Hong Kong Institute of Certified Public Accountants 香港會計師公會

MEMBERS' HANDBOOK

Update No. 56

(Issued November 2008)

This Update relates to an Amendment to HKAS 39 *Financial Instruments: Recognition and Measurement*— Eligible Hedged Items.

Document Reference and Title	*Instructions*	*Explanations*
VOLUME II		
Contents of Volume II	Discard the existing pages i and ii and replace with the new pages i and ii.	Revised contents pages
HONG KONG ACCOUNTING STANDARDS (HKAS)		
HKAS 39 *Financial Instruments: Recognition and Measurement* (Standard)	Replace cover page, pages 4 and 6A with revised cover page, pages 4 and 6A. Insert pages 87I – 87J after page 87H.	Amendment to HKAS 39 – Note
HKAS 39 *Financial Instruments: Recognition and Measurement* (Basis for Conclusions)	Insert pages 147G – 147I after page 147F.	Amendment to HKAS 39 – Note

Note:

BACKGROUND ABOUT AN AMENDMENT TO HKAS 39

The amendment clarifies how the existing principles underlying hedge accounting should be applied in two particular situations:

(a) a one-sided risk in a hedged item, and

(b) inflation in a financial hedged item.

Qualifying hedged items – a one-sided risk in a hedged item

An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The amendment clarifies that only the intrinsic value, not the time value, of an option reflects a one-sided risk and therefore an option designated in its entirety cannot be perfectly effective.

Designation of inflation as a hedged item

The amendment clarifies that inflation cannot be designated as a risk or a portion of a financial instrument unless inflation is a contractually specified portion of the cash flows of a recognised financial instrument, such as an inflation-linked bond.

The amendment has developed application guidance to illustrate how the principles underlying hedge accounting should be applied in those situations.

Entities are required to apply the amendment retrospectively for annual periods beginning on or after 1 July 2009, with earlier application permitted.

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CONTENTS OF VOLUME II

(Updated to November 2008)

Issue/(Review date)

PREFACE AND FRAMEWORK

HONG KONG ACCOUNTING STANDARDS (HKAS)

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

(a) The related amendments to HKAS 39 and HKFRS 7 on *Reclassification of Financial Assets* are set out in Appendix D of this HKAS 39 issued in October 2008. An entity shall apply those amendments from 1 July 2008.

(b) An entity shall apply amendments resulting from *Improvements to HKFRSs* issued in October 2008 for annual periods beginning on or after 1 January 2009.

(c) The related amendment to HKAS 39 on *Eligible Hedged Items* is set out in Appendix E of this HKAS 39 issued in November 2008. An entity shall apply this amendment retrospectively for annual periods beginning on or after 1 July 2009.

Implementation Guidance

Illustrative Example

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 1-109 and Appendices A-D. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Appendix E

Amendment to HKAS 39 *Eligible Hedged Items* (issued in November 2008) - effective for annual periods beginning on or after 1 July 2009

In November 2008, the Institute issued an Amendment to HKAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items that is effective for annual periods beginning on or after 1 July 2009.

In the Standard, paragraph 103G is added.

Effective date and transition

103G An entity shall apply paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B retrospectively for annual periods beginning on or after 1 July 2009, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies *Eligible Hedged Items* (Amendment to HKAS 39) for periods beginning before 1 July 2009, it shall disclose that fact.

In Appendix A *Application guidance*, paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B are added.

Hedged items (paragraphs 78–84)

Qualifying items (paragraphs 78–80)

AG99BA An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).

Designation of financial items as hedged items (paragraphs 81 and 81A)

AG99E Paragraph 81 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:

(a) all of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or

(b) some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (ie a ‘portion’ of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

AG99F To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:

(a) for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.

(b) inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.

(c) a contractually specified inflation portion of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

Hedge accounting (paragraphs 85–102)

Assessing hedge effectiveness

AG110A Paragraph 74(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

AG110B If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG99BA, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.

Appendix D

Amendments to Basis for Conclusions on HKAS 39 *Eligible Hedged Items* (issued in November 2008) – effective for annual periods beginning on or after 1 July 2009

In November 2008, the Institute issued an Amendment to HKAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items that is effective for annual periods beginning on or after 1 July 2009.

In the Basis for Conclusions, paragraph BC11D is added.

After paragraph BC172A, a heading and paragraphs BC172B and BC172C, a side heading and paragraphs BC172D–BC172F, and another side heading and paragraphs BC172G–BC172J are added.

Background

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.

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.

