

# **Hong Kong Accounting Standard 39**

## **Financial Instruments: Recognition and Measurement**

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### Hong Kong Accounting Standard 39

#### Financial Instruments: Recognition and Measurement

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### **Illustrative Example**

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 1-110 and Appendices A and B. 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.

# Hong Kong Accounting Standard 39

## Financial Instruments: Recognition and Measurement

### Objective

1. The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting and disclosing information about financial instruments are set out in HKAS 32 *Financial Instruments: Disclosure and Presentation*.

### Scope

2. *This Standard shall be applied by all entities to all types of financial instruments except:*
  - (a) *those interests in subsidiaries, associates and joint ventures that are accounted for under HKAS 27 Consolidated and Separate Financial Statements, HKAS 28 Investments in Associates or HKAS 31 Interests in Joint Ventures. However, entities shall apply this Standard to an interest in a subsidiary, associate or joint venture that according to HKAS 27, HKAS 28 or HKAS 31 is accounted for under this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in HKAS 32.*
  - (b) *rights and obligations under leases to which HKAS 17 Leases applies. However:*
    - (i) *lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15-37, 58, 59, 63-65 and Appendix A paragraphs AG36-AG52 and AG84-AG93);*
    - (ii) *finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63); and*
    - (iii) *derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).*
  - (c) *employers' rights and obligations under employee benefit plans, to which HKAS 19 Employee Benefits applies.*
  - (d) *rights and obligations arising under insurance contracts. However, entities shall apply this Standard to a financial instrument that takes the form of an insurance (or reinsurance) contract as described in paragraph 6 of HKAS 32, but principally involves the transfer of financial risks described in paragraph 52 of that Standard. In addition, derivatives that are embedded in insurance contracts are subject to the embedded derivatives provisions of this Standard (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).*

- (e) *financial instruments issued by the entity that meet the definition of an equity instrument in HKAS 32 (including options and warrants). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.*
  - (f) *financial guarantee contracts (including letters of credit and other credit default contracts) that provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (see paragraph 3). An issuer of such a financial guarantee contract shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under HKAS 37 Provisions, Contingent Liabilities and Contingent Assets, and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with HKAS 18 Revenue. Financial guarantees are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63).*
  - (g) *contracts for contingent consideration in a business combination (see paragraphs 65-67 of HKAS 22 Business Combinations). This exemption applies only to the acquirer.*
  - (h) *contracts that require a payment based on climatic, geological or other physical variables (see Appendix A paragraph AG1). However, other types of derivatives that are embedded in such contracts are subject to the embedded derivatives provisions of this Standard (for example, if an interest rate swap is contingent on a climatic variable such as heating degree days, the interest rate swap element is an embedded derivative that is within the scope of this Standard—see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).*
  - (i) *except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under HKAS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with HKAS 18. An issuer of loan commitments shall apply HKAS 37 to other loan commitments that are not within the scope of this Standard. Loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15-42 and Appendix A paragraphs AG36-AG63).*
3. *Financial guarantee contracts are subject to this Standard if they provide for payments to be made in response to changes 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 (sometimes called the ‘underlying’). For example, a financial guarantee contract that provides for payments to be made if the credit rating of a debtor falls below a particular level is within the scope of this Standard.*



4. *Loan commitments that the entity designates as financial liabilities at fair value through profit or loss are within the scope of this Standard. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.*
5. *This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.*
6. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
- (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
  - (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
  - (c) when, for similar contracts, 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
  - (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

7. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 6(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

## Definitions

8. The terms defined in HKAS 32 are used in this Standard with the meanings specified in paragraph 11 of HKAS 32. HKAS 32 defines the following terms:
- financial instrument
  - financial asset

- financial liability
- equity instrument

and provides guidance on applying those definitions.

