the shortcut method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the shortcut method.
- BC135 Additionally, IAS 39 permits the hedging of portions of financial assets and financial liabilities in cases when US GAAP does not. The Board noted that under IAS 39 an entity may hedge a portion of a financial

instrument (eg interest rate risk or credit risk), and that if the critical terms of the hedging instrument and the hedged item are the same, the entity would, in many cases, recognise no ineffectiveness.

Hedges of portions of financial assets and financial liabilities (paragraphs 81, 81A, AG99A and AG99B)

- BC135A IAS 39 permits a hedged item to be designated as a portion of the cash flows or fair value of a financial asset or financial liability. In finalising the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, the Board received comments that demonstrated that the meaning of a ‘portion’ was unclear in this context. Accordingly, the Board decided to amend IAS 39 to provide further guidance on what may be designated as a hedged portion, including confirmation that it is not possible to designate a portion that is greater than the total cash flows of the asset or liability.

Expected effectiveness (paragraphs AG105–AG113)

- BC136 Qualification for hedge accounting is based on expectations of future effectiveness (prospective) and evaluation of actual effectiveness (retrospective). In the original IAS 39, the prospective test was expressed as ‘almost fully offset’, whereas the retrospective test was ‘within a range of 80–125 per cent’. The Board considered whether to amend IAS 39 to permit the prospective effectiveness to be within the range of 80–125 per cent rather than ‘almost fully offset’. The Board noted that an undesirable consequence of such an amendment could be that entities would deliberately underhedge a hedged item in a cash flow hedge so as to reduce recognised ineffectiveness. Therefore, the Board initially decided to retain the guidance in the original IAS 39.
- BC136A However, when subsequently finalising the requirements for portfolio hedges of interest rate risk, the Board received representations from constituents that some hedges would fail the ‘almost fully offset’ test in IAS 39, including some hedges that would qualify for the shortcut method in US GAAP and thus be assumed to be 100 per cent effective. The Board was persuaded that the concern described in the previous paragraph that an entity might deliberately underhedge would be met by an explicit statement that an entity could not deliberately hedge less than 100 per cent of the exposure on an item and designate the hedge as a hedge of 100 per cent of the exposure. Therefore, the Board decided to amend IAS 39:
- (a) to remove the words ‘almost fully offset’ from the prospective effectiveness test, and replace them by a requirement that the hedge is expected to be ‘highly effective’. (This amendment is consistent with the wording in US GAAP.)
 - (b) to include a statement in the Application Guidance in IAS 39 that if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness on the basis of the change in the whole of that designated 85 per cent exposure.
- BC136B Additionally, comments made in response to the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* demonstrated that it was unclear how the prospective effectiveness test was to be applied. The Board noted that the objective of the test was to ensure there was firm evidence to support an expectation of high effectiveness. Therefore, the Board decided to amend the Standard to clarify that an expectation of high effectiveness may be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value of cash flows of the hedged item and those of the hedging instrument. The Board noted that the entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

Hedges of portions of non-financial assets and non-financial liabilities for risk other than foreign currency risk (paragraph 82)

- BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non-financial item other than foreign currency risk.
- BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.

- BC139 The Board confirmed that non-financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the market. In this context, the Board decided to clarify that a hedge ratio of other than one-to-one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

Loan servicing rights

- BC140 The Board also considered whether IAS 39 should permit the interest rate risk portion of loan servicing rights to be designated as the hedged item.
- BC141 The Board considered the argument that interest rate risk can be separately identified and measured in loan servicing rights, and that changes in market interest rates have a predictable and separately measurable effect on the value of loan servicing rights. The Board also considered the possibility of treating loan servicing rights as financial assets (rather than non-financial assets).
- BC142 However, the Board concluded that no exceptions should be permitted for this matter. The Board noted that (a) the interest rate risk and prepayment risk in loan servicing rights are interdependent, and thus inseparable, (b) the fair values of loan servicing rights do not change in a linear fashion as interest rates increase or decrease, and (c) concerns exist about how to isolate and measure the interest rate risk portion of a loan servicing right. Moreover, the Board expressed concern that in jurisdictions in which loan servicing right markets are not developed, the interest rate risk portion may not be measurable.
- BC143 The Board also considered whether IAS 39 should be amended to allow, on an elective basis, the inclusion of loan servicing rights in its scope provided that they are measured at fair value with changes in fair value recognised immediately in profit or loss. The Board noted that this would create two exceptions to the general principles in IAS 39. First, it would create a scope exception because IAS 39 applies only to financial assets and financial liabilities; loan servicing rights are non-financial assets. Second, *requiring* an entity to measure loan servicing rights at fair value through profit or loss would create a further exception, because this treatment is optional (except for items that are held for trading). The Board therefore decided not to amend the scope of IAS 39 for loan servicing rights.

Whether to permit hedge accounting using cash instruments

- BC144 In finalising the amendments to IAS 39, the Board discussed whether an entity should be permitted to designate a financial asset or financial liability other than a derivative (ie a 'cash instrument') as a hedging instrument in hedges of risks other than foreign currency risk. The original IAS 39 precluded such designation because of the different bases for measuring derivatives and cash instruments. The Exposure Draft did not propose a change to this limitation. However, some commentators suggested a change, noting that entities do not distinguish between derivative and non-derivative financial instruments in their hedging and other risk management activities and that entities may have to use a non-derivative financial instrument to hedge risk if no suitable derivative financial instrument exists.
- BC145 The Board acknowledged that some entities use non-derivatives to manage risk. However, it decided to retain the restriction against designating non-derivatives as hedging instruments in hedges of risks other than foreign currency risk. It noted the following arguments in support of this conclusion:
- (a) The need for hedge accounting arises in part because derivatives are measured at fair value, whereas the items they hedge may be measured at cost or not recognised at all. Without hedge accounting, an entity might recognise volatility in profit or loss for matched positions. For non-derivative items that are not measured at fair value or for which changes in fair value are not recognised in profit or loss, there is generally no need to adjust the accounting of the hedging instrument or the hedged item to achieve matched recognition of gains and losses in profit or loss.
 - (b) To allow designation of cash instruments as hedging instruments would diverge from US GAAP: SFAS 133 precludes the designation of non-derivative instruments as hedging instruments except for some foreign currency hedges.
 - (c) To allow designation of cash instruments as hedging instruments would add complexity to the Standard. More financial instruments would be measured at an amount that represents neither amortised cost nor fair value. Hedge accounting is, and should be, an exception to the normal measurement requirements.
 - (d) If cash instruments were permitted to be designated as hedging instruments, there would be much less discipline in the accounting model because, in the absence of hedge accounting, a non-derivative may not be selectively measured at fair value. If the entity subsequently decides that it would rather not apply fair value measurement to a cash instrument that had been designated as a hedging instrument, it can breach one of the hedge accounting requirements, conclude that the non-derivative

no longer qualifies as a hedging instrument and selectively avoid recognising the changes in fair value of the non-derivative instrument in equity (for a cash flow hedge) or profit or loss (for a fair value hedge).

- (e) The most significant use of cash instruments as hedging instruments is to hedge foreign currency exposures, which is permitted under IAS 39.

Whether to treat hedges of forecast transactions as fair value hedges

- BC146 The Board considered a suggestion made in some of the comment letters received on the Exposure Draft that a hedge of a forecast transaction should be treated as a fair value hedge, rather than as a cash flow hedge. Some argued that the hedge accounting provisions should be simplified by having only one type of hedge accounting. Some also raised concern about an entity's ability, in some cases, to choose between two hedge accounting methods for the same hedging strategy (ie the choice between designating a forward contract to sell an existing asset as a fair value hedge of the asset or a cash flow hedge of a forecast sale of the asset).
- BC147 The Board acknowledged that the hedge accounting provisions would be simplified, and their application more consistent in some situations, if the Standard permitted only one type of hedge accounting. However, the Board concluded that IAS 39 should continue to distinguish between fair value hedge accounting and cash flow hedge accounting. It noted that removing either type of hedge accounting would narrow the range of hedging strategies that could qualify for hedge accounting.
- BC148 The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the *Framework*; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

Hedges of firm commitments (paragraphs 93 and 94)

- BC149 The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. In other words, hedging gains and losses, to the extent that the hedge is effective, were initially recognised in equity and were subsequently 'recycled' to profit or loss in the same period(s) that the hedged firm commitment affected profit or loss (although, when basis adjustment was used, they adjusted the initial carrying amount of an asset or liability recognised in the meantime). Some believe this is appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised. Moreover, some believe it is conceptually incorrect to recognise the hedged fair value exposure of a firm commitment as an asset or liability merely because it has been hedged.
- BC150 The Board considered whether hedges of firm commitments should be treated as cash flow hedges or fair value hedges. The Board concluded that hedges of firm commitments should be accounted for as fair value hedges.
- BC151 The Board noted that, in concept, a hedge of a firm commitment is a fair value hedge. This is because the fair value of the item being hedged (the firm commitment) changes with changes in the hedged risk.
- BC152 The Board was not persuaded by the argument that it is conceptually incorrect to recognise an asset or liability for a firm commitment merely because it has been hedged. It noted that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised. For example, assume an entity hedges a fixed rate loan asset with a pay-fixed, receive-variable interest rate swap. If there is a loss on the swap, applying fair value hedge accounting requires the offsetting gain on the loan to be recognised, ie the carrying amount of the loan is increased. Thus, applying hedge accounting has the effect of recognising a part of an asset (the increase in the loan's value attributable to interest rate movements) that would otherwise not have been recognised. The only difference in the case of a firm commitment is that, without hedge accounting, none of the commitment is recognised, ie the carrying amount is zero. However, this difference merely reflects that the historical cost of a firm commitment is usually zero. It is not a fundamental difference in concept.
- BC153 Furthermore, the Board's decision converges with SFAS 133, and thus eliminates practical problems and eases implementation for entities that report under both standards.
- BC154 However, the Board clarified that a hedge of the foreign currency risk of a firm commitment may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly a foreign currency cash flow hedge of a forecast

transaction need not be re-designated as a fair value hedge when the forecast transaction becomes a firm commitment.

Basis adjustments (paragraphs 97–99)

- BC155 The question of basis adjustment arises when an entity hedges the future purchase of an asset or the future issue of a liability. One example is that of a US entity that expects to make a future purchase of a German machine that it will pay for in euro. The entity enters into a derivative to hedge against possible future changes in the US dollar/euro exchange rate. Such a hedge is classified as a cash flow hedge under IAS 39, with the effect that gains and losses on the hedging instrument (to the extent that the hedge is effective) are initially recognised in equity.²⁵ The question the Board considered is what the accounting should be once the future transaction takes place. In its deliberations on this issue, the Board discussed the following approaches:
- (a) to remove the hedging gain or loss from equity and recognise it as part of the initial carrying amount of the asset or liability (in the example above, the machine). In future periods, the hedging gain or loss is automatically recognised in profit or loss by being included in amounts such as depreciation expense (for a fixed asset), interest income or expense (for a financial asset or financial liability), or cost of sales (for inventories). This treatment is commonly referred to as ‘basis adjustment’.
 - (b) to leave the hedging gain or loss in equity. In future periods, the gain or loss on the hedging instrument is ‘recycled’ to profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. This recycling requires a separate adjustment and is not automatic.
- BC156 It should be noted that both approaches have the same effect on profit or loss and net assets for all periods affected, so long as the hedge is accounted for as a cash flow hedge. The difference relates to balance sheet presentation and, possibly, the line item in the income statement.
- BC157 In the Exposure Draft, the Board proposed that the ‘basis adjustment’ approach for forecast transactions (approach (a)) should be eliminated and replaced by approach (b) above. It further noted that eliminating the basis adjustment approach would enable IAS- 39 to converge with SFAS 133.
- BC158 Many of the comments received from constituents disagreed with the proposal in the Exposure Draft. Those responses argued that it would unnecessarily complicate the accounting to leave the hedging gain or loss in equity when the hedged forecast transaction occurs. They particularly noted that tracking the effects of cash flow hedges after the asset or liability is acquired would be complicated and would require systems changes. They also pointed out that treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment results in the recognition of an asset or liability. For example, for a perfectly effective hedge of the foreign currency risk of a firm commitment to buy a machine, the effect is to recognise the machine initially at its foreign currency price translated at the forward rate in effect at the inception of the hedge rather than the spot rate. Therefore, they questioned whether it is consistent to treat a hedge of a firm commitment as a fair value hedge while precluding basis adjustments for hedges of forecast transactions.
- BC159 Others believe that a basis adjustment is difficult to justify in principle for forecast transactions, and also argue that such basis adjustments impair comparability of financial information. In other words, two identical assets that are purchased at the same time and in the same way, except for the fact that one was hedged, should not be recognised at different amounts.
- BC160 The Board concluded that IAS 39 should distinguish between hedges of forecast transactions that will result in the recognition of a *financial* asset or a *financial* liability and those that will result in the recognition of a *non-financial* asset or a *non-financial* liability.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability

- BC161 For hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability, the Board concluded that basis adjustments are not appropriate. Its reason was that basis adjustments cause the initial carrying amount of acquired assets (or assumed liabilities) arising from forecast transactions to move away from fair value and hence would override the requirement in IAS 39 to measure a financial instrument initially at its fair value.

²⁵ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

- BC161A If a hedged forecast transaction results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 required the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged item affects profit or loss (such as in the periods that interest income or interest expense is recognised).
- BC161B The Board was informed that there was uncertainty about how paragraph 97 should be applied when the designated cash flow exposure being hedged differs from the financial instrument arising from the hedged forecast cash flows.
- BC161C The example below illustrates the issue:

An entity applies the guidance in the answer to Question F.6.3 of the guidance on implementing IAS 39. On 1 January 20X0 the entity designates forecast cash flows for the risk of variability arising from changes in interest rates. Those forecast cash flows arise from the repricing of existing financial instruments and are scheduled for 1 April 20X0. The entity is exposed to variability in cash flows for the three-month period beginning on 1 April 20X0 attributable to changes in interest rate risk that occur from 1 January 20X0 to 31 March 20X0.

The occurrence of the forecast cash flows is deemed to be highly probable and all the other relevant hedge accounting criteria are met.

The financial instrument that results from the hedged forecast cash flows is a five-year interest-bearing instrument.

- BC161D Paragraph 97 required the gains or losses on the hedging instrument to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affected profit or loss. The financial instrument that was recognised is a five-year instrument that will affect profit or loss for five years. The wording in paragraph 97 suggested that the gains or losses should be reclassified over five years, even though the cash flows designated as the hedged item were hedged for the effects of interest rate changes over only a three-month period.
- BC161E The Board believes that the wording of paragraph 97 did not reflect the underlying rationale in hedge accounting, ie that the gains or losses on the hedging instrument should offset the gains or losses on the hedged item, and the offset should be reflected in profit or loss by way of reclassification adjustments.
- BC161F The Board believes that in the example set out above the gains or losses should be reclassified over a period of three months beginning on 1 April 20X0, and not over a period of five years beginning on 1 April 20X0.
- BC161G Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 97 of IAS 39 to clarify that the gains or losses on the hedged instrument should be reclassified from equity to profit or loss during the period that the hedged forecast cash flows affect profit or loss. The Board also decided that to avoid similar confusion paragraph 100 of IAS 39 should be amended to be consistent with paragraph 97.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

- BC162 For hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability, the Board decided to permit entities a choice of whether to apply basis adjustment.
- BC163 The Board considered the argument that changes in the fair value of the hedging instrument are appropriately included in the initial carrying amount of the recognised asset or liability because such changes represent a part of the 'cost' of that asset or liability. Although the Board has not yet considered the broader issue of what costs may be capitalised at initial recognition, the Board believes that its decision to provide an option for basis adjustments in the case of non-financial items will not pre-empt that future discussion. The Board also recognised that financial items and non-financial items are not necessarily measured at the same amount on initial recognition, because financial items are measured at fair value and non-financial items are measured at cost.
- BC164 The Board concluded that, on balance, providing entities with a choice in this case was appropriate. The Board took the view that allowing basis adjustments addresses the concern that precluding basis adjustments complicates the accounting for hedges of forecast transactions. In addition, the number of balance sheet line items that could be affected is quite small, generally being only property, plant and equipment, inventory and the cash flow hedge line item in equity. The Board also noted that US GAAP precludes basis adjustments and that applying a basis adjustment is inconsistent with the accounting for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability. The Board acknowledged the merits of these arguments, and recognised that by permitting a choice in IAS 39, entities could apply the accounting treatment required by US GAAP.

Hedging using internal contracts

- BC165 IAS 39 does not preclude entities from using internal contracts as a risk management tool, or as a tracking device in applying hedge accounting for external contracts that hedge external positions. Furthermore, IAS 39 permits hedge accounting to be applied to transactions between entities in the same group in the *separate reporting* of those entities. However, IAS 39 does not permit hedge accounting for transactions between entities in the same group in consolidated financial statements. The reason is the fundamental requirement of consolidation that the accounting effects of internal contracts should be eliminated in consolidated financial statements, including any internally generated gains or losses. Designating internal contracts as hedging instruments could result in non-elimination of internal gains and losses and have other accounting effects. The Exposure Draft did not propose any change in this area.
- BC166 To illustrate, assume the banking book division of Bank A enters into an internal interest rate swap with the trading book division of the same bank. The purpose is to hedge the net interest rate risk exposure in the banking book of a group of similar fixed rate loan assets funded by floating rate liabilities. Under the swap, the banking book pays fixed interest payments to the trading book and receives variable interest rate payments in return. The bank wants to designate the internal interest rate swap in the banking book as a hedging instrument in its consolidated financial statements.
- BC167 If the internal swap in the banking book is designated as a hedging instrument in a cash flow hedge of the liabilities, and the internal swap in the trading book is classified as held for trading, internal gains and losses on that internal swap would not be eliminated. This is because the gains and losses on the internal swap in the banking book would be recognised in equity²⁶ to the extent the hedge is effective and the gains and losses on the internal swap in the trading book would be recognised in profit or loss.
- BC168 If the internal swap in the banking book is designated as a hedging instrument in a fair value hedge of the loan assets and the internal swap in the trading book is classified as held for trading, the changes in the fair value of the internal swap would offset both in total net assets in the balance sheet and profit or loss. However, without elimination of the internal swap, there would be an adjustment to the carrying amount of the hedged loan asset in the banking book to reflect the change in the fair value attributable to the risk hedged by the internal contract. Moreover, to reflect the effect of the internal swap the bank would in effect recognise the fixed rate loan at a floating interest rate and recognise an offsetting trading gain or loss in the income statement. Hence the internal swap would have accounting effects.
- BC169 Some respondents to the Exposure Draft and some participants in the round-tables objected to not being able to obtain hedge accounting in the consolidated financial statements for internal contracts between subsidiaries or between a subsidiary and the parent (as illustrated above). Among other things, they emphasised that the use of internal contracts is a key risk management tool and that the accounting should reflect the way in which risk is managed. Some suggested that IAS 39 should be changed to make it consistent with US GAAP, which allows the designation of internal derivative contracts as hedging instruments in cash flow hedges of forecast foreign currency transactions in specified, limited circumstances.
- BC170 In considering these comments, the Board noted that the following principles apply to consolidated financial statements:
- (a) financial statements provide financial information about an entity or group as a whole (as that of a single entity). Financial statements do not provide financial information about an entity as if it were two separate entities.
 - (b) a fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts as hedging instruments would require a change to the consolidation principles.
 - (c) it is conceptually wrong to permit an entity to recognise internally generated gains and losses or make other accounting adjustments because of internal transactions. No external event has occurred.
 - (d) an ability to recognise internally generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control the associated risks. It is not the purpose of accounting standards to prescribe how entities should manage and control risks.
 - (e) permitting the designation of internal contracts as hedging instruments violates the following requirements in IAS 39:
 - (i) the prohibition against designating as a hedging instrument a non-derivative financial asset or non-derivative financial liability for other than foreign currency risk. To illustrate, if an

²⁶ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 these other gains and losses are recognised in other comprehensive income.

entity has two offsetting internal contracts and one is the designated hedging instrument in a fair value hedge of a non-derivative asset and the other is the designated hedging instrument in a fair value hedge of a non-derivative liability, from the entity's perspective the effect is to designate a hedging relationship between the asset and the liability (ie a non-derivative asset or non-derivative liability is used as the hedging instrument).

- (ii) the prohibition on designating a net position of assets and liabilities as the hedged item. To illustrate, an entity has two internal contracts. One is designated in a fair value hedge of an asset and the other in a fair value hedge of a liability. The two internal contracts do not fully offset, so the entity lays off the net risk exposure by entering into a net external derivative. In that case, the effect from the entity's perspective is to designate a hedging relationship between the net external derivative and a net position of an asset and a liability.
 - (iii) the option to fair value assets and liabilities does not extend to portions of assets and liabilities.
 - (f) the Board is considering separately whether to make an amendment to IAS 39 to facilitate fair value hedge accounting for portfolio hedges of interest rate risk. The Board believes that that is a better way to address the concerns raised about symmetry with risk management systems than permitting the designation of internal contracts as hedging instruments.
 - (g) the Board decided to permit an option to measure any financial asset or financial liability at fair value with changes in fair value recognised in profit or loss. This enables an entity to measure matching asset/liability positions at fair value without a need for hedge accounting.
- BC171 The Board reaffirmed that it is a fundamental principle of consolidation that any accounting effect of internal contracts is eliminated on consolidation. The Board decided that no exception to this principle should be made in IAS 39. Consistently with this decision, the Board also decided not to explore an amendment to permit internal derivative contracts to be designated as hedging instruments in hedges of some forecast foreign currency transactions, as is permitted by SFAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities*.
- BC172 The Board also decided to clarify that IAS 39 does not preclude hedge accounting for transactions between entities in the same group in individual or separate financial statements of those entities because they are not internal to the entity (ie the individual entity).
- BC172A Previously, paragraphs 73 and 80 referred to the need for hedging instruments to involve a party external to the reporting entity. In doing so, it used a segment as an example of a reporting entity. However, IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non-IFRS basis. Therefore, the two IFRSs appeared to conflict. In *Improvements to IFRSs* issued in May 2008 and April 2009, the Board removed from paragraphs 73 and 80 references to the designation of hedging instruments at the segment level.

Eligible hedged items in particular situations (paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B)

- BC172B The Board amended IAS 39 in July 2008 to clarify the application of the principles that determine whether a hedged risk or portion of cash flows is eligible for designation in particular situations. This followed a request by the IFRIC for guidance.
- BC172C The responses to the exposure draft *Exposures Qualifying for Hedge Accounting* demonstrated that diversity in practice existed, or was likely to occur, in two situations:
- (a) the designation of a one-sided risk in a hedged item
 - (b) the designation of inflation as a hedged risk or portion in particular situations.

Designation of a one-sided risk in a hedged item

- BC172D The IFRIC received requests for guidance on whether an entity can designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option, including changes in the time value, are regarded as effective and would be recognised in other comprehensive income. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.
- BC172E After considering the responses to the exposure draft, the Board confirmed that the designation set out in paragraph BC172D is not permitted.

BC172F The Board reached that decision by considering the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase (a one-sided risk). The Board noted that the forecast transaction contained no separately identifiable risk that affects profit or loss that is equivalent to the time value of a purchased option hedging instrument (with the same principal terms as the designated risk). The Board concluded that the intrinsic value of a purchased option, but not its time value, reflects a one-sided risk in a hedged item. The Board then considered a purchased option designated in its entirety as the hedging instrument. The Board noted that hedge accounting is based on a principle of offsetting changes in fair value or cash flows between the hedging instrument and the hedged item. Because a designated one-sided risk does not contain the time value of a purchased option hedging instrument, the Board noted that there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. Therefore, the Board concluded that a purchased option designated in its entirety as the hedging instrument of a one-sided risk will not be perfectly effective.

Designation of inflation in particular situations

BC172G The IFRIC received a request for guidance on whether, for a hedge of a fixed rate financial instrument, an entity can designate inflation as the hedged item. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172H After considering the responses to the exposure draft, the Board acknowledged that expectations of future inflation rates can be viewed as an economic component of nominal interest. However, the Board also noted that hedge accounting is an exception to normal accounting principles for the hedged item (fair value hedges) or hedging instrument (cash flow hedges). To ensure a disciplined use of hedge accounting the Board noted that restrictions regarding eligible hedged items are necessary, especially if something other than the entire fair value or cash flow variability of a hedged item is designated.

BC172I The Board noted that paragraph 81 permits an entity to designate as the hedged item something other than the entire fair value change or cash flow variability of a financial instrument. For example, an entity may designate some (but not all) risks of a financial instrument, or some (but not all) cash flows of a financial instrument (a 'portion').

BC172J The Board noted that, to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the fair value or cash flows of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. The Board noted that these principles were important in order for the effectiveness requirements set out in paragraph 88 to be applied in a meaningful way. The Board also noted that deciding whether designated risks and portions are separately identifiable and reliably measurable requires judgement. However, the Board confirmed that unless the inflation portion is a contractually specified portion of cash flows and other cash flows of the financial instrument are not affected by the inflation portion, inflation is not separately identifiable and reliably measurable and is not eligible for designation as a hedged risk or portion of a financial instrument.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Background

BC173 The Exposure Draft of proposed improvements to IAS 39 published in June 2002 did not propose any substantial changes to the requirements for hedge accounting as they applied to a portfolio hedge of interest rate risk. However, some of the comment letters on the Exposure Draft and participants in the round-table discussions raised this issue. In particular, some were concerned that portfolio hedging strategies they regarded as effective hedges would not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39. Rather, they would have either:

- (a) not qualified for hedge accounting at all, with the result that reported profit or loss would be volatile; or
- (b) qualified only for cash flow hedge accounting, with the result that reported equity would be volatile.

BC174 In the light of these concerns, the Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges of interest rate risk. As a result, in August 2003 the Board published a second Exposure Draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003. More than 120 comment letters were received. The amendments proposed in this second Exposure Draft were finalised in March 2004. Paragraphs BC135A–BC136B and BC175–BC220 summarise the Board's considerations in reaching conclusions on the issues raised.

Scope

BC175 The Board decided to limit any amendments to IAS 39 to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:

- (a) implementation guidance on IAS 39²⁷ explains how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.
- (b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in paragraph BC176 do not arise in combination for such other hedging arrangements.

The issue: why fair value hedge accounting was difficult to achieve in accordance with previous versions of IAS 39

BC176 The Board identified the following three main reasons why a portfolio hedge of interest rate risk might not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39.

- (a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual repricing date. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness tests.²⁸ Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement²⁹ that a group of hedged assets or liabilities must be 'similar' and the related requirement³⁰ that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.
- (b) IAS 39³¹ prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets or a group of similar assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.
- (c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk.³² Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life.³³ This, too, gives rise to significant systems needs.

BC177 The Board decided that any change to IAS 39 must be consistent with the principles that underlie IAS 39's requirements on derivatives and hedge accounting. The three principles that are most relevant to a portfolio hedge of interest rate risk are:

- (a) derivatives should be measured at fair value;
- (b) hedge ineffectiveness should be identified and recognised in profit or loss;³⁴ and

²⁷ see Q&A F.6.1 and F.6.2

²⁸ see IAS 39, paragraph AG105

²⁹ see AS 39, paragraph 78

³⁰ see IAS 39, paragraph 83

³¹ see IAS 39, paragraph AG101

³² see IAS 39, paragraph 89(b)

³³ see IAS 39, paragraph 92

³⁴ Subject to the same materiality considerations that apply in this context as throughout IFRSs.

- (c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet.

Prepayment risk

- BC178 In considering the issue described in paragraph BC176(a), the Board noted that a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. It follows that the fair value of a fixed rate prepayable item changes for two reasons when interest rates move:
- (a) the fair value of the contracted cash flows to the contractual repricing date changes (because the rate used to discount them changes); and
 - (b) the fair value of the prepayment option changes (reflecting, among other things, that the likelihood of prepayment is affected by interest rates).
- BC179 The Board also noted that, for risk management purposes, many entities do not consider these two effects separately. Instead they incorporate the effect of prepayments by grouping the hedged portfolio into repricing time periods based on *expected* repayment dates (rather than contractual repayment dates). For example, an entity with a portfolio of 25-year mortgages of CU100 may expect 5 per cent of that portfolio to repay in one year's time, in which case it schedules an amount of CU5 into a 12-month time period. The entity schedules all other items contained in its portfolio in a similar way (ie on the basis of expected repayment dates) and hedges all or part of the resulting overall net position in each repricing time period.
- BC180 The Board decided to permit the scheduling that is used for risk management purposes, ie on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting. As a result, an entity would not be required to compute the effect that a change in interest rates has on the fair value of the prepayment option embedded in a prepayable item. Instead, it could incorporate the effect of a change in interest rates on prepayments by grouping the hedged portfolio into repricing time periods based on expected repayment dates. The Board noted that this approach has significant practical advantages for preparers of financial statements, because it allows them to use the data they use for risk management. The Board also noted that the approach is consistent with paragraph 81 of IAS 39, which permits hedge accounting for a portion of a financial asset or financial liability. However, as discussed further in paragraphs BC193–BC206, the Board also concluded that if the entity changes its estimates of the time periods in which items are expected to repay (eg in the light of recent prepayment experience), ineffectiveness will arise, regardless of whether the revision in estimates results in more or less being scheduled in a particular time period.
- BC181 The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged.

Designation of the hedged item and liabilities with a demand feature

- BC182 The Board considered two main ways to overcome the issue noted in paragraph BC176(b). These were:
- (a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a repricing time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.
 - (b) to designate the hedged item as a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.
- BC183 Some of those who commented on the Exposure Draft favoured designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset-liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.
- BC184 In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair

value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

BC185 The Board noted that under the first approach in paragraph BC182 (designating an overall net position), an issue arises if the entity has liabilities that are repayable on demand or after a notice period (referred to below as ‘demandable liabilities’). This includes items such as demand deposits and some types of time deposits. The Board was informed that, when managing interest rate risk, many entities that have demandable liabilities include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of demandable liabilities in the portfolio to be due because of net withdrawals from the accounts in the portfolio. This expected repayment date is typically a period covering several years into the future (eg 0–10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include demandable liabilities in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

- (a) it is consistent with how demandable liabilities are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. The interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.
- (b) it is consistent with the treatment of prepayable assets to include demandable liabilities in a portfolio hedge based on expected repayment dates.
- (c) as with prepayable assets, expected maturities for demandable liabilities are based on the historical behaviour of customers.
- (d) applying the fair value hedge accounting framework to a portfolio that includes demandable liabilities would not entail an immediate gain on origination of such liabilities because all assets and liabilities enter the hedged portfolio at their carrying amounts. Furthermore, IAS 39³⁵ requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (ie the amount deposited).
- (e) historical analysis shows that a base level of a portfolio of demandable liabilities, such as chequing accounts, is very stable. Whilst a portion of the demandable liabilities varies with interest rates, the remaining portion—the base level—does not. Hence, entities regard this base level as a long-term fixed rate item and include it as such in the scheduling that is used for risk management purposes.
- (f) the distinction between ‘old’ and ‘new’ money makes little sense at a portfolio level. The portfolio behaves like a long-term item even if individual liabilities do not.

BC186 The Board noted that this issue is related to that of how to measure the fair value of a demandable liability. In particular, it interrelates with the requirement in IAS 39³⁶ that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This requirement applies to all liabilities with a demand feature, not only to those included in a portfolio hedge.

BC187 The Board also noted that:

- (a) although entities, when managing risk, may schedule demandable liabilities based on the expected repayment date of the total balance of a portfolio of accounts, the deposit liabilities included in that balance are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Put another way, the balance of the portfolio is relatively stable only because withdrawals on some accounts (which usually occur relatively quickly) are offset by new deposits into others. Thus, the liability being hedged is actually the forecast replacement of existing deposits by the receipt of new deposits. IAS 39 does not permit a hedge of such a forecast transaction to qualify for fair value hedge accounting. Rather, fair value hedge accounting can be applied only to the liability (or asset) or firm commitment that exists today.
- (b) a portfolio of demandable liabilities is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit demandable liabilities to be

³⁵ see IAS 39, paragraph AG76

³⁶ see IAS 39, paragraph 49

included in a fair value hedge on the basis of a stable base level created by expected replacements, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.

- (c) a portfolio of similar core deposits is not different from an individual deposit, other than that, in the light of the ‘law of large numbers’, the behaviour of the portfolio is more predictable. There are no diversification effects from aggregating many similar items.
- (d) it would be inconsistent with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, to schedule such liabilities for hedging purposes using a different date. For example, consider a deposit of CU100 that can be withdrawn on demand without penalty. IAS 39 states that the fair value of such a deposit is CU100. That fair value is unaffected by interest rates and does not change when interest rates move. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk—there is no fair value exposure to hedge.

BC188 For these reasons, the Board concluded that demandable liabilities should not be included in a portfolio hedge on the basis of the expected repayment date of the *total balance of a portfolio* of demandable liabilities, ie including expected rollovers or replacements of existing deposits by new ones. However, as part of its consideration of comments received on the Exposure Draft, the Board also considered whether a demandable liability, such as a demand deposit, could be included in a portfolio hedge based on the expected repayment date of the *existing balance of individual deposits*, ie ignoring any rollovers or replacements of existing deposits by new deposits. The Board noted the following.

- (a) For many demandable liabilities, this approach would imply a much earlier expected repayment date than is generally assumed for risk management purposes. In particular, for chequing accounts it would probably imply an expected maturity of a few months or less. However, for other demandable liabilities, such as fixed term deposits that can be withdrawn only by the depositor incurring a significant penalty, it might imply an expected repayment date that is closer to that assumed for risk management.
- (b) This approach implies that the *fair value* of the demandable liability should also reflect the expected repayment date of the existing balance, ie that the fair value of a demandable deposit liability is the present value of the amount of the deposit discounted from the expected repayment date. The Board noted that it would be inconsistent to permit fair value hedge accounting to be based on the expected repayment date, but to measure the fair value of the liability on initial recognition on a different basis. The Board also noted that this approach would give rise to a difference on initial recognition between the amount deposited and the fair value recognised in the balance sheet. This, in turn, gives rise to the issue of what the difference represents. Possibilities the Board considered include (i) the value of the depositor’s option to withdraw its money before the expected maturity, (ii) prepaid servicing costs or (iii) a gain. The Board did not reach a conclusion on what the difference represents, but agreed that if it were to require such differences to be recognised, this would apply to all demandable liabilities, not only to those included in a portfolio hedge. Such a requirement would represent a significant change from present practice.
- (c) If the fair value of a demandable deposit liability at the date of initial recognition is deemed to equal the amount deposited, a fair value portfolio hedge based on an expected repayment date is unlikely to be effective. This is because such deposits typically pay interest at a rate that is significantly lower than that being hedged (eg the deposits may pay interest at zero or at very low rates, whereas the interest rate being hedged may be LIBOR or a similar benchmark rate). Hence, the fair value of the deposit will be significantly less sensitive to interest rate changes than that of the hedging instrument.
- (d) The question of how to fair value a demandable liability is closely related to issues being debated by the Board in other projects, including Insurance (phase II), Revenue Recognition, Leases and Measurement. The Board’s discussions in these other projects are continuing and it would be premature to reach a conclusion in the context of portfolio hedging without considering the implications for these other projects.

BC189 As a result, the Board decided:

- (a) to confirm the requirement in IAS 39³⁷ that ‘the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid’, and
- (b) consequently, that a demandable liability cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

³⁷ see paragraph 49

The Board noted that, depending on the outcome of its discussions in other projects (principally Insurance (phase II), Revenue Recognition, Leases and Measurement), it might reconsider these decisions at some time in the future.

- BC190 The Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a portion of *the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular repricing time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes to hedge its net exposure of CU20. Also assume that all of the liabilities are demandable liabilities and the time period is later than that containing the earliest date on which the items can be repaid. If the hedged item is designated as CU20 of *assets*, then the demandable *liabilities* are not included in the hedged item, but rather are used only to determine how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demandable liabilities can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item, because the net position comprises CU100 of assets and CU80 of demandable liabilities, whether the demandable liabilities can be designated as a hedged item in a fair value hedge becomes critical.
- BC191 Given the above points, the Board decided that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the demandable liabilities issue. It also noted that this approach is consistent with IAS 39,³⁸ whereas designating an overall net position is not. IAS 39³⁹ prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating an amount of assets (or liabilities) equal to the net position.
- BC192 However, the Board also recognised that this method of designation would not fully resolve the demandable liabilities issue. In particular, the issue is still relevant if, in a particular repricing time period, the entity has so many demandable liabilities whose earliest repayment date is before that time period that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including the demandable liabilities) exceed its fixed rate assets in this repricing time period. In this case, the entity is in a net liability position. Thus, it needs to designate an amount of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than those that can be demanded before that time period, this implies designating the demandable liabilities as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting. (If the liabilities are non-interest bearing, they cannot be designated as the hedged item in a cash flow hedge because their cash flows do not vary with changes in interest rates, ie there is no cash flow exposure to interest rates.⁴⁰ However, the hedging relationship may qualify for cash flow hedge accounting if designated as a hedge of associated assets.)

What portion of assets should be designated and the impact on ineffectiveness

- BC193 Having decided that a portion of assets (or liabilities) could be designated as the hedged item, the Board considered how to overcome the systems problems noted in paragraph BC176(b) and (c). The Board noted that these problems arise from designating individual assets (or liabilities) as the hedged item. Accordingly, the Board decided that the hedged item could be expressed as an *amount* (of assets or liabilities) rather than as individual assets or liabilities.
- BC194 The Board noted that this decision—that the hedged item may be designated as an amount of assets or liabilities rather than as specified items—gives rise to the issue of how the amount designated should be specified. The Board considered comments received on the Exposure Draft that it should not specify any method for designating the hedged item and hence measuring effectiveness. However, the Board concluded that if it provided no guidance, entities might designate in different ways, resulting in little comparability between them. The Board also noted that its objective, when permitting an amount to be designated, was to overcome the systems problems associated with designating individual items whilst achieving a very similar accounting result. Accordingly, it concluded that it should require a method of designation that closely approximates the accounting result that would be achieved by designating individual items.
- BC195 Additionally, the Board noted that designation determines how much, if any, ineffectiveness arises if actual repricing dates in a particular repricing time period vary from those estimated or if the estimated repricing dates are revised. Taking the above example of a repricing time period in which there are CU100 of fixed rate assets and the entity designates as the hedged item an amount of CU20 of assets, the Board considered two approaches (a layer approach and a percentage approach) that are summarised below.

³⁸ see IAS 39, paragraph 84

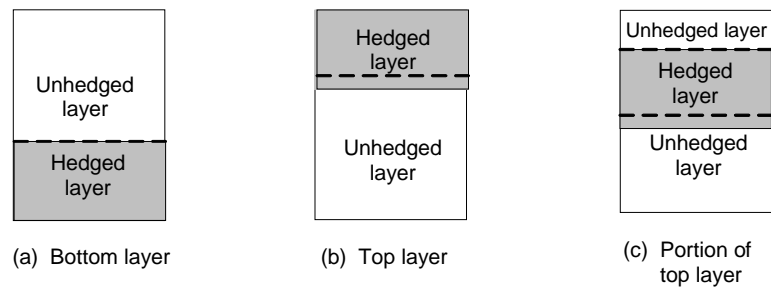
³⁹ see IAS 39, paragraph AG101

⁴⁰ see Guidance on Implementing IAS 39, Question and Answer F.6.3.

Layer approach

BC196 The first of these approaches, illustrated in figure 1, designates the hedged item as a ‘layer’ (eg (a) the bottom layer, (b) the top layer or (c) a portion of the top layer) of the assets (or liabilities) in a repricing time period. In this approach, the portfolio of CU100 in the above example is considered to comprise a hedged layer of CU20 and an unhedged layer of CU80.

Figure 1: Illustrating the designation of an amount of assets as a layer



BC197 The Board noted that the layer approach does not result in the recognition of ineffectiveness in all cases when the estimated amount of assets (or liabilities) changes. For example, in a bottom layer approach (see figure 2), if some assets prepay earlier than expected so that the entity revises downward its estimate of the amount of assets in the repricing time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged top layer (figure 2(b)). Whether any ineffectiveness arises depends on whether the downward revision reaches the hedged layer of CU20. Thus, if the bottom layer is designated as the hedged item, it is unlikely that the hedged (bottom) layer will be reached and that any ineffectiveness will arise. Conversely, if the top layer is designated (see figure 3), any downward revision to the estimated amount in a repricing time period will reduce the hedged (top) layer and ineffectiveness will arise (figure 3(b)).