**9. The following terms are used in this Standard with the meanings specified:**

**Definition of a Derivative**

*A **derivative** is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-7) 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 (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.*

**Definitions of Four Categories of Financial Instruments**

*A **financial asset or financial liability at fair value through profit or loss** is a financial asset or financial liability that meets either of the following conditions.*

- (a) *It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:*
  - (i) *acquired or incurred principally for the purpose of selling or repurchasing it in the near term;*
  - (ii) *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; or*
  - (iii) *a derivative (except for a derivative that is a designated and effective hedging instrument).*
- (b) *Upon initial recognition it is designated by the entity as at fair value through profit or loss. Any financial asset or financial liability within the scope of this Standard may be designated when initially recognised as a financial asset or financial liability at fair value through profit or loss except for investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81).*

***Held-to-maturity investments** are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG16-AG25) other than:*

- (a) *those that the entity upon initial recognition designates as at fair value through profit or loss;*

- (b) *those that the entity designates as available for sale; and*
- (c) *those that meet the definition of loans and receivables.*

*An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:*

- (i) *are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;*
- (ii) *occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or*
- (iii) *are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.*

*Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:*

- (a) *those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;*
- (b) *those that the entity upon initial recognition designates as available for sale; or*
- (c) *those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.*

*An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.*

*Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.*

#### **Definitions Relating to Recognition and Measurement**

*The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.*

*The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or,*

*when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see HKAS 18), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).*

**Derecognition** is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

**Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. \*

**A regular way purchase or sale** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

**Transaction costs** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

#### **Definitions Relating to Hedge Accounting**

**A firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

**A forecast transaction** is an uncommitted but anticipated future transaction.

**A hedging instrument** is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72-77 and Appendix A paragraphs AG94-AG97 elaborate on the definition of a hedging instrument).

**A hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 78-84 and Appendix A paragraphs AG98-AG101 elaborate on the definition of hedged items).

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\* Paragraphs 48, 49 and AG69-AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

***Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113).***

## **Embedded Derivatives**

10. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to 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. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
11. ***An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:***
- (a) ***the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);***
  - (b) ***a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and***
  - (c) ***the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).***
- If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately on the face of the financial statements.***
12. ***If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall treat the entire combined contract as a financial asset or financial liability that is held for trading.***
13. If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 12 applies and the combined instrument is treated as held for trading.

## Recognition and Derecognition

### Initial Recognition

14. *An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)*

### Derecognition of a Financial Asset

15. In consolidated financial statements, paragraphs 16-23 and Appendix A paragraphs AG34-AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with HKAS 27 and SIC-12 *Consolidation—Special Purpose Entities* and then applies paragraphs 16-23 and Appendix A paragraphs AG34-AG52 to the resulting group.
16. *Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.*
- (a) *Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.*
- (i) *The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.*
- (ii) *The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 17-23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.*
- (iii) *The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.*

- (b) *In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.*

*In paragraphs 17-26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.*

17. *An entity shall derecognise a financial asset when, and only when:*

- (a) *the contractual rights to the cash flows from the financial asset expire; or*
- (b) *it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.*

*(See paragraph 38 for regular way sales of financial assets.)*

18. *An entity transfers a financial asset if, and only if, it either:*

- (a) *transfers the contractual rights to receive the cash flows of the financial asset; or*
- (b) *retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.*

19. *When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.*

- (a) *The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.*
- (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, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in HKAS 7 Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.*

20. ***When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:***
- (a) ***if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.***
  - (b) ***if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.***
  - (c) ***if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:***
    - (i) ***if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.***
    - (ii) ***if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 30).***
21. The transfer of risks and rewards (see paragraph 20) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g. because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g. because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 19).
22. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
23. Whether the entity has retained control (see paragraph 20(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.



**Transfers that Qualify for Derecognition (see paragraph 20(a) and (c)(i))**

24. *If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 27.*
25. *If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.*
26. *On derecognition of a financial asset in its entirety, the difference between:*
- (a) the carrying amount and*
  - (b) the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised directly in equity (see paragraph 55(b))*
- shall be recognised in profit or loss.*
27. *If the transferred asset is part of a larger financial asset (e.g. when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 16(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:*
- (a) the carrying amount allocated to the part derecognised and*
  - (b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity (see paragraph 55(b))*
- shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.*
28. When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be determined. When the entity has a history of selling parts similar to the part that continues to be recognised or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.