Figure 2: Illustrating the effect on changes in prepayments in a bottom layer approach

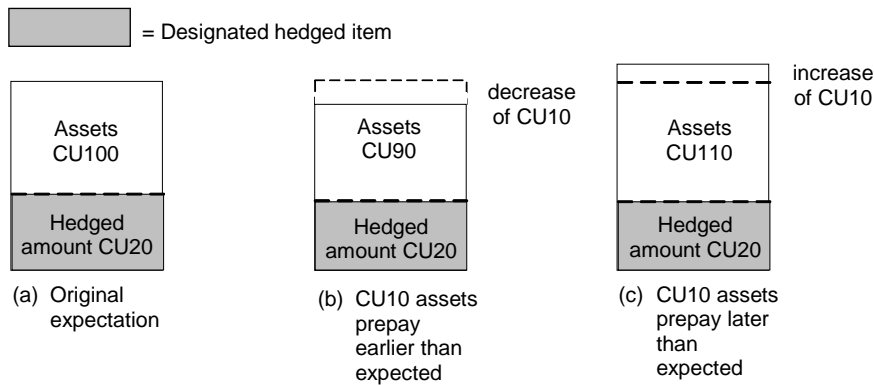
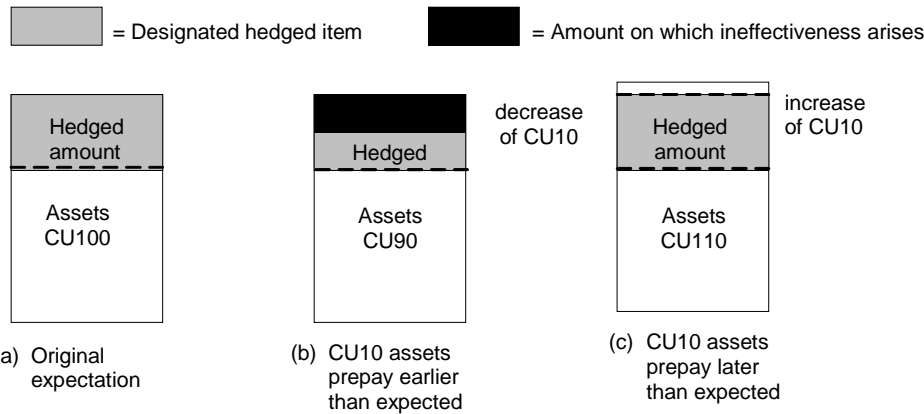


Figure 3: Illustrating the effect on changes in prepayments in a top layer approach

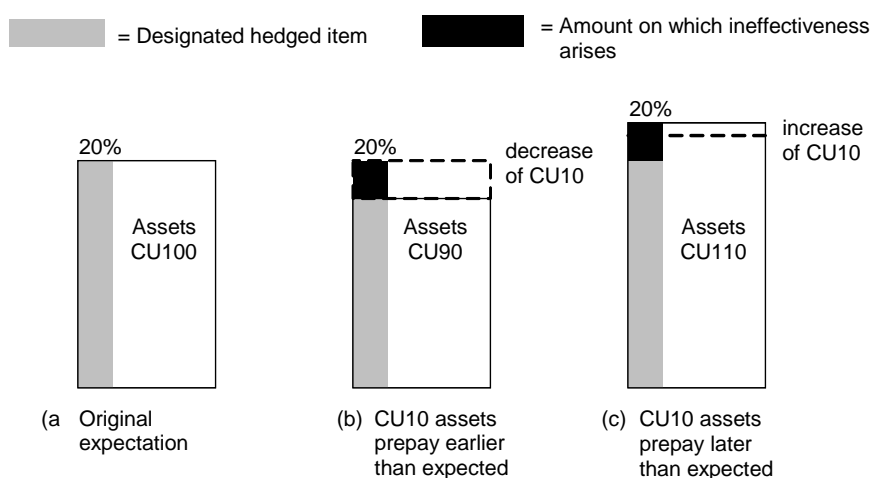


BC198 Finally, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, see figures 2(c) and 3(c)), no ineffectiveness arises no matter how the layer is designated, on the grounds that the hedged layer of CU20 is still there and that was all that was being hedged.

Percentage approach

BC199 The percentage approach, illustrated in figure 4, designates the hedged item as a percentage of the assets (or liabilities) in a repricing time period. In this approach, in the portfolio in the above example, 20 per cent of the assets of CU100 in this repricing time period is designated as the hedged item (figure 4(a)). As a result, if some assets prepay *earlier* than expected so that the entity revises *downwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU90, figure 4(b)), ineffectiveness arises on 20 per cent of the decrease (in this case ineffectiveness arises on CU2). Similarly, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, figure 4(c)), ineffectiveness arises on 20 per cent of the increase (in this case ineffectiveness arises on CU2).

Figure 4: Illustrating the designation of an amount of assets as a percentage



Arguments for and against the layer approach

BC200 The arguments for the layer approach are as follows:

- Designating a bottom layer would be consistent with the answers to Questions F.6.1 and F.6.2 of the Guidance on Implementing IAS 39, which allow, for a cash flow hedge, the 'bottom' portion of reinvestments of collections from assets to be designated as the hedged item.
- The entity is hedging interest rate risk rather than prepayment risk. Any changes to the portfolio because of changes in prepayments do not affect how effective the hedge was in mitigating interest rate risk.
- The approach captures all ineffectiveness on the hedged portion. It merely allows the hedged portion to be defined in such a way that, at least in a bottom layer approach, the first of any potential ineffectiveness relates to the unhedged portion.
- It is correct that no ineffectiveness arises if changes in prepayment estimates cause more assets to be scheduled into that repricing time period. So long as assets equal to the hedged layer remain, there is no ineffectiveness and upward revisions of the amount in a repricing time period do not affect the hedged layer.
- A prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. The designation of a bottom layer can be viewed as hedging a part of the life of the non-prepayable item, but none of the prepayment option. For example, a 25-year prepayable mortgage can be viewed as a combination of (i) a non-prepayable, fixed term, 25-year mortgage and (ii) a written prepayment option that allows the borrower to repay the mortgage early. If the entity hedges this asset with a 5-year derivative, this is equivalent to hedging the first five years of component (i). If the position is viewed in this way, no ineffectiveness arises when interest rate changes cause the value of the prepayment option to change (unless the option is exercised and the asset prepaid) because the prepayment option was not hedged.

BC201 The arguments against the layer approach are as follows:

- (a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.
- (b) The fact that no ineffectiveness is recognised if the amount in a repricing time period is re-estimated upwards (with the effect that the entity becomes underhedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both when the entity becomes overhedged (ie the derivative exceeds the hedged item) and when it becomes underhedged (ie the derivative is smaller than the hedged item).
- (c) As noted in paragraph BC200(e), a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. When interest rates change, the fair value of both of these components changes.
- (d) The objective of applying fair value hedge accounting to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain results that closely approximate those that would have been obtained if individual assets or liabilities had been designated as the hedged item. If individual prepayable assets had been designated as the hedged item, the change in both the components noted in (c) above (to the extent they are attributable to the hedged risk) would be recognised in profit or loss, both when interest rates increase and when they decrease. Accordingly, the change in the fair value of the hedged asset would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that in the simplified approach of designating the hedged item as an amount, ineffectiveness should similarly arise.
- (e) All prepayable assets in a repricing time period, and not just a layer of them, contain a prepayment option whose fair value changes with changes in interest rates. Accordingly, when interest rates change, the fair value of the hedged assets (which include a prepayment option whose fair value has changed) will change by an amount different from that of the hedging derivative (which typically does not contain a prepayment option), and ineffectiveness will arise. This effect occurs regardless of whether interest rates increase or decrease—ie regardless of whether re-estimates of prepayments result in the amount in a time period being more or less.
- (f) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item. Often the biggest single cause of changes in prepayment rates is changes in interest rates. This close relationship is the reason why IAS 39⁴¹ prohibits a held-to-maturity asset from being a hedged item with respect to either interest rate risk or prepayment risk. Furthermore, most entities do not separate the two components for risk management purposes. Rather, they incorporate the prepayment option by scheduling amounts based on expected maturities. When entities choose to use risk management practices—based on not separating prepayment and interest rate risk—as the basis for designation for hedge accounting purposes, it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item.
- (g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be different from the effect on the fair value of a portfolio of otherwise identical but non-prepayable items. However, using a layer approach, this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

BC202 The Board was persuaded by the arguments in paragraph BC201 and rejected layer approaches. In particular, the Board concluded that the hedged item should be designated in such a way that if the entity changes its estimates of the repricing time periods in which items are expected to repay or mature (eg in the light of recent prepayment experience), ineffectiveness arises. It also concluded that ineffectiveness should arise both when estimated prepayments decrease, resulting in more assets in a particular repricing time period, and when they increase, resulting in fewer.

⁴¹ see IAS 39, paragraph 79

Arguments for a third approach—measuring directly the change in fair value of the entire hedged item

- BC203 The Board also considered comments on the Exposure Draft that:
- (a) some entities hedge prepayment risk and interest rate risk separately, by hedging to the expected prepayment date using interest rate swaps, and hedging possible variations in these expected prepayment dates using swaptions.
 - (b) the embedded derivatives provisions of IAS 39 require some prepayable assets to be separated into a prepayment option and a non-prepayable host contract⁴² (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for trading⁴³). This seems to conflict with the view in the Exposure Draft that the two risks are too difficult to separate for the purposes of a portfolio hedge.
- BC204 In considering these arguments, the Board noted that the percentage approach described in paragraph AG126(b) is a proxy for measuring the change in the fair value of the *entire* asset (or liability)—including any embedded prepayment option—that is attributable to changes in interest rates. The Board had developed this proxy in the Exposure Draft because it had been informed that most entities (a) do not separate interest rate risk and prepayment risk for risk management purposes and hence (b) were unable to value the change in the value of the entire asset (including any embedded prepayment option) that is attributable to changes in the hedged interest rates. However, the comments described in paragraph BC203 indicated that in some cases, entities may be able to measure this change in value directly. The Board noted that such a direct method of measurement is conceptually preferable to the proxy described in paragraph AG126(b) and, accordingly, decided to recognise it explicitly. Thus, for example, if an entity that hedges prepayable assets using a combination of interest rate swaps and swaptions is able to measure directly the change in fair value of the entire asset, it could measure effectiveness by comparing the change in the value of the swaps and swaptions with the change in the fair value of the entire asset (including the change in the value of the prepayment option embedded in them) that is attributable to changes in the hedged interest rate. However, the Board also decided to permit the proxy proposed in the Exposure Draft for those entities that are unable to measure directly the change in the fair value of the entire asset.

Consideration of systems requirements

- BC205 Finally, the Board was informed that, to be practicable in terms of systems needs, any approach should not require tracking of the amount in a repricing time period for multiple periods. Therefore it decided that ineffectiveness should be calculated by determining the change in the estimated amount in a repricing time period between one date on which effectiveness is measured and the next, as described more fully in paragraphs AG126 and AG127. This requires the entity to track how much of the change in each repricing time period between these two dates is attributable to revisions in estimates and how much is attributable to the origination of new assets (or liabilities). However, once ineffectiveness has been determined as set out above, the entity in essence starts again, ie it establishes the new amount in each repricing time period (including new items that have been originated since it last tested effectiveness), designates a new hedged item, and repeats the procedures to determine ineffectiveness at the next date it tests effectiveness. Thus the tracking is limited to movements between one date when effectiveness is measured and the next. It is not necessary to track for multiple periods. However, the entity will need to keep records relating to each repricing time period (a) to reconcile the amounts for each repricing time period with the total amounts in the two separate line items in the balance sheet (see paragraph AG114(f)), and (b) to ensure that amounts in the two separate line items are derecognised no later than when the repricing time period to which they relate expires.
- BC206 The Board also noted that the amount of tracking required by the percentage approach is no more than what would be required by any of the layer approaches. Thus, the Board concluded that none of the approaches was clearly preferable from the standpoint of systems needs.

The carrying amount of the hedged item

- BC207 The last issue noted in paragraph BC176 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands of—individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the

⁴² see IAS 39, paragraphs 11 and AG30(g)

⁴³ see IAS 39, paragraph 12

change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a decrease in the fair value of a financial asset (financial liability) being recognised as a financial liability (financial asset). Furthermore, for some repricing time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such repricing time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.

BC208 Accordingly, the Board decided that two line items should be presented, as follows:

- (a) for those repricing time periods for which the hedged item is an asset, the change in its fair value is presented in a single separate line item within assets; and
- (b) for those repricing time periods for which the hedged item is a liability, the change in its fair value is presented in a single separate line item within liabilities.

BC209 The Board noted that these line items represent changes in the fair value of the hedged item. For this reason, the Board decided that they should be presented next to financial assets or financial liabilities.

Derecognition of amounts included in the separate line items

Derecognition of an asset (or liability) in the hedged portfolio

BC210 The Board discussed how and when amounts recognised in the separate balance sheet line items should be removed from the balance sheet. The Board noted that the objective is to remove such amounts from the balance sheet in the same periods as they would have been removed had individual assets or liabilities (rather than an amount) been designated as the hedged item.

BC211 The Board noted that this objective could be fully met only if the entity schedules individual assets or liabilities into repricing time periods and tracks both for how long the scheduled individual items have been hedged and how much of each item was hedged in each time period. In the absence of such scheduling and tracking, some assumptions would need to be made about these matters and, hence, about how much should be removed from the separate balance sheet line items when an asset (or liability) in the hedged portfolio is derecognised. In addition, some safeguards would be needed to ensure that amounts included in the separate balance sheet line items are removed from the balance sheet over a reasonable period and do not remain in the balance sheet indefinitely. With these points in mind, the Board decided to require that:

- (a) whenever an asset (or liability) in the hedged portfolio is derecognised—whether through earlier than expected prepayment, sale or write-off from impairment—any amount included in the separate balance sheet line item relating to that derecognised asset (or liability) should be removed from the balance sheet and included in the gain or loss on derecognition.
- (b) if an entity cannot determine into which time period(s) a derecognised asset (or liability) was scheduled:
 - (i) it should assume that higher than expected prepayments occur on assets scheduled into the first available time period; and
 - (ii) it should allocate sales and impairments to assets scheduled into all time periods containing the derecognised item on a systematic and rational basis.
- (c) the entity should track how much of the total amount included in the separate line items relates to each repricing time period, and should remove the amount that relates to a particular time period from the balance sheet no later than when that time period expires.

Amortisation

BC212 The Board also noted that if the designated hedged amount for a repricing time period is reduced, IAS 39⁴⁴ requires that the separate balance sheet line item described in paragraph 89A relating to that reduction is amortised on the basis of a recalculated effective interest rate. The Board noted that for a portfolio hedge of interest rate risk, amortisation based on a recalculated effective interest rate could be complex to determine and could demand significant additional systems requirements. Consequently, the Board decided that in the case of a portfolio hedge of interest rate risk (and only in such a hedge), the line item balance may be amortised using a straight-line method when a method based on a recalculated effective interest rate is not practicable.

⁴⁴ see paragraph 92

The hedging instrument

- BC213 The Board was asked by commentators to clarify whether the hedging instrument may be a portfolio of derivatives containing offsetting risk positions. Commentators noted that previous versions of IAS 39 were unclear on this point.
- BC214 The issue arises because the assets and liabilities in each repricing time period change over time as prepayment expectations change, as items are derecognised and as new items are originated. Thus the net position, and the amount the entity wishes to designate as the hedged item, also changes over time. If the hedged item decreases, the hedging instrument needs to be reduced. However, entities do not normally reduce the hedging instrument by disposing of some of the derivatives contained in it. Instead, entities adjust the hedging instrument by entering into new derivatives with an offsetting risk profile.
- BC215 The Board decided to permit the hedging instrument to be a portfolio of derivatives containing offsetting risk positions for both individual and portfolio hedges. It noted that all of the derivatives concerned are measured at fair value. It also noted that the two ways of adjusting the hedging instrument described in the previous paragraph can achieve substantially the same effect. Therefore the Board clarified paragraph 77 to this effect.

Hedge effectiveness for a portfolio hedge of interest rate risk

- BC216 Some respondents to the Exposure Draft questioned whether IAS 39's effectiveness tests⁴⁵ should apply to a portfolio hedge of interest rate risk. The Board noted that its objective in amending IAS 39 for a portfolio hedge of interest rate risk is to permit fair value hedge accounting to be used more easily, whilst continuing to meet the principles of hedge accounting. One of these principles is that the hedge is highly effective. Thus, the Board concluded that the effectiveness requirements in IAS 39 apply equally to a portfolio hedge of interest rate risk.
- BC217 Some respondents to the Exposure Draft sought guidance on how the effectiveness tests are to be applied to a portfolio hedge. In particular, they asked how the prospective effectiveness test is to be applied when an entity periodically 'rebalances' a hedge (ie adjusts the amount of the hedging instrument to reflect changes in the hedged item). The Board decided that if the entity's risk management strategy is to change the amount of the hedging instrument periodically to reflect changes in the hedged position, that strategy affects the determination of the term of the hedge. Thus, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. The Board noted that this decision does not conflict with the requirement in paragraph 75 that 'a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding'. This is because the entire hedging instrument is designated (and not only some of its cash flows, for example, those to the time when the hedge is next adjusted). However, expected effectiveness is assessed by considering the change in the fair value of the entire hedging instrument only for the period until it is next adjusted.
- BC218 A third issue raised in the comment letters was whether, for a portfolio hedge, the retrospective effectiveness test should be assessed for all time buckets in aggregate or individually for each time bucket. The Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.

Transition to fair value hedge accounting for portfolios of interest rate risk

- BC219 In finalising the amendments to IAS 39, the Board considered whether to provide additional guidance for entities wishing to apply fair value hedge accounting to a portfolio hedge that had previously been accounted for using cash flow hedge accounting. The Board noted that such entities could apply paragraph 101(d) to revoke the designation of a cash flow hedge and re-designate a new fair value hedge using the same hedged item and hedging instrument, and decided to clarify this in the Application Guidance. Additionally, the Board concluded that clarification was not required for first-time adopters because IFRS 1 already contained sufficient guidance.
- BC220 The Board also considered whether to permit retrospective designation of a portfolio hedge. The Board noted that this would conflict with the principle in paragraph 88(a) that 'at the inception of the hedge there is formal designation and documentation of the hedging relationship' and accordingly, decided not to permit retrospective designation.

⁴⁵ see paragraph AG105

Elimination of selected differences from US GAAP

BC221 The Board considered opportunities to eliminate differences between IAS 39 and US GAAP. The guidance on measurement and hedge accounting under revised IAS 39 is generally similar to that under US GAAP. The amendments will further reduce or eliminate differences between IAS 39 and US GAAP in the areas listed below. In some other areas, a difference will remain. For example, US GAAP in many, but not all, areas is more detailed, which may result in a difference in accounting when an entity applies an accounting approach under IAS 39 that would not be permitted under US GAAP.

Contracts to buy or sell a non-financial item

- (a) The Board decided that a contract to buy or sell a non-financial item is a derivative within the scope of IAS 39 if the non-financial item that is the subject of the contract is readily convertible to cash and the contract is not a 'normal' purchase or sale. This requirement is comparable to the definition of a derivative in SFAS 133, which also includes contracts for which the underlying is readily convertible to cash, and to the scope exclusion in SFAS 133 for 'normal' purchases and sales.

Scope: loan commitments

- (b) The Board decided to add a paragraph to IAS 39 to exclude particular loan commitments that are not settled net. Such loan commitments were within the scope of the original IAS 39. The amendment moves IAS 39 closer to US GAAP.

Unrealised gains and losses on available-for-sale financial assets

- (c) The Board decided to eliminate the option to recognise in profit or loss gains and losses on available-for-sale financial assets (IAS 39, paragraph 55(b)), and thus require such gains and losses to be recognised in equity.⁴⁶ The change is consistent with SFAS 115, which does not provide the option in the original IAS 39 to recognise gains and losses on available-for-sale financial assets in profit or loss. SFAS 115 requires those unrealised gains and losses to be recognised in other comprehensive income (not profit or loss).

Fair value in active markets

- (d) The Board decided to amend the wording in IAS 39, paragraph AG71, to state that, instead of a quoted market price *normally* being the best evidence of fair value, a quoted market price is the best evidence of fair value. This is similar to SFAS 107 *Disclosures about Fair Value of Financial Instruments*.

Fair value in inactive markets

- (e) The Board decided to include in IAS 39 a requirement that the best evidence of the fair value of an instrument that is not traded in an active market is the transaction price, unless the fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique incorporating only observable market data. This is similar to the requirements of EITF 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.

Impaired fixed rate loans: observable market price

- (f) The Board decided to permit an impaired fixed interest rate loan to be measured using an observable market price. SFAS 114 allows impairment to be measured on the basis of a loan's observable market price.

Reversal of impairment losses on investments in equity instruments

- (g) The Board decided that if an entity recognises an impairment loss on an available-for-sale equity investment and the fair value of the investment subsequently increases, the increase in fair value should be recognised in equity. This is comparable to US GAAP under which reversals of impairment losses are not permitted.

Hedges of firm commitments

- (h) The Board decided to require hedges of firm commitments to be treated as fair value hedges instead of cash flow hedges as was required under the original IAS 39 (except foreign currency risk when the hedge may be designated as either a cash flow hedge or a fair value hedge). This change brings IAS 39 closer to SFAS 133.

⁴⁶ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

Basis adjustments to financial assets or financial liabilities resulting from hedges of forecast transactions

- (i) Basis adjustments to financial assets or financial liabilities resulting from hedges of forecast transactions are not permitted under SFAS 133. The revised IAS 39 also precludes such basis adjustments.

Basis adjustments to non-financial assets or non-financial liabilities resulting from hedges of forecast transactions

- (j) The Board decided to permit entities to apply basis adjustments to non-financial assets or non-financial liabilities that result from hedges of forecast transactions. Although US GAAP precludes basis adjustments, permitting a choice in IAS 39 allows entities to meet the US GAAP requirements.

Summary of changes from the Exposure Draft

BC222 The main changes from the Exposure Draft's proposals are as follows:

Scope

- (a) The Standard adopts the proposal in the Exposure Draft that loan commitments that cannot be settled net and are not classified at fair value through profit or loss are excluded from the scope of the Standard. The Standard requires, however, that a commitment to extend a loan at a below-market interest rate is initially recognised at fair value, and subsequently measured at the higher of (i) the amount determined under IAS 37 and (ii) the amount initially recognised, less where appropriate, cumulative amortisation recognised in accordance with IAS 18.
- (b) The Standard adopts the proposal in the Exposure Draft that financial guarantees are initially recognised at fair value, but clarifies that subsequently they are measured at the higher of (a) the amount determined under IAS 37 and (b) the amount initially recognised, less, where appropriate, cumulative amortisation recognised in accordance with IAS 18.

Definitions

- (c) The Standard amends the definition of 'originated loans and receivables' to 'loans and receivables'. Under the revised definition, an entity is permitted to classify as loans and receivables purchased loans that are not quoted in an active market.
- (d) The Standard amends the definition of transaction costs in the Exposure Draft to include internal costs, provided they are incremental and directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.
- (e) The Standard amends the definition of the effective interest rate proposed in the Exposure Draft so that the effective interest rate is calculated using estimated cash flows for all instruments. An exception is made for those rare cases in which it is not possible to estimate cash flows reliably, when the Standard requires the use of contractual cash flows over the contractual life of the instrument. The Standard further stipulates that when accounting for a change in estimates, entities adjust the carrying amount of the instrument in the period of change with a corresponding gain or loss recognised in profit or loss. To calculate the new carrying amount, entities discount revised estimated cash flows at the original effective rate.

Derecognition of a financial asset

- (f) The Exposure Draft proposed that an entity would continue to recognise a financial asset to the extent of its continuing involvement in that asset. Hence, an entity would derecognise a financial asset only if it did not have any continuing involvement in that asset. The Standard uses the concepts of control and of risks and rewards of ownership to determine whether, and to what extent, a financial asset is derecognised. The continuing involvement approach applies only if an entity retains some, but not substantially all, the risks and rewards of ownership and also retains control (see also (i) below).
- (g) Unlike the Exposure Draft, the Standard clarifies when a part of a larger financial asset should be considered for derecognition. The Standard requires a part of a larger financial asset to be considered for derecognition if, and only if, the part is one of:
- only specifically identified cash flows from a financial asset;
 - only a fully proportionate (pro rata) share of the cash flows from a financial asset; or
 - only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset.

In all other cases, the Standard requires the financial asset to be considered for derecognition in its entirety.

- (h) The Standard retains the conditions proposed in the Exposure Draft for ‘pass-through arrangements’ in which an entity retains the contractual rights to receive cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities. However, because of confusion over the meaning of the term ‘pass-through arrangements’, the Standard does not use this term.
- (i) The Standard requires that an entity first assesses whether it has transferred substantially all the risks and rewards of ownership. If an entity has retained substantially all such risks and rewards, it continues to recognise the transferred asset. If it has transferred substantially all such risks and rewards, it derecognises the transferred asset. If an entity has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred asset, it assesses whether it has retained control over the transferred asset. If it has retained control, the Standard requires the entity to continue recognising the transferred asset to the extent of its continuing involvement in the transferred asset. If it has not retained control, the entity derecognises the transferred asset.
- (j) The Standard provides guidance on how to evaluate the concepts of risks and rewards and of control for derecognition purposes.

Measurement

- (k) The Standard adopts the option proposed in the Exposure Draft to permit designation of any financial asset or financial liability on initial recognition as one to be measured at fair value, with changes in fair value recognised in profit or loss. However, the Standard clarifies that the fair value of liabilities with a demand feature, for example, demand deposits, is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid.
- (l) The Standard adopts the proposal in the Exposure Draft that quoted prices in active markets should be used to determine fair value in preference to other valuation techniques. The Standard adds guidance that if a rate (rather than a price) is quoted, these quoted rates are used as inputs into valuation techniques to determine the fair value. The Standard further clarifies that if an entity operates in more than one active market, the entity uses the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market to which the entity has immediate access.
- (m) The Standard simplifies the fair value measurement hierarchy in an inactive market so that recent market transactions do not take precedence over a valuation technique. Rather, when there is not a price in an active market, a valuation technique is used. Such valuation techniques include using recent arm’s length market transactions.
- (n) The Standard also clarifies that the best estimate of fair value at initial recognition of a financial instrument that is not quoted in an active market is the transaction price, unless the fair value of the instrument is evidenced by other observable market transactions or is based on a valuation technique whose variables include only data from observable markets.

Impairment of financial assets

- (o) The Standard clarifies that an impairment loss is recognised only when it has been incurred. The Standard eliminates some of the detailed guidance in the Exposure Draft, in particular, the example of how to calculate the discount rate for the purpose of measuring impairment in a group of financial assets.
- (p) The Exposure Draft proposed that impairment losses recognised on investments in debt or equity instruments that are classified as available for sale cannot be reversed through profit or loss. The Standard requires that for available-for-sale debt instruments, an impairment loss is reversed through profit or loss when fair value increases and the increase can be objectively related to an event occurring after the loss was recognised. Impairment losses recognised on available-for-sale equity instruments cannot be reversed through profit or loss, ie any subsequent increase in fair value is recognised in equity.⁴⁷

Hedge accounting

- (q) The Standard requires that when a hedged forecast transaction actually occurs and results in the recognition of a financial asset or a financial liability, the gain or loss deferred in equity does not adjust the initial carrying amount of the asset or liability (ie ‘basis adjustment’ is prohibited), but remains in

⁴⁷ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such an income is recognised in other comprehensive income.

equity and is recognised in profit or loss consistently with the recognition of gains and losses on the asset or liability. For hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability, the entity has a choice of whether to apply basis adjustment or retain the hedging gain or loss in equity and recognise it in profit or loss when the asset or liability affects profit or loss.

- (r) The Exposure Draft proposed to treat hedges of firm commitments as fair value hedges (rather than as cash flow hedges). The Standard adopts this requirement but clarifies that a hedge of the foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or a cash flow hedge.
- (s) The Exposure Draft maintained the prior guidance that a forecast intragroup transaction may be designated as the hedged item in a foreign currency cash flow hedge provided the transaction is highly probable, meets all other hedge accounting criteria, and will result in the recognition of an intragroup monetary item. The Standard (as revised in 2003) did not include this guidance in the light of comments received from some constituents questioning its conceptual basis. After the revised Standard was issued, constituents raised concerns that it was common practice for entities to designate a forecast intragroup transaction as the hedged item and that the revised IAS 39 created a difference from US GAAP. In response to these concerns, the Board published an Exposure Draft in July 2004. That Exposure Draft proposed to allow an entity to apply hedge accounting in the consolidated financial statements to a highly probable forecast external transaction denominated in the functional currency of the entity entering into the transaction, provided the transaction gave rise to an exposure that would have an effect on the consolidated profit or loss (ie was denominated in a currency other than the group's presentation currency). After discussing the comment letters received on that Exposure Draft, the Board decided to permit the foreign currency risk of a forecast intragroup transaction to be the hedged item in a cash flow hedge in consolidated financial statements provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. In issuing this amendment the Board concluded that:
 - (i) allowing a forecast intragroup transaction to be designated as the hedged item in consolidated financial statements is consistent with the functional currency framework in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, which recognises a functional currency exposure whenever a transaction (including a forecast transaction) is denominated in a currency different from the functional currency of the entity entering into the transaction.
 - (ii) allowing a forecast transaction (intragroup or external) to be designated as the hedged item in consolidated financial statements would not be consistent with the functional currency framework in IAS 21 if the transaction is denominated in the functional currency of the entity entering into it. Accordingly, such transactions should not be permitted to be designated as hedged items in a foreign currency cash flow hedge.
 - (iii) it is consistent with paragraphs 97 and 98 that any gain or loss that is recognised directly in equity⁴⁸ in a cash flow hedge of a forecast intragroup transaction should be reclassified into consolidated profit or loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Transition

- (t) The revised Standard adopts the proposal in the Exposure Draft that, on transition, an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or a financial liability at fair value through profit or loss or available for sale.
 However, a disclosure requirement has been added to IAS 32⁴⁹ to provide information about the fair value of the financial assets or financial liabilities designated into each category and the classification and carrying amount in the previous financial statements.
- (u) The Exposure Draft proposed retrospective application of the derecognition provisions of the revised IAS 39 to financial assets derecognised under the original IAS 39. The Standard requires prospective application, namely that entities do not recognise those assets that were derecognised under the original Standard, but permits retrospective application from a date of the entity's choosing, provided that the information needed to apply IAS 39 to assets and liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.
- (v) The Exposure Draft proposed, and the revised Standard originally required, retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76. After the revised Standard was

⁴⁸ As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such a gain or loss is recognised in other comprehensive income.

⁴⁹ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

issued, constituents raised concerns that retrospective application would diverge from the requirements of US GAAP, would be difficult and expensive to implement, and might require subjective assumptions about what was observable and what was not. In response to these concerns, the Board decided:

- (i) to permit entities to apply the requirements in the last sentence of paragraph AG76 in any one of the following ways:
 - retrospectively, as previously required by IAS 39
 - prospectively to transactions entered into after 25 October 2002, the effective date of equivalent US GAAP requirements
 - prospectively to transactions entered into after 1 January 2004, the date of transition to IFRSs for many entities.
- (ii) to clarify that a gain or loss should be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price. Some constituents asked the Board to clarify that straight-line amortisation is an appropriate method of recognising the difference between a transaction price (used as fair value in accordance with paragraph AG76) and a valuation made at the time of the transaction that was not based solely on data from observable markets. The Board decided not to do this. It concluded that although straight-line amortisation may be an appropriate method in some cases, it will not be appropriate in others.

Dissenting opinions

Dissent of Anthony T Cope, James J Leisenring and Warren J McGregor from the issue of IAS 39 in December 2003

- DO1 Messrs Cope, Leisenring and McGregor dissent from the issue of this Standard.
- DO2 Mr Leisenring dissents because he disagrees with the conclusions concerning derecognition, impairment of certain assets and the adoption of basis adjustment hedge accounting in certain circumstances.
- DO3 The Standard requires in paragraphs 30 and 31 that to the extent of an entity's continuing involvement in an asset, a liability should be recognised for the consideration received. Mr Leisenring believes that the result of that accounting is to recognise assets that fail to meet the definition of assets and to record liabilities that fail to meet the definition of liabilities. Furthermore, the Standard fails to recognise forward contracts, puts or call options and guarantees that are created, but instead records a fictitious 'borrowing' as a result of rights and obligations created by those contracts. There are other consequences of the continuing involvement approach that has been adopted. For transferors, it results in very different accounting by two entities when they have identical contractual rights and obligations only because one entity once owned the transferred financial asset. Furthermore, the 'borrowing' that is recognised is not accounted for like other loans, so no interest expense may be recorded. Indeed, implementing the proposed approach requires the specific override of measurement and presentation standards applicable to other similar financial instruments that do not arise from derecognition transactions. For example, derivatives created by derecognition transactions are not accounted for at fair value. For transferees, the approach also requires the override of the recognition and measurement requirements applicable to other similar financial instruments. If an instrument is acquired in a transfer transaction that fails the derecognition criteria, the transferee recognises and measures it differently from an instrument that is acquired from the same counterparty separately.
- DO4 Mr Leisenring also disagrees with the requirement in paragraph 64 to include an asset that has been individually judged not to be impaired in a portfolio of similar assets for an additional portfolio assessment of impairment. Once an asset is judged not to be impaired, it is irrelevant whether the entity owns one or more similar assets as those assets have no implications for whether the asset that was individually considered for impairment is or is not impaired. The result of this accounting is that two entities could each own 50 per cent of a single loan. Both entities could conclude the loan is not impaired. However, if one of the two entities happens to have other loans that are similar, it would be allowed to recognise an impairment with respect to the loan where the other entity is not. Accounting for identical exposures differently is unacceptable. Mr Leisenring believes that the arguments in paragraph BC115 are compelling.
- DO5 Mr Leisenring also dissents from paragraph 98 which allows but does not require basis adjustment for hedges of forecast transactions that result in the recognition of non-financial assets or liabilities. This accounting results in always adjusting the recorded asset or liability at the date of initial recognition away from its fair value. It also records an asset, if the basis adjustment alternative is selected, at an amount other than its cost as defined in IAS 16 *Property, Plant and Equipment* and further described in paragraph 16 of that Standard. If a derivative were to be considered a part of the cost of acquiring an asset, hedge accounting in these circumstances should not be elective to be consistent with IAS 16. Mr Leisenring also objects to creating this alternative as a result of an improvement project that ostensibly had as an objective the reduction of alternatives. The non-comparability that results from this alternative is both undesirable and unnecessary.
- DO6 Mr Leisenring also dissents from the application guidance in paragraph AG71 and in particular the conclusion contained in paragraph BC98. He does not believe that an entity that originates a contract in one market should measure the fair value of the contract by reference to a different market in which the transaction did not take place. If prices change in the transacting market, that price change should be recognised when subsequently measuring the fair value of the contract. However, there are many implications of switching between markets when measuring fair value that the Board has not yet addressed. Mr Leisenring believes a gain or loss should not be recognised based on the fact a transaction could occur in a different market.
- DO7 Mr Cope dissents from paragraph 64 and agrees with Mr Leisenring's analysis and conclusions on loan impairment as set out above in paragraph DO4. He finds it counter-intuitive that a loan that has been determined not to be impaired following careful analysis should be subsequently accounted for as if it were impaired when included in a portfolio.
- DO8 Mr Cope also dissents from paragraph 98, and, in particular, the Board's decision to allow a free choice over whether basis adjustment is used when accounting for hedges of forecast transactions that result in the recognition of non-financial assets or non-financial liabilities. In his view, of the three courses of action open to the Board—retaining IAS 39's requirement to use basis adjustment, prohibiting basis adjustment as

- proposed in the June 2002 Exposure Draft, or providing a choice—the Board has selected the worst course. Mr Cope believes that the best approach would have been to prohibit basis adjustment, as proposed in the Exposure Draft, because, in his opinion, basis adjustments result in the recognition of assets and liabilities at inappropriate amounts.
- DO9 Mr Cope believes that increasing the number of choices in international standards is bad policy. The Board's decision potentially creates major differences between entities choosing one option and those choosing the other. This lack of comparability will adversely affect users' ability to make sound economic decisions.
- DO10 In addition, Mr Cope notes that entities that are US registrants may choose not to adopt basis adjustment in order to avoid a large reconciling difference to US GAAP. Mr Cope believes that increasing differences between IFRS-compliant entities that are US registrants and those that are not is undesirable.
- DO11 Mr McGregor dissents from paragraph 98 and agrees with Mr Cope's and Mr Leisenring's analyses and conclusions as set out above in paragraphs DO5 and DO8–DO10.
- DO12 Mr McGregor also dissents from this Standard because he disagrees with the conclusions about impairment of certain assets.
- DO13 Mr McGregor disagrees with paragraphs 67 and 69, which deal with the impairment of equity investments classified as available for sale. These paragraphs require impairment losses on such assets to be recognised in profit or loss when there is objective evidence that the asset is impaired. Previously recognised impairment losses are not to be reversed through profit and loss when the assets' fair value increases. Mr McGregor notes that the Board's reasoning for prohibiting reversals through profit or loss of previously impaired available-for-sale equity investments, set out in paragraph BC130 of the Basis for Conclusions, is that it '...could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value'. He agrees with this reasoning but believes that it applies equally to the recognition of impairment losses in the first place. Mr McGregor believes that the significant subjectivity involved in assessing whether a reduction in fair value represents an impairment (and thus should be recognised in profit or loss) or another decrease in value (and should be recognised directly in equity) will at best lead to a lack of comparability within an entity over time and between entities, and at worst provide an opportunity for entities to manage reported profit or loss.
- DO14 Mr McGregor believes that all changes in the fair value of assets classified as available for sale should be recognised in profit or loss. However, such a major change to the Standard would need to be subject to the Board's full due process. At this time, to overcome the concerns expressed in paragraph DO13, he believes that for equity investments classified as available for sale, the Standard should require all changes in fair value below cost to be recognised in profit or loss as impairments and reversals of impairments and all changes in value above cost to be recognised in equity. This approach treats all changes in value the same way, no matter what their cause. The problem of how to distinguish an impairment loss from another decline in value (and of deciding whether there is an impairment in the first place) is eliminated because there is no longer any subjectivity involved. In addition, the approach is consistent with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.
- DO15 Mr McGregor disagrees with paragraph 106 of the Standard and with the consequential amendments to paragraph 27⁵⁰ of IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Paragraph 106 requires entities to apply the derecognition provisions prospectively to financial assets. Paragraph 27 of IFRS 1 requires first-time adopters to apply the derecognition provisions of IAS 39 (as revised in 2003) prospectively to non-derivative financial assets and financial liabilities. Mr McGregor believes that existing IAS 39 appliers should apply the derecognition provisions retrospectively to financial assets, and that first-time adopters should apply the derecognition provisions of IAS 39 retrospectively to all financial assets and financial liabilities. He is concerned that financial assets may have been derecognised under the original IAS 39 by entities that were subject to it, which might not have been derecognised under the revised IAS 39. He is also concerned that non-derivative financial assets and financial liabilities may have been derecognised by first-time adopters under previous GAAP that would not have been derecognised under the revised IAS 39. These amounts may be significant in many cases. Not requiring recognition of such amounts will result in the loss of relevant information and will impair the ability of users of financial statements to make sound economic decisions.

⁵⁰ As a result of the revision of IFRS 1 *First-time Adoption of International Financial Reporting Standards* in November 2008, paragraph 27 became paragraph B2.

Dissent of John T Smith from the issue in March 2004 of *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Amendments to IAS 39)

- DO1 Mr Smith dissents from these Amendments to IAS 39 Financial Instruments: Recognition and Measurement—*Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. He agrees with the objective of finding a macro hedging solution that would reduce systems demands without undermining the fundamental accounting principles related to derivative instruments and hedging activities. However, Mr Smith believes that some respondents' support for these Amendments and their willingness to accept IAS 39 is based more on the extent to which the Amendments reduce recognition of ineffectiveness, volatility of profit or loss, and volatility of equity than on whether the Amendments reduce systems demands without undermining the fundamental accounting principles.
- DO2 Mr Smith believes some decisions made during the Board's deliberations result in an approach to hedge accounting for a portfolio hedge that does not capture what was originally intended, namely a result that is substantially equivalent to designating an individual asset or liability as the hedged item. He understands some respondents will not accept IAS 39 unless the Board provides still another alternative that will further reduce reported volatility. Mr Smith believes that the Amendments already go beyond their intended objective. In particular, he believes that features of these Amendments can be applied to smooth out ineffectiveness and achieve results substantially equivalent to the other methods of measuring ineffectiveness that the Board considered when developing the Exposure Draft. The Board rejected those methods because they did not require the immediate recognition of all ineffectiveness. He also believes those features could be used to manage earnings.

Dissent of Mary E Barth, Robert P Garnett and Geoffrey Whittington from the issue in June 2005 of *The Fair Value Option* (Amendments to IAS 39)

- DO1 Professor Barth, Mr Garnett and Professor Whittington dissent from the amendment to IAS 39 Financial Instruments: Recognition and Measurement—*The Fair Value Option*. Their dissenting opinions are set out below.
- DO2 These Board members note that the Board considered the concerns expressed by the prudential supervisors on the fair value option as set out in the December 2003 version of IAS 39 when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39 and providing relevant information to users of financial statements, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion. Furthermore, the majority of constituents have clearly expressed a preference for the fair value option as set out in the December 2003 version of IAS 39 over the fair value option as contained in the amendment.
- DO3 Those Board members note that the amendment introduces a series of complex rules, including those governing transition which would be entirely unnecessary in the absence of the amendment. There will be consequential costs to preparers of financial statements, in order to obtain, in many circumstances, substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39. They believe that the complex rules will also inevitably lead to differing interpretations of the eligibility criteria for the fair value option contained in the amendment.
- DO4 These Board members also note that, for paragraph 9(b)(i), application of the amendment may not mitigate, on an ongoing basis, the anomaly of volatility in profit or loss that results from the different measurement attributes in IAS 39 any more than would the option in the December 2003 version of IAS 39. This is because the fair value designation is required to be continued even if one of the offsetting instruments is derecognised. Furthermore, for paragraphs 9(b)(i), 9(b)(ii) and 11A, the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions that permitted the use of the option still hold. Therefore, these Board members question the purpose of and need for requiring the criteria to be met at initial designation.

Dissent of James J Leisenring and John T Smith from the issue in October 2008 of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7)

- DO1 Messrs Leisenring and Smith dissent from *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7). The amendments to IAS 39 are asserted to level the playing field with US GAAP. It accomplishes that with respect to the reclassification of financial instruments to the held-to-maturity category⁵¹ of loans and receivables from other classifications. However, once reclassified, the measurement of impairment and when that measurement is required are quite different and a level playing field in accounting for these instruments is not achieved. Messrs Leisenring and Smith would have been willing to support the alternative approach considered by the Board that would have closely aligned the impairment requirements of US GAAP with IFRSs.
- DO2 As described in paragraph BC11E, in October 2008 the Board received requests to address differences between the reclassification requirements of IAS 39 and US GAAP. SFAS 115 permits a security to be reclassified out of the trading category in rare situations. SFAS 65 permits a loan to be reclassified out of the Held for Sale category if the entity has the intention to hold the loan for the foreseeable future or until maturity. IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held-for-trading category as is permitted by SFAS 115 and SFAS 65.
- DO3 Messrs Leisenring and Smith both believe that the current requirements in IFRSs for reclassification are superior to US GAAP and that the accounting for impairments in US GAAP is superior to the requirements of IAS 39.
- DO4 Furthermore, Messrs Leisenring and Smith do not believe that amendments to standards should be made without any due process.