**Transfers that Do Not Qualify for Derecognition (see paragraph 20(b))**

29. *If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.*

**Continuing Involvement in Transferred Assets (see paragraph 20(c)(ii))**

30. *If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:*
- (a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').*
  - (b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG48).*
  - (c) when the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.*
31. *When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:*
- (a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or*
  - (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.*
32. *The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.*

33. *For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 55, and shall not be offset.*
34. *If an entity's continuing involvement is in only a part of a financial asset (e.g. when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:*
- (a) *the carrying amount allocated to the part that is no longer recognised; and*
- (b) *the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity (see paragraph 55(b))*
- shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.*
35. If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.

#### All Transfers

36. *If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see HKAS 32 paragraph 42).*
37. *If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:*
- (a) *If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its balance sheet (e.g. as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.*
- (b) *If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.*
- (c) *If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.*

- (d) *Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.*

## **Regular Way Purchase or Sale of a Financial Asset**

38. *A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG53-AG56).*

## **Derecognition of a Financial Liability**

39. *An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expires.*
40. *An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.*
41. *The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.*
42. If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

## **Measurement**

### **Initial Measurement of Financial Assets and Financial Liabilities**

43. *When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.*
44. When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see Appendix A paragraphs AG53-AG56).

## Subsequent Measurement of Financial Assets

45. For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 9:

- (a) financial assets at fair value through profit or loss;
- (b) held-to-maturity investments;
- (c) loans and receivables; and
- (d) available-for-sale financial assets.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information on the face of the financial statements. The entity shall disclose in the notes the information required by HKAS 32.

46. *After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:*

- (a) *loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;*
- (b) *held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and*
- (c) *investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).*

*Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58-70 and Appendix A paragraphs AG84-AG93.*

## Subsequent Measurement of Financial Liabilities

47. *After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:*

- (a) *financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.*

- (b) *financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using the continuing involvement approach. Paragraphs 29 and 31 apply to the measurement of such financial liabilities*

*Financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102.*

## **Fair Value Measurement Considerations**

48. *In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard or HKAS 32, an entity shall apply paragraphs AG69-AG82 of Appendix A.*
49. The fair value of a financial liability with a demand feature (e.g. 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.

## **Reclassifications**

50. *An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.*
51. *If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).*
52. *Whenever sales or reclassifications of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 9, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).*
53. *If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 46(c) and 47), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.*
54. *If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 46(c) and 47) or because the ‘two preceding financial years’ referred to in paragraph 9 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised directly in equity in accordance with paragraph 55(b) shall be accounted for as follows:*
- (a) *In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining*

*life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in equity is recognised in profit or loss in accordance with paragraph 67.*

- (b) *In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in profit or loss. If the financial asset is subsequently impaired any previous gain or loss that has been recognised directly in equity is recognised in profit or loss in accordance with paragraph 67.*

## **Gains and Losses**

55. *A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 89-102), shall be recognised, as follows.*
- (a) *A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.*
- (b) *A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity (see HKAS 1 Presentation of Financial Statements), except for impairment losses (see paragraphs 67-70) and foreign exchange gains and losses (see Appendix A paragraph AG83), until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss. However, interest calculated using the effective interest method (see paragraph 9) is recognised in profit or loss (see HKAS 18 Revenue). Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see HKAS 18).*
56. *For financial assets and financial liabilities carried at amortised cost (see paragraphs 46 and 47), a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 78-84 and Appendix A paragraphs AG98-AG101) the accounting for the gain or loss shall follow paragraphs 89-102.*
57. *If an entity recognises financial assets using settlement date accounting (see paragraph 38 and Appendix A paragraphs AG53 and AG56), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in equity, as appropriate under paragraph 55.*

## **Impairment and Uncollectibility of Financial Assets**

58. *An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.*

59. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. 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. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:
- (a) significant financial difficulty of the issuer or obligor;
  - (b) a breach of contract, such as a default or delinquency in interest or principal payments;
  - (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
  - (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
  - (e) the disappearance of an active market for that financial asset because of financial difficulties; or
  - (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
    - (i) adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
    - (ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).
60. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. 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. 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 risk-free interest rate).