⁵¹ IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of held-to-maturity.

IAS 39 *Financial Instruments: Recognition and Measurement*

Illustrative example

This example accompanies, but is not part of, IAS 39.

Facts

- IE1 On 1 January 20X1, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.
- IE2 For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (ie it has 60 separate monthly time periods)⁵². The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.
- IE3 This example deals only with the repricing time period expiring in three months' time, ie the time period maturing on 31 March 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million⁵³ and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.
- IE4 Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap⁵⁴ on 1 January 20X1 to pay a fixed rate and receive LIBOR, with a notional principal amount of CU20 million and a fixed life of three months.
- IE5 This Example makes the following simplifying assumptions:
- (a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;
 - (b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and
 - (c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.
- In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)
- IE6 It is also assumed that Entity A tests effectiveness on a monthly basis.
- IE7 The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows:

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

⁵² In this Example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this Example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

⁵³ In this example monetary amounts are denominated in 'currency units (CU)'.

⁵⁴ The Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

IE8 The fair value of the swap at various times during the period of the hedge is as follows:

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting treatment

IE9 On 1 January 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (ie the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 88(d) and AG119 of the Standard.

IE10 Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (31 January 20X1)

IE11 On 31 January 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12 The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)⁵⁵ (the swap is a liability).

IE13 Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

- First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20 million ÷ CU100 million).
- Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.
- Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408⁵⁶ × (CU19.2 million ÷ CU20 million)).

IE14 Entity A makes the following accounting entries relating to this time period:

Dr Cash	CU172,097	
Cr Profit or loss (interest income) ^a		CU172,097

To recognise the interest received on the hedged amount (CU19.2 million).

Dr Profit or loss (interest expense)	CU179,268	
Cr Profit or loss (interest income)		CU179,268
Cr Cash		Nil

To recognise the interest received and paid on the swap designated as the hedging instrument.

Dr Profit or loss (loss)	CU47,408	
Cr Derivative liability		CU47,408

To recognise the change in the fair value of the swap.

⁵⁵ see paragraph IE8

⁵⁶ ie CU20,047,408 – CU20,000,000. See paragraph IE7

Dr	Separate line item in the statement of financial position	CU45,511	
	Cr Profit or loss (gain)		CU45,511

To recognise the change in the fair value of the hedged amount.

(a) This Example does not show how amounts of interest income and interest expense are calculated.

- IE15 The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of month 2

- IE16 On 1 February 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold $8\frac{1}{3}$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

- IE17 On this basis, Entity A computes that it has sold $8\frac{1}{3}$ per cent of the assets allocated to the three-month time period, ie CU8 million ($8\frac{1}{3}$ per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.⁵⁷ On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8\frac{1}{3}$ per cent of the total line item balance of CU45,511, ie CU3,793.

- IE18 Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position:

Dr	Cash	CU8,018,400	
	Cr Asset		CU8,000,000
	Cr Separate line item in the statement of financial position		CU3,793
	Cr Profit or loss (gain)		CU14,607

To recognise the sale of the asset at fair value and to recognise a gain on sale.

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

- IE19 Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.

- IE20 Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.⁵⁸ It also complies with the other designation requirements in paragraphs 88(a) and AG119 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in profit or loss, or is designated as the hedging instrument in a different hedge.⁵⁹

- IE21 As at 1 February 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6⁶⁰ million of assets. However, as at 1 February 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.⁶¹ The remaining separate line item in the statement of financial position of CU22,755⁶² relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, ie it amortises CU22,755 over two months.

⁵⁷ The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

⁵⁸ CU47,408 × 40 per cent

⁵⁹ The entity could instead enter into an offsetting swap with a notional principal of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

⁶⁰ CU19.2 million – ($8\frac{1}{3}\%$ × CU19.2 million)

⁶¹ CU41,718 × (CU8 million ÷ CU17.6 million)

⁶² CU41,718 – CU18,963

- IE22 Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

End of month 2 (28 February 20X1)

- IE23 On 28 February 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)⁶³ (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at 2 February 20X1 as CU8,009,518.⁶⁴

- IE24 Entity A makes the following accounting entries relating to the hedge in this time period:

Dr Cash	CU71,707	
	Cr Profit or loss (interest income)	CU71,707

To recognise the interest received on the hedged amount (CU8 million).

Dr Profit or loss (interest expense)	CU71,707	
	Cr Profit or loss (interest income)	CU62,115
	Cr Cash	CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr Derivative liability	CU9,445	
	Cr Profit or loss (gain)	CU9,445

To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million) (CU9,518 – CU18,963).

Dr Profit or loss (loss)	CU9,445	
	Cr Separate line item in the statement of financial position	CU9,445

To recognise the change in the fair value of the hedged amount (CU8,009,518 – CU8,018,963).

- IE25 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

- IE26 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr Profit or loss (loss)	CU11,378	
	Cr Separate line item in the statement of financial position	CU11,378 ^a

To recognise the amortisation charge for the period.

(a) $CU22,755 \div 2$

End of month 3

- IE27 During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20X1 the assets and the swap mature and all balances are recognised in profit or loss.

⁶³ $CU23,795$ [see paragraph IE8] \times (CU8 million \div CU20 million)

⁶⁴ $CU20,023,795$ [see paragraph IE7] \times (CU8 million \div CU20 million)

IE28 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU8,071,707	
	Cr	Asset (statement of financial position)	CU8,000,000
	Cr	Profit or loss (interest income)	CU71,707

To recognise the interest and cash received on maturity of the hedged amount (CU8 million).

Dr	Profit or loss (interest expense)	CU71,707	
	Cr	Profit or loss (interest income)	CU62,115
	Cr	Cash	CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,518	
	Cr	Profit or loss (gain)	CU9,518

To recognise the expiry of the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Profit or loss (loss)	CU9,518	
	Cr	Separate line item in the statement of financial position	CU9,518

To remove the remaining line item balance on expiry of the time period.

IE29 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE30 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Profit or loss (loss)	CU11,377	
	Cr	Separate line item in the statement of financial position	CU11,377 ^(a)

To recognise the amortisation charge for the period.

(a) $CU22,755 \div 2$

Summary

IE31 The tables below summarise:

- (a) changes in the separate line item in the statement of financial position;
- (b) the fair value of the derivative;
- (c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and
- (d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
	CU	CU	CU	CU	CU
Amount of asset hedged	20,000,000	19,200,000	8,000,000	8,000,000	8,000,000
(a) Changes in the separate line item in the statement of financial position					
Brought forward:					
Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortised	Nil	Nil	22,755	11,377	Nil
Remaining balance	Nil	45,511	18,963	9,518	Nil

(b) The fair value of the derivative

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
CU20,000,000	Nil	47,408	–	–	–
CU12,000,000				No longer designated as the hedging instrument.	
	Nil	–	28,445		
CU8,000,000	Nil	–	18,963	9,518	Nil
Total	Nil	47,408	47,408	9,518	Nil

(c) Profit or loss effect of the hedge

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	Nil	(1,897)	N/A	Nil	Nil
Amortisation	Nil	Nil	N/A	(11,378)	(11,377)

In addition, there is a gain on sale of assets of CU14,607 at 1 February 20X1.

(d) Interest income and interest expense relating to the amount designated as hedged

Profit or loss recognised for the amount hedged	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Interest income					
– on the asset	Nil	172,097	N/A	71,707	71,707
– on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
– on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

CONTENTS

GUIDANCE ON IMPLEMENTING IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT***SECTION A SCOPE**

- A.1 Practice of settling net: forward contract to purchase a commodity
- A.2 Option to put a non-financial asset

SECTION B DEFINITIONS

- B.1 Definition of a financial instrument: gold bullion
- B.2 Definition of a derivative: examples of derivatives and underlyings
- B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement
- B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)
- B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap
- B.6 Definition of a derivative: offsetting loans
- B.7 Definition of a derivative: option not expected to be exercised
- B.8 Definition of a derivative: foreign currency contract based on sales volume
- B.9 Definition of a derivative: prepaid forward
- B.10 Definition of a derivative: initial net investment
- B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit taking
- B.12 Definition of held for trading: balancing a portfolio
- B.13 Definition of held-to-maturity financial assets: index-linked principal
- B.14 Definition of held-to-maturity financial assets: index-linked interest
- B.15 Definition of held-to-maturity financial assets: sale following rating downgrade
- B.16 Definition of held-to-maturity financial assets: permitted sales
- B.17 Definition of held-to-maturity investments: sales in response to entity-specific capital requirements
- B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (repos) and securities lending agreements
- B.19 Definition of held-to-maturity financial assets: 'tainting'
- B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule
- B.21 Definition of held-to-maturity investments: application of the 'tainting' rule on consolidation
- B.22 Definition of loans and receivables: equity instrument
- B.23 Definition of loans and receivables: banks' deposits in other banks
- B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate
- B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate
- B.26 Example of calculating amortised cost: financial asset
- B.27 Example of calculating amortised cost: debt instruments with stepped interest payments
- B.28 Regular way contracts: no established market
- B.29 Regular way contracts: forward contract
- B.30 Regular way contracts: which customary settlement provisions apply?
- B.31 Regular way contracts: share purchase by call option
- B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

SECTION C EMBEDDED DERIVATIVES

- C.1 Embedded derivatives: separation of host debt instrument**
- C.2 Embedded derivatives: separation of embedded option**
- C.3 Embedded derivatives: accounting for a convertible bond**
- C.4 Embedded derivatives: equity kicker**
- C.5 Embedded derivatives: debt or equity host contract**
- C.6 Embedded derivatives: synthetic instruments**
- C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments**
- C.8 Embedded foreign currency derivatives: unrelated foreign currency provision**
- C.9 Embedded foreign currency derivatives: currency of international commerce**
- C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment**
- C.11 Embedded derivatives: reliable determination of fair value**

SECTION D RECOGNITION AND DERECOGNITION**D.1 Initial recognition**

- D.1.1 Recognition: cash collateral

D.2 Regular way purchase or sale of a financial asset

- D.2.1 Trade date vs settlement date: amounts to be recorded for a purchase
- D.2.2 Trade date vs settlement date: amounts to be recorded for a sale
- D.2.3 Settlement date accounting: exchange of non-cash financial assets

SECTION E MEASUREMENT**E.1 Initial measurement of financial assets and financial liabilities**

- E.1.1 Initial measurement: transaction costs

E.3 Gains and losses

- E.3.1 Available-for-sale financial assets: exchange of shares
- E.3.2 IAS 39 and IAS 21 Available-for-sale financial assets: separation of currency component
- E.3.3 IAS 39 and IAS 21 Exchange differences arising on translation of foreign entities: other comprehensive income or profit or loss?
- E.3.4 IAS 39 and IAS 21 Interaction between IAS 39 and IAS 21

E.4 Impairment and uncollectibility of financial assets

- E.4.1 Objective evidence of impairment
- E.4.2 Impairment: future losses
- E.4.3 Assessment of impairment: principal and interest
- E.4.4 Assessment of impairment: fair value hedge
- E.4.5 Impairment: provision matrix
- E.4.6 Impairment: excess losses
- E.4.7 Recognition of impairment on a portfolio basis
- E.4.8 Impairment: recognition of collateral
- E.4.9 Impairment of non-monetary available-for-sale financial asset
- E.4.10 Impairment: whether the available-for-sale reserve in equity can be negative

SECTION F HEDGING**F.1 Hedging instruments**

- F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency
- F.1.2 Hedging with a non-derivative financial asset or liability
- F.1.3 Hedge accounting: use of written options in combined hedging instruments
- F.1.4 Internal hedges
- F.1.5 Offsetting internal derivative contracts used to manage interest rate risk
- F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk
- F.1.7 Internal derivatives: examples of applying Question F.1.6
- F.1.8 Combination of written and purchased options
- F.1.9 Delta-neutral hedging strategy
- F.1.10 Hedging instrument: out of the money put option
- F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument
- F.1.12 Hedges of more than one type of risk
- F.1.13 Hedging instrument: dual foreign currency forward exchange contract
- F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

F.2 Hedged items

- F.2.1 Whether a derivative can be designated as a hedged item
- F.2.2 Cash flow hedge: anticipated issue of fixed rate debt
- F.2.3 Hedge accounting: core deposit intangibles
- F.2.4 Hedge accounting: hedging of future foreign currency revenue streams
- F.2.5 Cash flow hedges: 'all in one' hedge
- F.2.6 Hedge relationships: entity-wide risk
- F.2.7 Cash flow hedge: forecast transaction related to an entity's equity
- F.2.8 Hedge accounting: risk of a transaction not occurring
- F.2.9 Held-to-maturity investments: hedging variable interest rate payments
- F.2.10 Hedged items: purchase of held-to-maturity investment
- F.2.11 Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments
- F.2.12 Hedge accounting: prepayable financial asset
- F.2.13 Fair value hedge: risk that could affect profit or loss
- F.2.14 Intragroup and intra-entity hedging transactions
- F.2.15 Internal contracts: single offsetting external derivative
- F.2.16 Internal contracts: external derivative contracts that are settled net
- F.2.17 Partial term hedging
- F.2.18 Hedging instrument: cross-currency interest rate swap
- F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares
- F.2.20 Hedge accounting: stock index
- F.2.21 Hedge accounting: netting of assets and liabilities

F.3 Hedge accounting

- F.3.1 Cash flow hedge: fixed interest rate cash flows
- F.3.2 Cash flow hedge: reinvestment of fixed interest rate cash flows
- F.3.3 Foreign currency hedge
- F.3.4 Foreign currency cash flow hedge
- F.3.5 Fair value hedge: variable rate debt instrument
- F.3.6 Fair value hedge: inventory
- F.3.7 Hedge accounting: forecast transaction
- F.3.8 Retrospective designation of hedges
- F.3.9 Hedge accounting: designation at the inception of the hedge

- F.3.10 Hedge accounting: identification of hedged forecast transaction
- F.3.11 Cash flow hedge: documentation of timing of forecast transaction

F.4 Hedge effectiveness

- F.4.1 Hedging on an after-tax basis
- F.4.2 Hedge effectiveness: assessment on cumulative basis
- F.4.3 Hedge effectiveness: counterparty credit risk
- F.4.4 Hedge effectiveness: effectiveness tests
- F.4.5 Hedge effectiveness: less than 100 per cent offset
- F.4.7 Assuming perfect hedge effectiveness

F.5 Cash flow hedges

- F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument
- F.5.2 Cash flow hedges: performance of hedging instrument (1)
- F.5.3 Cash flow hedges: performance of hedging instrument (2)
- F.5.4 Cash flow hedges: forecast transaction occurs before the specified period
- F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument
- F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

F.6 Hedges: other issues

- F.6.1 Hedge accounting: management of interest rate risk in financial institutions
- F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis
- F.6.3 Illustrative example of applying the approach in Question F.6.2
- F.6.4 Hedge accounting: premium or discount on forward exchange contract
- F.6.5 IAS 39 and IAS 21 Fair value hedge of asset measured at cost

SECTION G OTHER

- G.1 Disclosure of changes in fair value
- G.2 IAS 39 and IAS 7 Hedge accounting: statement of cash flows

Guidance on implementing IAS 39 *Financial Instruments: Recognition and Measurement*

This guidance accompanies, but is not part of, IAS 39.

Section A Scope

A.1 Practice of settling net: forward contract to purchase a commodity

Entity XYZ enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IAS 39. Instead, it is accounted for as an executory contract.

A.2 Option to put a non-financial asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175⁶⁵ million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (IAS 39.5 and IAS 39.AG10).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (IAS 39.7). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from IAS 39 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative.

Section B Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

⁶⁵ In this Guidance, monetary amounts are denominated in 'currency units' (CU).

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

IAS 39 defines a derivative as follows:

A *derivative* is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’);
- (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (c) it is settled at a future date.

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

The above list provides examples of contracts that normally qualify as derivatives under IAS 39. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of IAS 39 may apply, for example, if it is a weather derivative (see IAS 39.AG1), a contract to buy or sell a non-financial item such as commodity (see IAS 39.5 and IAS 39.AG10) or a contract settled in an entity’s own shares (see IAS 32.21–IAS 32.24). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under IAS 39, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of CU50 million ($\text{CU100 million} \times 10 \text{ per cent} \times 5 \text{ years}$) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' provision of IAS 39. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under IAS 39.

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, ie CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of IAS 39. Therefore, the contract is not accounted for as a derivative under IAS 39. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IAS 39?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IAS 39.9 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in IAS 39.9 requires that the instrument ‘is settled at a future date’. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the US dollar, sells products in France denominated in euro. XYZ enters into a contract with an investment bank to convert euro to US dollars at a fixed exchange rate. The contract requires XYZ to remit euro based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IAS 39 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the ‘no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’ test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, ie CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T’s shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit taking

The definition of a financial asset or financial liability held for trading states that ‘a financial asset or financial liability is classified as held for trading if it is ... part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking’. What is a ‘portfolio’ for the purposes of applying this definition?

Although the term ‘portfolio’ is not explicitly defined in IAS 39, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (IAS 39.9). If there is evidence of a recent actual pattern of short-term profit taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of held for trading: balancing a portfolio

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A’s intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.13 Definition of held-to-maturity financial assets:index-linked principal

Entity A purchases a five-year equity-index-linked note with an original issue price of CU10 at a market price of CU12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of CU10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of CU10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (IAS 39.9). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under IAS 39.11. The purchase price of CU12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is CU4, the host debt instrument is measured at CU8 on initial recognition. In this case, the discount of CU2 that is implicit in the host bond (principal of CU10 minus the original carrying amount of CU8) is amortised to profit or loss over the term to maturity of the note using the effective interest method.

B.14 Definition of held-to-maturity financial assets: index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IAS 39.11). IAS 39.12 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.15 Definition of held-to-maturity financial assets: sale following rating downgrade

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. IAS 39 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in IAS 39 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in IAS 39. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.16 Definition of held-to-maturity financial assets: permitted sales

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under IAS 39.AG22 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the board of directors, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the board. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.17 Definition of held-to-maturity investments: sales in response to entity-specific capital requirements

In some countries, regulators of banks or other industries may set *entity-specific* capital requirements that are based on an assessment of the risk in that particular entity. IAS 39.AG22(e) indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the *industry's* capital requirements may do so under IAS 39 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators (ie capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales 'taint' the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfil the condition in IAS 39.9 in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (repos) and securities lending agreements

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a repo or securities lending transaction, and continues to be recognised cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.19 Definition of held-to-maturity financial assets: 'tainting'

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favourable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with IAS 39?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in IAS 39.9 and IAS 39.AG22 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under IAS 39.51. IAS 39.9 makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule

Can an entity apply the conditions for held-to-maturity classification in IAS 39.9 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in US dollars and debt instruments denominated in euro?

No. The 'tainting rule' in IAS 39.9 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.21 Definition of held-to-maturity investments: application of the 'tainting' rule on consolidation

Can an entity apply the conditions in IAS 39.9 separately to held-to-maturity financial assets held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in IAS 39.9 are met.

B.22 Definition of loans and receivables: equity instrument

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. IAS 32.15–IAS 32.22 provide guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under IAS 32, it cannot be classified within loans and receivables by the holder.

B.23 Definition of loans and receivables: banks' deposits in other banks

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under IAS 39.9?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortised cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ('the maturity amount') be amortised immediately on initial recognition for the purpose of determining amortised cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (IAS 39.9).

B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortised cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 per cent for the first ten years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortised cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.26 Example of calculating amortised cost: financial asset

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortised cost. How is amortised cost calculated?

Under IAS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7 per cent that is paid annually ($\text{CU1,250} \times 4.7 \text{ per cent} = \text{CU59 per year}$). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

Year	(a) Amortised cost at the beginning of the year	(b = a × 10%) Interest income	(c) Cash flows	(d = a + b – c) Amortised cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 per cent of the principal will be prepaid at the end of 20X2 and the remaining 50 per cent at the end of 20X4. In accordance with IAS 39.AG8, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 per cent). This results in the new opening balance in 20X2 of CU1138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in profit or loss in 20X2. The table below provides information about the amortised cost, interest income and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a) Amortised cost at the beginning of the year	(b = a × 10%) Interest income	(c) Cash flows	(d = a + b – c) Amortised cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (CU595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 per cent).

B.27 Example of calculating amortised cost: debt instruments with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at CU1,250 and has a maturity amount of CU1,250, would the amortised cost equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (IAS 39.9).

The following example illustrates how amortised cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

On 1 January 2000, Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the debt instrument is repayable on 31 December 2004. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 per cent in 2000 (CU75), 8.0 per cent in 2001 (CU100), 10.0 per cent in 2002 (CU125), 12.0 per cent in 2003 (CU150), and 16.4 per cent in 2004 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortised cost in each period. In each period, the amortised cost at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the amortised cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortised cost in each period is as follows:

Year	(a) Amortised cost at the beginning of the year	(b = a × 10%) Interest income	(c) Cash flows	(d = a + b – c) Amortised cost at the end of the year
2000	1,250	125	75	1,300
2001	1,300	130	100	1,330
2002	1,330	133	125	1,338
2003	1,338	134	150	1,322
2004	1,322	133	1,250 + 205	–

B.28 Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. IAS 39.9 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in IAS 39.9, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.31 Regular way contracts: share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to

settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

IAS 39 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IAS 39 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in IAS 39.14 and IAS 39.39 apply. IAS 39.14 states that financial liabilities are recognised on the date the entity ‘becomes a party to the contractual provisions of the instrument’. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IAS 39. IAS 39.39 specifies that financial liabilities are derecognised only when they are extinguished, ie when the obligation specified in the contract is discharged or cancelled or expires.

Section C Embedded derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a principal payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behaviour of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, capton, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 Embedded derivatives: accounting for a convertible bond

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into shares of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature—the right to convert into equity shares before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (ie fair value changes recognised in other comprehensive income until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognised in profit or loss unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognised in profit or loss, separating the embedded derivative from the host bond is not permitted.

C.4 Embedded derivatives: equity kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an ‘equity kicker’) in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in profit or loss (IAS 39.11(c)), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (IAS 39.11(a)). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (IAS 39.11(b) and IAS 39.9(a)). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. IAS 39.AG9 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 Embedded derivatives: debt or equity host contract

Entity A purchases a five-year 'debt' instrument issued by Entity B with a principal amount of CU1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is CU110. No separate interest payments are made by Entity B. The purchase price is CU1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, ie it does not meet the definition of an equity instrument (IAS 32.11 and IAS 32.16). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on CU1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded derivatives: synthetic instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since IAS 39.AG33(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ('synthetic instrument' accounting) for the purpose of applying IAS 39. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IAS 39?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IAS 39 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IAS 39.5 and IAS 39.AG10). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under IAS 39.11, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (IAS 39.AG33(d)).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from IAS 39.AG33(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IAS 39.11.

C.9 Embedded foreign currency derivatives: currency of international commerce

IAS 39.AG33(d) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in IAS 39.AG33(a) that the holder would not recover substantially all of its recognised investment?

No. The condition that 'the holder would not recover substantially all of its recognised investment' is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that 'the holder would not recover substantially all of its recognised investment' applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.

C.11 Embedded derivatives: reliable determination of fair value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (IAS 39.12). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant

to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D Recognition and derecognition

D.1 Initial recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular way purchase or sale of a financial asset

D.2.1 Trade date vs settlement date: amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On 29 December 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On 31 December 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement date accounting			
Balances	Held-to-maturity investments carried at amortised cost	Available-for- sale assets remeasured to fair value with changes in other comprehensive income	Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss
29 December 20X1			
Financial asset	—	—	—
Financial liability	—	—	—
31 December 20X1			
Receivable	—	2	2
Financial asset	—	—	—
Financial liability	—	—	—
Equity (fair value adjustment)	—	(2)	—
Retained earnings (through profit or loss)	—	—	(2)
4 January 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Equity (fair value adjustment)	—	(3)	—
Retained earnings (through profit or loss)	—	—	(3)

Trade date accounting			
Balances	Held-to-maturity investments carried at amortised cost	Available-for- sale assets remeasured to fair value with changes in other comprehensive income	Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss
29 December 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Equity (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Equity (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

D.2.2 Trade date vs settlement date: amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On 29 December 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortised cost is CU1,000. On 31 December 20X2 (financial year-end), the fair value of the asset is CU1,012. On 4 January 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting			
Balances	Held-to-maturity investments carried at amortised cost	Available-for- sale assets remeasured to fair value with changes in other comprehensive income	Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss
29 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
31 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
4 January 20X3			
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

Trade date accounting			
Balances	Held-to-maturity investments carried at amortised cost	Available-for- sale assets remeasured to fair value with changes in other comprehensive income	Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss
29 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10
31 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10
4 January 20X3			
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with IAS 39.57?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under IAS 39.57 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in IAS 39.AG55. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is carried at amortised cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of CU1,010 on 29 December, while the amortised cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On 31 December 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On 4 January 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

29 December 20X2

Dr Bond B	CU1,010	
Cr Payable		CU1,010

31 December 20X2

Dr Trading loss	CU1	
Cr Bond B		CU1

4 January 20X3

Dr Payable	CU1,010	
Dr Trading loss	CU2	
Cr Note Receivable A		CU1,000
Cr Bond B		CU2
Cr Realisation gain		CU10

Section E Measurement

E.1 Initial measurement of financial assets and financial liabilities

E.1.1 Initial measurement: transaction costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through profit or loss. How should this requirement be applied in practice?

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognised. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognised. For financial instruments that are measured at fair value through profit or loss, transaction costs are not added to the fair value measurement at initial recognition.

For financial instruments that are carried at amortised cost, such as held-to-maturity investments, loans and receivables, and financial liabilities that are not at fair value through profit or loss, transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

For available-for-sale financial assets, transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement. If an available-for-sale financial asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortised to profit or loss using the effective interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 [Deleted]

E.3 Gains and losses

E.3.1 Available-for-sale financial assets: exchange of shares

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On 20 December 2000, the fair value of the shares is CU120 and the cumulative gain recognised in other comprehensive income is CU20. On the same day, Entity B is acquired by Entity C, a large public entity. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under IAS 39.55(b), should Entity A reclassify the cumulative gain of CU20 recognised in other comprehensive income from equity to profit or loss as a reclassification adjustment?

Yes. The transaction qualifies for derecognition under IAS 39. IAS 39.55(b) requires the cumulative gain or loss on an available-for-sale financial asset that has been recognised in other comprehensive income to be reclassified from equity to profit or loss when the asset is derecognised. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 IAS 39 and IAS 21 Available-for-sale financial assets: separation of currency component

For an available-for-sale monetary financial asset, the entity recognises changes in the carrying amount relating to changes in foreign exchange rates in profit or loss in accordance with IAS 21.23(a) and IAS 21.28 and other changes in the carrying amount in other comprehensive income in accordance with IAS 39. How is the cumulative gain or loss that is recognised in other comprehensive income determined?

It is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying IAS 21.28 the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on 31 December 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a principal amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually ($FC1,250 \times 4.7$ per cent = FC59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available for sale, and thus recognises gains and losses in other comprehensive income. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 ($= FC1,000 \times 1.5$).

Dr Bond	LC1,500	
Cr Cash		LC1,500

On 31 December 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 ($= FC1,060 \times 2$). The amortised cost is FC1,041 ($= LC2,082$). In this case, the cumulative gain or loss to be recognised in other comprehensive income and accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X2, ie LC38 ($= LC2,120 - LC2,082$).

Interest received on the bond on 31 December 20X2 is FC59 ($= LC118$). Interest income determined in accordance with the effective interest method is FC100 ($= 1,000 \times 10$ per cent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (IAS 21.22). Thus, reported interest income is LC175 ($= FC100 \times 1.75$) including accretion of the initial discount of LC72 ($= [FC100 - FC59] \times 1.75$). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC510 ($= LC2,082 - LC1,500 - LC72$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= FC59 \times [200 - 1.75]$).

Dr Bond	LC620	
Dr Cash	LC118	
Cr Interest income		LC175
Cr Exchange gain		LC525
Cr Fair value change in other comprehensive income		LC38

On 31 December 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 ($= \text{FC1,070} \times 2.50$). The amortised cost is FC1,086 ($= \text{LC2,715}$). The cumulative gain or loss to be accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X3, ie negative LC40 ($= \text{LC2,675} - \text{LC2,715}$). Thus, the amount to be recognised in other comprehensive income equals the change in the difference during 20X3 of LC78 ($= \text{LC40} + \text{LC38}$).

Interest received on the bond on 31 December 20X3 is FC59 ($= \text{LC148}$). Interest income determined in accordance with the effective interest method is FC104 ($= \text{FC1,041} \times 10 \text{ per cent}$). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (IAS 21.22). Thus, recognised interest income is LC234 ($= \text{FC104} \times 2.25$) including accretion of the initial discount of LC101 ($= [\text{FC104} - \text{FC59}] \times 2.25$). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC532 ($= \text{LC2,715} - \text{LC2,082} - \text{LC101}$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= \text{FC59} \times [2.50 - 2.25]$).

Dr Bond	LC555	
Dr Cash	LC148	
Dr Fair value change in other comprehensive income	LC78	
Cr Interest income		LC234
Cr Exchange gain		LC547

E.3.3 IAS 39 and IAS 21 Exchange differences arising on translation of foreign entities: other comprehensive income or profit or loss?

IAS 21.32 and IAS 21.48 states that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive income until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through profit or loss and financial assets that are available for sale.

IAS 39.55 requires that changes in fair value of financial assets classified as at fair value through profit or loss should be recognised in profit or loss and changes in fair value of available-for-sale investments should be recognised in other comprehensive income.

If the foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are IAS 39.55 and IAS 21.39 applied?

IAS 39 applies in the accounting for financial instruments in the financial statements of a foreign operation and IAS 21 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under IAS 39.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 ($= \text{LCY100} \times 2.00$) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognises the trading asset at LCY110 in its balance sheet and recognises a fair value gain of LCY10 in its profit or loss. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 ($= \text{LCY110} \times 3.00$) in the currency of Country X. Therefore, Entity A recognises the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of comprehensive income of B 'at the exchange rates at the dates of the transactions' (IAS 21.39(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ($[3.00 + 2.00] / 2 = 2.50$, in accordance with IAS 21.22). Therefore, while the fair value of the trading asset has increased by LCX130 ($= \text{LCX330} - \text{LCX200}$), Entity A recognises only LCX25 ($= \text{LCY10} \times 2.5$) of this increase in consolidated profit or loss to comply with IAS 21.39(b). The resulting exchange difference, ie the remaining increase in the fair value of the debt instrument ($\text{LCX130} - \text{LCX25} = \text{LCX105}$), is as accumulated in equity until the disposal of the net investment in the foreign operation in accordance with IAS 21.48.

E.3.4 IAS 39 and IAS 21 Interaction between IAS 39 and IAS 21

IAS 39 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in profit or loss. IAS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in profit or loss. In what order are IAS 21 and IAS 39 applied?

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IAS 39. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (IAS 39.AG83). For example, if a monetary financial asset (such as a debt instrument) is carried at amortised cost under IAS 39, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (IAS 21.23). That applies regardless of whether a monetary item is measured at cost, amortised cost or fair value in the foreign currency (IAS 21.24). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (IAS 21.23(c)) and at a historical rate if it is not carried at fair value under IAS 39 because its fair value cannot be reliably measured (IAS 21.23(b) and IAS 39.46(c)).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IAS 39, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under IAS 21 (IAS 39.89), ie the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IAS 21.23(b)).

Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising a *monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in profit or loss or in other comprehensive income in accordance with IAS 21 (IAS 39.AG83, IAS 21.28 and IAS 21.32), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.95). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognised in profit or loss or in other comprehensive income in accordance with IAS 39. For example, although an entity recognises gains and losses on available-for-sale monetary financial assets in other comprehensive income (IAS 39.55(b)), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in profit or loss (IAS 21.23(a)).

Any changes in the carrying amount of a *non-monetary item* are recognised in profit or loss or in other comprehensive income in accordance with IAS 39 (IAS 39.AG83). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is recognised in other comprehensive income. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.95).

When some portion of the change in carrying amount is recognised in other comprehensive income and some portion is recognised in profit or loss, for example, if the amortised cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in profit or loss) but its fair value has decreased in the functional currency (resulting in a loss recognised in other comprehensive income), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in profit or loss or in other comprehensive income.

E.4 Impairment and uncollectibility of financial assets

E.4.1 Objective evidence of impairment

Does IAS 39 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. IAS 39.59 states ‘It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.’ Also, IAS 39.60 states that ‘a downgrade of an entity’s credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information’. Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors’ or issuers’ liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: future losses

Does IAS 39 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends CU1,000 to Customer B, can it recognise an immediate impairment loss of CU10 if Entity A, based on historical experience, expects that 1 per cent of the principal amount of loans given will not be collected?

No. IAS 39.43 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, IAS 39.58 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with IAS 39.43 and IAS 39.58 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of impairment: principal and interest

Because of Customer B’s financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognise an impairment loss if the restructured terms are as reflected in any of the following cases?

- (a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.
- (b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.
- (c) Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.
- (d) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.
- (e) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.

IAS 39.58 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortised cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan’s original effective interest rate. In cases (a)–(d) above, the present value of the future principal and interest payments discounted at the loan’s original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognised in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan’s original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B’s financial difficulties.

E.4.4 Assessment of impairment: fair value hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortised cost of the loan are adjusted to take into account recognised fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: provision matrix

A financial institution calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90–180 days, 50 per cent if 181–365 days and 100 per cent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under IAS 39.63?

Not necessarily. IAS 39.63 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: excess losses

Does IAS 39 permit an entity to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. IAS 39 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (IAS 39.64) on the basis of objective evidence about the existence of impairment in those assets (IAS 39.58). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under IAS 39. However, if an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (IAS 39.64).

E.4.7 Recognition of impairment on a portfolio basis

IAS 39.63 requires that impairment be recognised for financial assets carried at amortised cost. IAS 39.64 states that impairment may be measured and recognised individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortised cost, does IAS 39 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortised cost is impaired, IAS 39.63 requires that the impairment of that asset should be recognised. It states: 'the amount of the loss is measured as the difference between *the asset's* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate' (emphasis added). Measurement of impairment on a portfolio basis under IAS 39.64 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: recognition of collateral

If an impaired financial asset is secured by collateral that does not meet the recognition criteria for assets in other Standards, is the collateral recognised as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral is not recognised as an asset separate from the impaired financial asset unless it meets the recognition criteria for an asset in another Standard.

E.4.9 Impairment of non-monetary available-for-sale financial asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognised in other comprehensive income becomes impaired, should the cumulative net loss recognised in other comprehensive income, including any portion attributable to foreign currency changes, be reclassified from equity to profit or loss as a reclassification adjustment?

Yes. IAS 39.67 states that when a decline in the fair value of an available-for-sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognised in other comprehensive income should be reclassified from equity to profit or loss even though the asset has not been derecognised. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognised in other comprehensive income is also reclassified from equity to profit or loss. Any subsequent losses, including any portion attributable to foreign currency changes, are also reclassified from equity to profit or loss until the asset is derecognised.

E.4.10 Impairment: whether the available-for-sale reserve in equity can be negative

IAS 39 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognised in other comprehensive income. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised in other comprehensive income be reclassified from equity to profit or loss as a reclassification adjustment?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with IAS 39.59–61. IAS 39.60 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F Hedging

F.1 Hedging instruments

F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency

Entity J, whose functional currency is the Japanese yen, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. IAS 39.72 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on profit or loss is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognised in profit or loss to correspond with the recognition of the change in spot rate on the hedged item in profit or loss as required by IAS 21.

F.1.2 Hedging with a non-derivative financial asset or liability

Entity J's functional currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 5. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. IAS 39.72 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. IAS 39 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (IAS 39.87). Any gain or loss on the non-derivative hedging instrument that is recognised in other comprehensive income during the period preceding the future sale is reclassified from equity to profit or loss as a reclassification adjustment when the sale takes place (IAS 39.95).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under IAS 39.11 and IAS 39.AG33(d), it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge accounting: use of written options in combined hedging instruments

Issue (a) – Does IAS 39.AG94 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IAS 39.AG94 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

- (a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- (b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. Does IAS 39.73 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. IAS 39 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for intragroup hedging transactions, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in paragraph B86 of IFRS 10 *Consolidated Financial Statements* require a parent to 'eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows'.

On the other hand, an intragroup hedging transaction may be designated as a hedge in the individual or separate financial statements of a group entity, if the intragroup transaction is an external transaction from the perspective of the group entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarises the application of IAS 39 to internal hedging transactions.

- IAS 39 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the banking division of Entity A enters into an internal interest rate swap with the trading division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, IAS 39 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions. IAS 39.73 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on intragroup or intra-entity transactions should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within a group do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under IAS 39. For the purposes of IAS 39, the hedged item is the loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under IAS 39, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the banking division are identified and the other conditions for hedge accounting are met. It should be noted, however, that IAS 39.79 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting internal derivative contracts used to manage interest rate risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage interest rate risk on a centralised basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the subsidiary level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in profit or loss (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in other comprehensive income (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for recognising the gain or loss on the internal derivative in other comprehensive income for one entity and recognising it in profit or loss by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the subsidiary or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other on consolidation. Accordingly,

since IAS 39.72 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on profit or loss and other comprehensive income of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the subsidiary or division level and, in the case of cash flow hedges, where the hedged items affect profit or loss in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognised in profit or loss, and their use as cash flow hedges by two separate entities or divisions within the consolidated group will also result in the fair value amounts being offset against each other in other comprehensive income. However, there may be an effect on individual line items in both the consolidated statement of comprehensive income and the consolidated statement of financial position, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognised in a different line item in the statement of financial position or statement of comprehensive income. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, gains and losses recognised would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognised in profit or loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognised in other comprehensive income.

Question F.1.4 describes the application of IAS 39 to internal hedging transactions.

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage foreign currency risk on a centralised basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. IFRS 10 requires all internal transactions to be eliminated in consolidated financial statements. As stated in IAS 39.73, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on profit or loss or other comprehensive income if (a) the internal derivatives are used in the same type of hedge relationship (ie fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognised in other comprehensive income are reclassified from equity to profit or loss in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognised in profit or loss or in other comprehensive income will offset on consolidation resulting in the same profit or loss and other comprehensive income as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of comprehensive income and the consolidated statement of financial position, that would need to be eliminated. In addition, there is an effect on profit or loss and other comprehensive income if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on profit or loss and other comprehensive income for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognised in other comprehensive income and reclassified to profit or loss in different periods (because the hedged items affect profit or loss in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IAS 39.72 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognised firm commitments. This is because an unrecognised firm commitment or forecast transaction does not qualify as a hedging instrument under IAS 39. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis

adjustment) or recognised in other comprehensive income would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal derivatives: examples of applying Question F.1.6

In each case, FC = foreign currency, LC = local currency (which is the entity's functional currency), and TC = treasury centre.

Case 1: Offset of fair value hedges

Subsidiary A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Subsidiary B has payables of FC50, also due in 60 days, which it hedges using a forward contract with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign exchange loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign exchange gain of LC5 on its payables offset by a loss of LC5 on its forward contract with TC. TC makes a loss of LC10 on its internal forward contract with A, a gain of LC5 on its internal forward contract with B, and a gain of LC5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr Foreign exchange loss	LC10	
Cr Receivables		LC10
Dr <i>Internal contract TC</i>	<i>LC10</i>	
Cr <i>Internal gain TC</i>		<i>LC10</i>

B's entries

Dr Payables	LC5	
Cr Foreign exchange gain		LC5
Dr <i>Internal loss TC</i>	<i>LC5</i>	
Cr <i>Internal contract TC</i>		<i>LC5</i>

TC's entries

Dr <i>Internal loss A</i>	<i>LC10</i>	
Cr <i>Internal contract A</i>		<i>LC10</i>
Dr <i>Internal contract B</i>	<i>LC5</i>	
Cr <i>Internal gain B</i>		<i>LC5</i>
Dr External forward contract	LC5	
Cr Foreign exchange gain		LC5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in IAS 39 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognised immediately in profit or loss of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under IAS 21 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IAS 39.

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
External forward contract	LC5	–
Gains and losses	–	–
Internal contracts	–	–

Case 2: Offset of cash flow hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (advertising cost), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a 'loss' of LC20 on its anticipated revenues because the LC value of these revenues decreases. This is offset by a 'gain' of LC20 on its forward contract with TC.

B incurs a 'gain' of LC50 on its anticipated advertising cost because the LC value of the expense decreases. This is offset by a 'loss' of LC50 on its transaction with TC.

TC incurs a 'gain' of LC50 on its internal transaction with B, a 'loss' of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A recognises the gain of LC20 on its internal derivative transaction in other comprehensive income and B recognises the loss of LC50 in other comprehensive income. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in *italics*.

A's entries

<i>Dr Internal contract TC</i>	<i>LC20</i>	
<i>Cr Other comprehensive income</i>		<i>LC20</i>

B's entries

<i>Dr Other comprehensive income</i>	<i>LC50</i>	
<i>Cr Internal contract TC</i>		<i>LC50</i>

TC's entries

<i>Dr Internal loss A</i>	<i>LC20</i>	
<i>Cr Internal contract A</i>		<i>LC20</i>
<i>Dr Internal contract B</i>	<i>LC50</i>	
<i>Cr Internal gain B</i>		<i>LC50</i>
<i>Dr Foreign exchange loss</i>	<i>LC30</i>	
<i>Cr External forward contract</i>		<i>LC30</i>

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. IAS 39 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of IAS 39 to be met.

	<i>Debit</i>	<i>Credit</i>
External forward contract	–	LC30
Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 3: Offset of fair value and cash flow hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on profit or loss in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognises a gain of LC20 on its internal derivative transaction in other comprehensive income and B recognises a loss of LC50 on its internal derivative transaction in other comprehensive income.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr Foreign exchange loss	LC10	
Cr Receivables		LC10
Dr <i>Internal contract TC</i>	LC10	
Cr <i>Internal gain TC</i>		LC10
Dr <i>Internal contract TC</i>	LC20	
Cr <i>Other comprehensive income</i>		LC20

B's entries

Dr Payables	LC5	
Cr Foreign exchange gain		LC5
Dr <i>Internal loss TC</i>	LC5	
Cr <i>Internal contract TC</i>		LC5
Dr <i>Other comprehensive income</i>	LC50	
Cr <i>Internal contract TC</i>		LC50

TC's entries

Dr <i>Internal loss A</i>	LC10	
Cr <i>Internal contract A</i>		LC10
Dr <i>Internal loss A</i>	LC20	
Cr <i>Internal contract A</i>		LC20
Dr <i>Internal contract B</i>	LC5	
Cr <i>Internal gain B</i>		LC5
Dr <i>Internal contract B</i>	LC50	
Cr <i>Internal gain B</i>		LC50
Dr Foreign exchange loss	LC25	
Cr External forward contract		LC25

<i>TOTAL (for the internal derivatives)</i>	<i>A</i>	<i>B</i>	<i>Total</i>
	<i>LC</i>	<i>LC</i>	<i>TC</i>
Profit or loss (fair value hedges)	10	(5)	5
Other comprehensive income (cash flow)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (ie those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Other comprehensive income LC5;
- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10, Cr Receivable LC10; and
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25.

In the consolidated financial statements at the end of month 1, IAS 39 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IAS 39.

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 4: Offset of fair value and cash flow hedges with adjustment to carrying amount of inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognised in other comprehensive income in month 1, is adjusted against the carrying amount of inventory in B. The gain of LC20 on A's internal derivative is recognised in other comprehensive income as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated

cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under IAS 39 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries (all at the end of month 1)

Dr Foreign exchange loss	LC10	
Cr Receivables		LC10
Dr <i>Internal contract TC</i>	<i>LC10</i>	
Cr <i>Internal gain TC</i>		<i>LC10</i>
Dr <i>Internal contract TC</i>	<i>LC20</i>	
Cr <i>Other comprehensive income</i>		<i>LC20</i>

B's entries

At the end of month 1:

Dr Payables	LC5	
Cr Foreign exchange gain		LC5
Dr <i>Internal loss TC</i>	<i>LC5</i>	
Cr <i>Internal contract TC</i>		<i>LC5</i>
Dr <i>Other comprehensive income</i>	<i>LC50</i>	
Cr <i>Internal contract TC</i>		<i>LC50</i>

At the end of month 2:

Dr Inventory	LC50	
Cr Other comprehensive income		LC50

TC's entries (all at the end of month 1)

Dr <i>Internal loss A</i>	<i>LC10</i>	
Cr <i>Internal contract A</i>		<i>LC10</i>
Dr <i>Internal loss A</i>	<i>LC20</i>	
Cr <i>Internal contract A</i>		<i>LC20</i>
Dr <i>Internal contract B</i>	<i>LC5</i>	
Cr <i>Internal gain B</i>		<i>LC5</i>
Dr <i>Internal contract B</i>	<i>LC50</i>	
Cr <i>Internal gain B</i>		<i>LC50</i>
Dr Foreign exchange loss	LC25	
Cr Forward		LC25

TOTAL (for the internal derivatives)	A	B	Total
	LC	LC	TC
Profit or loss (fair value hedges)	10	(5)	5
Other comprehensive income (cash flow hedges)	20	–	20
Basis adjustment (inventory)	–	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (ie those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	–	LC20
Basis adjustment (inventory)	LC50	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables LC5; Cr Other comprehensive income LC5.
- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Other comprehensive income LC10.
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Other comprehensive income LC25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	–	LC5
Basis adjustment (inventory)	LC35	–
Gains and losses	–	–
Internal contracts	–	–

These total net balances are different from those that would be recognised if the internal derivatives were not eliminated, and it is these net balances that IAS 39 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

- to reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and
- to reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr Other comprehensive income	LC15	
Cr Inventory		LC15

F.1.8 Combination of written and purchased options

In most cases, IAS 39.AG94 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with

one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. IAS 39.74 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-neutral hedging strategy

Does IAS 39 permit an entity to apply hedge accounting for a ‘delta-neutral’ hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. IAS 39.74 states that ‘a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting’. For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in IAS 39.88 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging instrument: out of the money put option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of CU90. At the inception of the hedging relationship, the share has a quoted price of CU100. Since the put option gives Entity A the right to dispose of the share at a price of CU90, the put should normally be fully effective in offsetting price declines below CU90 on an intrinsic value basis. Price changes above CU90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above CU90 regarded as hedge ineffectiveness under IAS 39.88 and recognised in profit or loss under IAS 39.89?

No. IAS 39.74 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of CU90. For prices above CU90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above CU90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognising gains and losses on the hedged item.

Therefore, Entity A recognises changes in the fair value of the share in other comprehensive income if it is associated with variation in its price above CU90 (IAS 39.55 and IAS 39.90). Changes in the fair value of the share associated with price declines below CU90 form part of the designated fair value hedge and are recognised in profit or loss under IAS 39.89(b). Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognised in profit or loss (IAS 39.89(a)). Changes in the time value of the put are excluded from the designated hedging relationship and recognised in profit or loss under IAS 39.55(a).

F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under IAS 39.75, and exclude the other cash flows from the designated hedging relationship?

No. IAS 39.75 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of more than one type of risk

Issue (a) – Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. IAS 39.76 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in IAS 39.76 are met.

Issue (b) – If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

IFRS 7.22 requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The instrument in question would be reported in the IFRS 7.22 disclosures separately for each type of hedge.

F.1.13 Hedging instrument: dual foreign currency forward exchange contract

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and liability when converted into the Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. IAS 39.76 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows.

- (a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.
- (b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.
- (c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of IAS 39. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. IAS 39 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralised dealer or treasury subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the organisation to hedge the subsidiaries' interest rate risk exposures. The dealer or treasury subsidiary also enters into internal derivative transactions with those subsidiaries in order to track those hedges operationally within the organisation. Because the dealer or treasury subsidiary also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another subsidiary. In this case, there is a valid business purpose for entering into each contract.

Judgement is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 Hedged items

F.2.1 Whether a derivative can be designated as a hedged item

Does IAS 39 permit designating a derivative instrument (whether a stand-alone or separately recognised embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in profit or loss unless they are designated and effective hedging instruments (IAS 39.9). As an exception, IAS 39.AG94 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 Cash flow hedge: anticipated issue of fixed rate debt

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect profit or loss (IAS 39.86) provided that the conditions in IAS 39.88 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 2000 Entity R decided it would issue CU200 million seven-year bonds in January 2001. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) CU186 million worth of futures on seven-year treasury bonds. From August 2000 to January 2001 interest rates increased. The short futures positions were closed in January 2001, the date the bonds were issued, and resulted in a CU1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect profit or loss over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge accounting: core deposit intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles?

It depends on whether the core deposit intangible is generated internally or acquired (eg as part of a business combination).

Internally generated core deposit intangibles are not recognised as intangible assets under IAS 38. Because they are not recognised, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognised separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in paragraph 21 of IAS 38 *Intangible Assets*. A recognised core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 88, including the requirement in paragraph 88(d) that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that the requirement in paragraph 88(d) will be met.

F.2.4 Hedge accounting: hedging of future foreign currency revenue streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under IAS 39.86(b) a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are 'highly probable', as required by IAS 39.88, it may designate a currency borrowing as a cash

flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised in other comprehensive income until the revenues occur.

It is unlikely that an entity can reliably predict 100 per cent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the 'highly probable' criterion.

F.2.5 Cash flow hedges: 'all in one' hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under IAS 39.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IAS 39 (for example, because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge relationships: entity-wide risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. IAS 39 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash flow hedge: forecast transaction related to an entity's equity

Can a forecast transaction in the entity's own equity instruments or forecast dividend payments to shareholders be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect profit or loss (IAS 39.86). The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognised in profit or loss (IAS 32). For example, distributions to holders of an equity instrument are debited by the issuer directly to equity (IAS 32.35). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge accounting: risk of a transaction not occurring

Does IAS 39 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (IAS 39.86).

F.2.9 Held-to-maturity investments: hedging variable interest rate payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held to maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. IAS 39.79 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk 'because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates'.

F.2.10 Hedged items: purchase of held-to-maturity investment

An entity forecasts the purchase of a financial asset that it intends to classify as held to maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, IAS 39 prohibits hedge accounting for financial assets that are classified as held-to-maturity (IAS 39.79). However, even though the entity intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments

An entity owns a variable rate asset that it has classified as held to maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held to maturity?

Yes. IAS 39.79 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.9 specifies that this applies not only to fair value hedges, ie hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, ie hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge accounting: prepayable financial asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are 'highly probable' (IAS 39.88). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair value hedge: risk that could affect profit or loss

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under IAS 39, loans and receivables are carried at amortised cost. Banking institutions in many countries hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect profit or loss. IAS 39.86 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect profit or loss. Therefore, IAS 39.86 may appear to preclude fair value hedge accounting for loans and receivables. However, it

follows from IAS 39.79 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect profit or loss. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and intra-entity hedging transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss parent entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian subsidiary that has the foreign currency exposure be a party to the hedging transaction?

The hedge can qualify for hedge accounting provided the other hedge accounting criteria in IAS 39 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's profit or loss and, therefore, would also affect consolidated profit or loss. IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal contracts: single offsetting external derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. IAS 39.84 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in IAS 39.84 and IAS 39.AG101 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal contracts: external derivative contracts that are settled net

Issue (a) – An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 per cent-fixed, pay-LIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 per cent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 per cent-fixed, receive-LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in IAS 39 are met. See also Question F.1.14.

Issue (b) – Treasury observes that by entering into the external offsetting contracts and including them in the centralised portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters

into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. Moreover, the answer to Question F.1.14 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive business purpose for structuring the transactions separately.

F.2.17 Partial term hedging

IAS 39.75 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available for sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging instrument: cross-currency interest rate swap

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. IAS 39.81 permits hedge accounting for components of risk, if effectiveness can be measured. Also, IAS 39.76 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognised in profit or loss. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under IAS 21 and the changes to their carrying amounts recognised in profit or loss.

F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to FC750 in foreign currency?

Yes. IAS 39 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (IAS 39.81). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below FC750.

F.2.20 Hedge accounting: stock index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IAS 39 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, IAS 39.83 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge accounting: netting of assets and liabilities

May an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but IAS 39.84 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IAS 39.AG101 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 Hedge accounting

F.3.1 Cash flow hedge: fixed interest rate cash flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. IAS 39.86(b) states that a cash flow hedge is 'a hedge of the exposure to variability in cash flows'. In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash flow hedge: reinvestment of fixed interest rate cash flows

An entity manages interest rate risk on a net basis. On 1 January 2001, it forecasts aggregate cash inflows of CU100 on fixed rate assets and aggregate cash outflows of CU90 on fixed rate liabilities in the first quarter of 2002. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of CU10. The entity designates as the hedged item the first CU10 of cash inflows on fixed rate assets in the first quarter of 2002. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 2002 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for example, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign currency hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

- (a) a fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognised in profit or loss; or
- (b) a cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in other comprehensive income?

IAS 39 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognised immediately in profit or loss. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognised in other comprehensive income, that amount is recognised in profit or loss in the same period or periods during which the hedged item (the liability) affects profit or loss, ie when the liability is remeasured for changes in foreign exchange rates.

Therefore, if the hedge is effective, the gain or loss on the derivative is released to profit or loss in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign currency cash flow hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under IAS 21, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to profit or loss (IAS 21.23 and IAS 21.28).

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in profit or loss and the gain or loss on remeasuring the receivable is also recognised in profit or loss.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognised in other comprehensive income, and the ineffective portion in profit or loss (IAS 39.95). The amount recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which changes in the measurement of the receivable affect profit or loss (IAS 39.100).

F.3.5 Fair value hedge: variable rate debt instrument

Does IAS 39 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair value hedge: inventory

IAS 39.86(a) states that a fair value hedge is 'a hedge of the exposure to changes in fair value of a recognised asset or liability ... that is attributable to a particular risk and could affect profit or loss'. Can an entity designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost and net realisable value under IAS 2 *Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net

realisable value test under IAS 2. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge accounting: forecast transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be ‘highly probable’. How should the term ‘highly probable’ be interpreted?

The term ‘highly probable’ indicates a much greater likelihood of happening than the term ‘more likely than not’. An assessment of the likelihood that a forecast transaction will take place is not based solely on management’s intentions because intentions are not verifiable. A transaction’s probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

- (a) the frequency of similar past transactions;
- (b) the financial and operational ability of the entity to carry out the transaction;
- (c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
- (d) the extent of loss or disruption of operations that could result if the transaction does not occur;
- (e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of ordinary shares); and
- (f) the entity’s business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity’s transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity’s ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective designation of hedges

Does IAS 39 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IAS 39.88 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge accounting: designation at the inception of the hedge

Does IAS 39 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, IAS 39 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (IAS 39.88); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (IAS 39.75). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge accounting: identification of hedged forecast transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash flow hedge: documentation of timing of forecast transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date when, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (IAS 39.AG110) and it must be possible to measure its effectiveness reliably (IAS 39.88(d)). Also, the hedged forecast transaction must be highly probable (IAS 39.88(c)). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with IAS 39.88(d), it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with IAS 39.101(c).

F.4 Hedge effectiveness

F.4.1 Hedging on an after-tax basis

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

IAS 39 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge effectiveness: assessment on cumulative basis

IAS 39.88(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognised in profit or loss as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25–50 basis points, while LIBOR changes daily. Over a period of 1–2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge effectiveness: counterparty credit risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument.

When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to

conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge effectiveness: effectiveness tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

IAS 39 does not provide specific guidance about how effectiveness tests are performed. IAS 39.AG105 specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80–125 per cent. IAS 39.AG105 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, ie a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge effectiveness: less than 100 per cent offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80–125 per cent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognised in other comprehensive income?

No. IAS 39.95(a) indicates that only the effective portion is recognised in other comprehensive income. IAS 39.95(b) requires the ineffective portion to be recognised in profit or loss.

F.4.7 Assuming perfect hedge effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. IAS 39.88(e) requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (IAS 39.AG109). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 Cash flow hedges

F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognised in profit or loss (IAS 21.28) and the exchange differences on the hedging instrument be recognised in other comprehensive income until the repayment of the liability (IAS 39.95)?

No. Exchange differences on the monetary asset and the monetary liability are both recognised in profit or loss in the period in which they arise (IAS 21.28). IAS 39.AG83 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognised in profit or loss.

F.5.2 Cash flow hedges: performance of hedging instrument (1)

Entity A has a floating rate liability of CU1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of CU49 in the fair value of the swap. This increase consists of a change of CU50 resulting from an increase in market interest rates and a change of minus CU1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by CU50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in profit or loss?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (IAS 39.AG109). However, because Entity A determines that the hedge relationship is still highly effective, it recognises the effective portion of the change in fair value of the swap, ie the net change in fair value of CU49, in other comprehensive income. There is no debit to profit or loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, ie CU50, exceeds the cumulative change in value of the hedging instrument, ie CU49.

Dr Swap	CU49	
Cr Other comprehensive income		CU49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with IAS 39.101.

Would the answer change if the fair value of the swap instead increases to CU51 of which CU50 results from the increase in market interest rates and CU1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to profit or loss of CU1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, ie CU51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, ie CU50. The difference of CU1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognised in profit or loss.

Dr Swap	CU51	
Cr Other comprehensive income		CU50
Cr Profit or loss		CU1

F.5.3 Cash flow hedges: performance of hedging instrument (2)

On 30 September 20X1, Entity A hedges the anticipated sale of 24 tonnes of pulp on 1 March 20X2 by entering into a short forward contract on 24 tonnes of pulp. The contract requires net settlement in cash determined as the difference between the future spot price of pulp on a specified commodity exchange and CU1,000. Entity A expects to sell the pulp in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On 31 December, the spot price of pulp has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is CU1,100. The fair value of Entity A's forward contract is negative CU80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in profit or loss?

No. In a cash flow hedge, ineffectiveness is not recognised in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is CU80, while the fair value of the cumulative change in expected future cash flows on the hedged item is CU100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognised in profit or loss (IAS 39.95(b)). Because Entity A determines that the hedge relationship is still highly effective, it recognises the entire change in fair value of the forward contract (CU80) in other comprehensive income.

Dr Other comprehensive income
Cr Forward

CU80

CU80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with IAS 39.101.

F.5.4 Cash flow hedges: forecast transaction occurs before the specified period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see IAS 39.75 and Question F.2.17).

F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a CU100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ('spot rates' or 'zero coupon rates') by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot-forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where F = forward rate (%)

SR = spot rate (%)

t = period in time (eg 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)					
<i>Forward periods</i>	1	2	3	4	5
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to $[1.0450^2 / 1.0375] - 1 = 5.25$ per cent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged item

In this example, the entity expects to issue a CU100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 per cent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 per cent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of fixed rate debt					
Beginning of period 2 – No rate changes (spot based on forward rates)					
<i>Total</i>					
<i>Original forward periods</i>	1	2	3	4	5
<i>Remaining periods</i>		1	2	3	4
Spot rates		5.25%	6.38%	6.75%	6.88%
Forward rates		5.25%	7.51%	7.50%	7.25%
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
<i>Fair value:</i>					
Interest	6,592	1,694	1,663	1,632	1,603
Principal	93,408				93,408 ^a
Total	100,000				

(a) $CU100,000 / (1 + [0.0688 / 4])^4$

Once it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 per cent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 per cent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 per cent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

Interest rate swap					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Forecast variable interest		1,313	1,877	1,876	1,813
<i>Forecast based on forward rate</i>		<i>5.25%</i>	<i>7.51%</i>	<i>7.50%</i>	<i>7.25%</i>
Net interest		(403)	161	160	97
<i>Fair value:</i>					
<i>Discount rate (spot)</i>		<i>5.25%</i>	<i>6.38%</i>	<i>6.75%</i>	<i>6.88%</i>
Fixed interest	6,592	1,694	1,663	1,632	1,603
Forecast variable interest	6,592	1,296	1,819	1,784	1,693
Fair value of interest rate swap	0	(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring hedge effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield curve – Rates increase 200 basis points					
<i>Forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Spot rates		5.75%	6.50%	7.50%	8.00%
Forward rates		5.75%	7.25%	9.51%	9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 per cent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair value of interest rate swap					
Total					
Original forward periods	1	2	3	4	5
Remaining periods		1	2	3	4
	CU	CU	CU	CU	CU
Cash flows:					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Forecast variable interest		1,438	1,813	2,377	2,376
Forecast based on new forward rate		5.75%	7.25%	9.51%	9.50%
Net interest		(279)	97	661	660
Fair value:					
New discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fixed interest	6,562	1,692	1,662	1,623	1,585
Forecast variable interest	7,615	1,417	1,755	2,248	2,195
Fair value of net interest	1,053	(275)	93	625	610

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A Compute change in fair value of debt					
Total					
Original forward periods	1	2	3	4	5
Remaining periods		1	2	3	4
	CU	CU	CU	CU	CU
Cash flows:					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
Fair value:					
New discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Interest	6,562	1,692	1,662	1,623	1,585
Principal	92,385				92,385 ^(a)
Total	98,947				
Fair value at inception	100,000				
Fair value difference	(1,053)				

(a) $CU100,000 / (1 + [0.08 / 4])^4$

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 per cent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B Compute change in fair value of cash flows					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Market rate at inception		6.86%	6.86%	6.86%	6.86%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal × rate)		CU279	(CU97)	(CU661)	(CU660)
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,053)	CU275	(CU93)	(CU625)	(CU610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the ‘theoretical swap’ method (or ‘hypothetical derivative’ method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, ie at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Forward rate at inception		5.25%	7.51%	7.50%	7.25%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal × rate)		(CU125)	CU64	(CU501)	(CU563)
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,055)	(CU123)	CU62	(CU474)	(CU520)
Fair value of interest rate swap	CU1,053				
Ineffectiveness	(CU2)				

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IAS 39 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IAS 39.74). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

Entity A has the Local Currency (LC) as its functional currency and presentation currency. On 30 June 20X1, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on 30 June 20X2 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase a certain quantity of paper on 31 March 20X2 and the resulting payable of FC100,000, which is to be paid on 30 June 20X2. All hedge accounting conditions in IAS 39 are met.

As indicated in the table below, on 30 June 20X1, the spot exchange rate is LC1.072 to FC1, while the twelve-month forward exchange rate is LC1.096 to FC1. On 31 December 20X1, the spot exchange rate is LC1.080 to FC1, while the six-month forward exchange rate is LC1.092 to FC1. On 31 March 20X2, the spot exchange rate is LC1.074 to FC1, while the three-month forward rate is LC1.076 to FC1. On 30 June 20X2, the spot exchange rate is LC1.072 to FC1. The applicable yield curve in the local currency is flat at 6 per cent per year throughout the period. The fair value of the forward exchange contract is negative LC388 on 31 December 20X1 $\{([1.092 \times 100,000] - 109,600)/1.06^{(6/12)}\}$, negative LC1.971 on 31 March 20X2 $\{([1.076 \times 100,000] - 109,600)/1.06^{(3/12)}\}$, and negative LC2,400 on 30 June 20X2 $\{1.072 \times 100,000 - 109,600\}$.

Date	Spot rate	Forward rate to 30 June 20X2	Fair value of forward contract
30 June 20X1	1.072	1.096	–
31 December 20X1	1.080	1.092	(388)
31 March 20X2	1.074	1.076	(1,971)
30 June 20X2	1.072	–	(2,400)

Issue (a) – What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

30 June 20X1

Dr Forward	LC0	
Cr Cash		LC0

To record the forward exchange contract at its initial amount of zero (IAS 39.43). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (IAS 39.AG108).

31 December 20X1

Dr Other comprehensive income	LC388	
Cr Forward liability		LC388

To record the change in the fair value of the forward exchange contract between 30 June 20X1 and 31 December 20X1, ie $LC388 - 0 = LC388$, in other comprehensive income (IAS 39.95). The hedge is fully effective because the loss on the forward exchange contract (LC388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price $[(LC388) = \{([1.092 \times 100,000] - 109,600)/1.06^{(6/12)}\} - \{([1.096 \times 100,000] - 109,600)/1.06\}]$.

31 March 20X2

Dr Other comprehensive income	LC1,583	
Cr Forward liability		LC1,583

To record the change in the fair value of the forward exchange contract between 1 January 20X2 and 31 March 20X2 (ie $LC1,971 - LC388 = LC1,583$), in other comprehensive income (IAS 39.95). The hedge is fully effective because the loss on the forward exchange contract based on the forward price $[(LC1,583) = \{([1.076 \times 100,000] - 109,600)/1.06^{(3/12)}\} - \{([1.092 \times 100,000] - 109,600)/1.06^{(6/12)}\}]$.

Dr Paper (purchase price)	LC107,400	
Dr Paper (hedging loss)	LC1,971	
Cr Other comprehensive income		LC1,971
Cr Payable		LC107,400

To recognise the purchase of the paper at the spot rate ($1.074 \times FC100,000$) and remove the cumulative loss on the forward exchange contract that has been recognised in other comprehensive income (initial measurement of the purchased paper is LC109,371 consisting of a purchase consideration of LC107,400 and a hedging loss of LC1,971).

30 June 20X2

Dr Payable	LC107,400	
Cr Cash		LC107,200
Cr Profit or loss		LC200

To record the settlement of the n of LC200 ($LC107,400 - LC107,200$).

Dr Profit or loss	LC429	
Cr Forward liability		LC429

To record the loss on the forward exchange contract between 1 April 20X2 and 30 June 20X2 (ie LC2,400 – LC1,971 = LC429) in profit or loss. The hedge is regarded as fully effective because the loss on the forward exchange contract (LC429) exactly offsets the change in the fair value of the payable based on the forward price ($LC429 = ([1.072 \times 100,000] - 109,600 - \{([1.076 \times 100,000] - 109,600)/1.06^{(3/12)}\})$).

Dr Forward liability	LC2,400	
Cr Cash		LC2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (IAS 39.74)?

The accounting entries are as follows.

30 June 20X1

Dr Forward	LC0	
Cr Cash		LC0

To record the forward exchange contract at its initial amount of zero (IAS 39.43). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (IAS 39.AG108).

31 December 20X1

Dr Profit or loss (interest element)	LC1,165	
Cr Other comprehensive income (spot element)		LC777
Cr Forward liability		LC388

To record the change in the fair value of the forward exchange contract between 30 June 20X1 and 31 December 20X1, ie LC388 – 0 = LC388. The change in the present value of spot settlement of the forward exchange contract is a gain of LC777 ($\{([1.080 \times 100,000] - 107,200)/1.06^{(6/12)}\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$), which is recognised in other comprehensive income (IAS 39.95(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,165 (388 + 777), which is recognised in profit or loss (IAS 39.74 and IAS 39.55(a)). The hedge is fully effective because the gain in the spot element of the forward contract (LC777) exactly offsets the change in the purchase price at spot rates ($LC777 = \{([1.080 \times 100,000] - 107,200)/1.06^{(6/12)}\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$).

31 March 20X2

Dr Other comprehensive income (spot element)	LC580	
Dr Profit or loss (interest element)	LC1,003	
Cr Forward liability		LC1,583

To record the change in the fair value of the forward exchange contract between 1 January 20X2 and 31 March 20X2, ie LC1,971 – LC388 = LC1,583. The change in the present value of the spot settlement of the forward exchange contract is a loss of LC580 ($\{([1.074 \times 100,000] - 107,200)/1.06^{(3/12)}\} - \{([1.080 \times 100,000] - 107,200)/1.06^{(6/12)}\}$), which is recognised in other comprehensive income (IAS 39.95(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,003 (LC1,583 – LC580), which is recognised in profit or loss (IAS 39.74 and IAS 39.55(a)). The hedge is fully effective because the loss in the spot element of the forward contract (LC580) exactly offsets the change in the purchase price at spot rates ($(580) = \{([1.074 \times 100,000] - 107,200)/1.06^{(3/12)}\} - \{([1.080 \times 100,000] - 107,200)/1.06^{(6/12)}\}$).

Dr Paper (purchase price)	LC107,400	
Dr Other comprehensive income	LC197	
Cr Paper (hedging gain)		LC197
Cr Payable		LC107,400

To recognise the purchase of the paper at the spot rate ($= 1.074 \times \text{FC}100,000$) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognised in other comprehensive income ($\text{LC}777 - \text{LC}580 = \text{LC}197$) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is LC107,203, consisting of a purchase consideration of LC107,400 and a hedging gain of LC197.

30 June 20X2

Dr Payable	LC107,400	
Cr Cash		LC107,200
Cr Profit or loss		LC200

To record the settlement of the payable at the spot rate ($\text{FC}100,000 \times 1.072 = \text{LC}107,200$) and the associated exchange gain of LC200 ($- [1.072 - 1.074] \times \text{FC}100,000$).

Dr Profit or loss (spot element)	LC197	
Dr Profit or loss (interest element)	LC232	
Cr Forward liability		LC429

To record the change in the fair value of the forward exchange contract between 1 April 20X2 and 30 June 20X2 (ie $\text{LC}2,400 - \text{LC}1,971 = \text{LC}429$). The change in the present value of the spot settlement of the forward exchange contract is a loss of LC197 ($[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06^{(3/12)}\}$), which is recognised in profit or loss. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC232 ($\text{LC}429 - \text{LC}197$), which is recognised in profit or loss. The hedge is fully effective because the loss in the spot element of the forward contract (LC197) exactly offsets the change in the present value of the spot settlement of the payable ($[\text{LC}197] = \{[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06^{(3/12)}\}\}$).

Dr Forward liability	LC2,400	
Cr Cash		LC2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	Change in spot settlement	Fair value of change in spot settlement	Change in forward settlement	Fair value of change in forward settlement	Fair value of change in interest element
	LC	LC	LC	LC	LC
June 20X1	–	–	–	–	–
December 20X1	800	777	(400)	(388)	(1,165)
March 20X2	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20X2	(200)	(197)	(400)	(429)	(232)
Total	–	–	(2,400)	(2,400)	(2,400)

F.6 Hedges: other issues

F.6.1 Hedge accounting: management of interest rate risk in financial institutions

Banks and other financial institutions often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their

financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many financial institutions use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If a financial institution manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under IAS 39?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (IAS 39.84, IAS 39.AG101 and IAS 39.AG111). It is not possible to designate a net position as a hedged item under IAS 39 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognised in profit or loss.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in IAS 39.88 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's profit or loss (IAS 39.AG110) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a)–(l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c)–(l) expand on various aspects of the accounting for cash flow hedges. Issues (c)–(f) consider the application of the hedge accounting criteria for cash flow hedges in IAS 39, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i)–(l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under IAS 39 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under IAS 39. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a bank has the following assets and liabilities with a maturity of two years.

	Variable interest	Fixed interest
	CU	CU
Assets	60	100
Liabilities	(100)	(60)
Net	<u>(40)</u>	<u>40</u>

The bank takes out a two-year swap with a notional principal of CU40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of CU40 of the fixed rate assets or as a cash flow hedge of CU40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (IAS 39.88(b)). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (IAS 39.88(c)) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (IAS 39.88(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (IAS 39.89). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortisation of the fair value adjustment to profit or loss, and

determine the amount that should be reclassified from equity to profit or loss when assets are sold or liabilities extinguished (IAS 39.89 and IAS 39.92). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortise the changes to profit or loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognised in other comprehensive income (IAS 39.95). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the cumulative gains and losses recognised in other comprehensive income from changes in the fair value of a hedging instrument should be reclassified to profit or loss (IAS 39.100 and IAS 39.101). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in profit or loss.

The timing of the recognition in profit or loss can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. IAS 39.100 specifies that the amounts recognised in other comprehensive income should be reclassified from equity to profit or loss in the same period or periods during which the hedged item affects profit or loss.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by IAS 39.88(a)?

The following would be included in the documentation.

The hedging relationship – The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge – The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge – The hedge is documented as a cash flow hedge.

The hedged item – The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk – The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument – Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness – The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in IAS 39.88(b)?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by IAS 39.88(c)?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of CU100 and aggregate gross cash outflows of CU90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of CU10 as the hedged item in the future time period. If more than CU10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of CU10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under IAS 39.88(d) and IAS 39.88(e)?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in profit or loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognised initially in other comprehensive income are reclassified from equity to profit or loss.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in IAS 39.95–IAS 39.100, as follows:

- (i) the portion of gains and losses on hedging derivatives determined to result from effective hedges is recognised in other comprehensive income whenever effectiveness is measured; and
- (ii) the ineffective portion of gains and losses resulting from hedging derivatives is recognised in profit or loss.

IAS 39.100 specifies that the amounts recognised in other comprehensive income should be reclassified from equity to profit or loss in the same period or periods during which the hedged item affects profit or loss. Accordingly, when the forecast transactions occur, the amounts previously recognised in other comprehensive income are reclassified from equity to profit or loss. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are reclassified from equity to profit or loss in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognised in other comprehensive income if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction occurs (IAS 39.101(a) and IAS 39.101(b)). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is reclassified from equity to profit or loss (IAS 39.101(c)).

Issue (i) – IAS 39.75 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does IAS 39.75 preclude redesignating the hedging instrument?

No. IAS 39.75 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. IAS 39.75 does not refer to the derivative instrument's original period to maturity.

If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognised immediately in profit or loss (IAS 39.95(b)) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (IAS 39.101). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognised in other comprehensive income remaining in equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognised in profit or loss in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognised in other comprehensive income are reclassified from equity to profit or loss in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest expenses are recognised). However, if an entity expects at any time that all or a portion of a net loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify immediately from equity to profit or loss the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does IAS 39 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. IAS 39 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, IAS 39.81 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by IAS 39.82, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in IAS 39.78 and IAS 39.83 requiring the hedged group to have similar risk characteristics?

IAS 39.78 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. IAS 39.83 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (ie the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in

fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (IAS 39.74). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative example of applying the approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when a financial institution manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges of commercial entities), for example, hedging the rollover of commercial paper financing.

Identifying, assessing and reducing cash flow exposures

The discussion and illustrations that follow focus on the risk management activities of a financial institution that manages its interest rate risk by analysing expected cash flows in a particular currency on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity, a financial institution, had the following expected future net cash flows and hedging positions outstanding in a specific currency, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management programme. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I End of period: expected cash flows and hedging positions							
<i>Quarterly period</i>	<i>X0</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
<i>Outstanding interest rate swaps:</i>							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x,xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation '...n'. A financial institution that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest

rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II Forecast net cash flow and repricing exposures							
<i>Quarterly period</i>	<i>Notes</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>		<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
CASH INFLOW AND REPRICING EXPOSURES – from assets							
<i>Principal and interest payments:</i>							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx
Variable rate – principal payments	(1)	2,000	1,000	–	500	500	x,xxx
Variable rate – estimated interest	(2)	125	110	105	114	118	x,xxx
<i>Total expected cash inflows</i>		<i>6,100</i>	<i>5,689</i>	<i>4,687</i>	<i>3,200</i>	<i>3,409</i>	<i>x,xxx</i>
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
Cash inflows and repricings	(4)	14,100	12,689	11,687	9,700	9,409	x,xxx
CASH OUTFLOW AND REPRICING EXPOSURES – from liabilities							
<i>Principal and interest payments:</i>							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	–	–	2,000	–	1,000	x,xxx
Variable rate – estimated interest	(2)	100	110	120	98	109	x,xxx
<i>Total expected cash outflows</i>		<i>2,935</i>	<i>1,247</i>	<i>3,358</i>	<i>1,338</i>	<i>2,152</i>	<i>x,xxx</i>
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx
Cash outflows and repricings	(4)	10,935	9,247	9,358	7,338	7,152	x,xxx
NET EXPOSURES	(5)	3,165	3,442	2,329	2,362	2,257	x,xxx

- 1 The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.
- 2 Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.
- 3 The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts for each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.
- 4 The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.
- 5 The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is

exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (ie the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some banks regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II *Forecast net cash flow and repricing exposures* provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III *Analysis of expected net exposures and hedging positions*. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III Analysis of expected net exposures and hedging positions						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
Pre-existing swaps outstanding:						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
<i>Net exposure after pre-existing swaps</i>	<i>2,165</i>	<i>2,442</i>	<i>1,629</i>	<i>1,662</i>	<i>1,557</i>	<i>x,xxx</i>
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps ...X						x,xxx
<i>Unhedged cash flow and repricing exposure</i>	<i>165</i>	<i>442</i>	<i>629</i>	<i>662</i>	<i>557</i>	<i>x,xxx</i>

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many financial institutions do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not

shown. However, it has the effect of creating an over-hedged position in Periods X3–X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3–X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that CU500 of the pay-fixed, receive-variable interest rate swaps fully offset CU500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1–X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV Interest rate swaps designated as hedges						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
<i>Net outstanding swaps positions</i>	<i>3,000</i>	<i>3,000</i>	<i>1,700</i>	<i>1,700</i>	<i>1,700</i>	<i>x,xxx</i>

For the purposes of the illustrations, it is assumed that swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge accounting considerations

Illustrating the designation of the hedging relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in IAS 39 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognised for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V *The general hedging relationship* illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V The general hedging relationship						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
<i>Hedged exposure percentage</i>	<i>24.8%</i>	<i>27.6%</i>	<i>23.1%</i>	<i>27.8%</i>	<i>28.7%</i>	<i>xx.x%</i>

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI *The specific hedging relationship* below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of CU14,100 is multiplied by the forward rate for Periods X2–X5 of 5.50 per cent, 6.00 per cent, 6.50 per cent and 7.25 per cent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates.

The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI The specific hedging relationship								
Term structure of interest rates								
Quarterly period		X1	X2	X3	X4	X5	...n	
Spot rates		5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%	
Forward rates ^a		5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%	
Cash flow exposures and expected interest amounts								
Repricing period	Time to forecast transaction	Gross amounts exposed	Expected interest					
			CU	CU	CU	CU	CU	CU
2	3 months	14,100	→	194	212	229	256	256
3	6 months	12,689			190	206	230	xxx
4	9 months	11,687				190	212	xxx
5	12 months	9,700					176	xxx
6	15 months	9,409						xxx
Hedged percentage (Schedule V) in the previous period				24.8%	27.6%	23.1%	27.8%	xx.x%
Hedged expected interest				48	52	44	49	xx

(a) The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the CU14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 per cent.

The expected interest is based on the forward interest rates for Period X2 of 5.50 per cent and for Period X3 of 6.00 per cent, equal to a blended rate of 5.75 per cent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 per cent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (for example, in a table that looks like Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the designation of the hedging relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognised for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example designation

Hedging objective

The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.

Type of hedge

Cash flow hedge.

Hedging instrument

The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.

Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:

- the forecast reinvestment or repricing of the principal amounts shown in Schedule V.
- unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.

The hedged item—General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

- the principal component giving rise to the interest cash inflow and the period in which it occurs,
- the interest rate component, and
- the time component or period covered by the hedge.

The hedged item—The principal component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

- that is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and
- that corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

continued...

...continued

Example designation*The hedged item—The interest rate component*

The portion of the interest rate change that is being hedged is the change in both of the following:

- the credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR, and
- the yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The hedged item—The hedged period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

- the period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur, and
- its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognise that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation objectives*Systems considerations*

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and bookkeeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognized in other comprehensive income after the forecast transactions occur (IAS 39.97 and IAS 39.98) because the portion of the cash flow risk being hedged is that portion that will be reclassified from equity to profit or loss in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be reclassified from equity to profit or loss to adjust the interest income on the asset when the interest income is recognised. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognised in other comprehensive income could be reclassified from equity to profit or loss upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognised in other comprehensive income. Accordingly, there is no portion of the fair value of the swap that is recognised in other comprehensive income that should be reclassified from equity to profit or loss when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in IAS 39 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 *Hedge accounting considerations when interest rate risk is managed on a net basis*. Some additional and supporting provisions and interpretations are identified below.

Hedging a portion of the risk exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in IAS 39.81 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 *Partial term hedging*.

Hedging multiple risks with a single instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on IAS 39.76 as interpreted in the answer to Question F.1.12 *Hedges of more than one type of risk*.

Hedging similar risks in a portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (l), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in IAS 39.101 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge accounting: premium or discount on forward exchange contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a foreign operation. Is it permitted to amortise the discount or premium on the forward exchange contract to profit or loss over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortised to profit or loss under IAS 39. Derivatives are always measured at fair value in the statement of financial position. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognised in profit or loss unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net

investment in a foreign operation, in which case the effective portion of the gain or loss is recognised in other comprehensive income. In that case, the amounts recognised in other comprehensive income are reclassified from equity to profit or loss when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under IAS 39.74(b), the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognised in profit or loss.

F.6.5 IAS 39 and IAS 21 Fair value hedge of asset measured at cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does IAS 39 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in IAS 39.88 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

To illustrate: a shipping entity in Denmark has a US subsidiary that has the same functional currency (the Danish krone). The shipping entity measures its ships at historical cost less depreciation in the consolidated financial statements. In accordance with IAS 21.23(b), the ships are recognised in Danish krone using the historical exchange rate. To hedge, fully or partly, the potential currency risk on the ships at disposal in US dollars, the shipping entity normally finances its purchases of ships with loans denominated in US dollars.

In this case, a US dollar borrowing (or a portion of it) may be designated as a cash flow hedge of the anticipated sale of the ship financed by the borrowing provided the sale is highly probable, for example, because it is expected to occur in the immediate future, and the amount of the sales proceeds designated as being hedged is equal to the amount of the foreign currency borrowing designated as the hedging instrument. The gains and losses on the currency borrowing that are determined to constitute an effective hedge of the anticipated sale are recognised in other comprehensive income in accordance with IAS 39.95(a).

Section G Other

G.1 Disclosure of changes in fair value

IAS 39 requires financial assets classified as available for sale (AFS) and financial assets and financial liabilities at fair value through profit or loss to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in profit or loss, and fair value changes for AFS assets are recognised in other comprehensive income. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IFRS 7.20 requires items of income, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognised in profit or loss and changes that are recognised in other comprehensive income. Further breakdown is provided of changes that relate to:

- (a) AFS assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount that was reclassified from equity to profit or loss for the period as a reclassification adjustment;
- (b) financial assets or financial liabilities at fair value through profit or loss, showing separately those fair value changes on financial assets or financial liabilities (i) designated as such upon initial recognition and (ii) classified as held for trading in accordance with IAS 39; and
- (c) hedging instruments.

IFRS 7 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that in accordance with IAS 39 it categorises as held for trading, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IFRS 7.8 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition and (ii) those held for trading in accordance with IAS 39.

G.2 IAS 39 and IAS 7 Hedge accounting: statement of cash flows

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IAS 7 has not been updated to reflect IAS 39, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IAS 39.