61. In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.
62. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

#### **Financial Assets Carried at Amortised Cost**

63. *If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, 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 (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.*
64. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). 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 and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.
65. *If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.*

#### **Financial Assets Carried at Cost**

66. *If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the*

*financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed.*

#### **Available-for-Sale Financial Assets**

67. *When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised.*
68. *The amount of the cumulative loss that is removed from equity and recognised in profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.*
69. *Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.*
70. *If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss.*

## **Hedging**

71. *If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 85-88 and Appendix A paragraphs AG102-AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89-102.*

## **Hedging Instruments**

### **Qualifying Instruments**

72. This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 88 are met, except for some written options (see Appendix A paragraph AG94). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.
73. For hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e. external to the group, segment or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided that they are external to the individual entity or segment that is being reported on.

## Designation of Hedging Instruments

74. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:
- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and
  - (b) separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

75. A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
76. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.
77. Two or more derivatives, or proportions of them, (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

## Hedged Items

### Qualifying Items

78. A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

79. Unlike loans and receivables, 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. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.
80. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (e.g. a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under HKAS 21 *The Effects of Changes in Foreign Exchange Rates*. Under HKAS 21, foreign exchange gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies.

#### **Designation of Financial Items as Hedged Items**

81. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).
- 81A. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g. an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

### Designation of Non-Financial Items as Hedged Items

82. *If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.*

### Designation of Groups of Items as Hedged Items

83. Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, 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.
84. Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

### Hedge Accounting

85. Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.
86. *Hedging relationships are of three types:*
- (a) *fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.*
  - (b) *cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.*
  - (c) *hedge of a net investment in a foreign operation as defined in HKAS 21.*
87. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
88. *A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met.*
- (a) *At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging*

*instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.*

- (b) *The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.*
- (c) *For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.*
- (d) *The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 46 and 47 and Appendix A paragraphs AG80 and AG81 for guidance on determining fair value).*
- (e) *The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.*

#### **Fair Value Hedges**

**89.** *If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:*

- (a) *the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with HKAS 21 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and*
- (b) *the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset.*

**89A.** For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 89(b) may be met by presenting the gain or loss attributable to the hedged item either:

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

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

90. If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 55.
91. *An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:*
- (a) *the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);*
  - (b) *the hedge no longer meets the criteria for hedge accounting in paragraph 88; or*
  - (c) *the entity revokes the designation.*
92. *Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument that is measured at amortised cost (or, in the case of a portfolio hedge of interest rate risk, to the separate balance sheet line item described in paragraph 89A) shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.*
93. When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The changes in the fair value of the hedging instrument are also recognised in profit or loss.
94. When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the balance sheet.

### Cash Flow Hedges

95. *If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:*
- (a) *the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised directly in equity through the statement of changes in equity (see HKAS 1); and*
  - (b) *the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.*

96. More specifically, a cash flow hedge is accounted for as follows:
- (a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
    - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
    - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
  - (b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and
  - (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 55.
97. *If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised directly in equity in accordance with paragraph 95 shall be reclassified into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.*
98. *If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:*
- (a) *It reclassifies the associated gains and losses that were recognised directly in equity in accordance with paragraph 95 into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.*
  - (b) *It removes the associated gains and losses that were recognised directly in equity in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.*
99. *An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.*
100. *For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised directly in equity shall be recognised in profit or loss in the same period or periods during which the hedged forecast transaction affects profit or loss (for example, when a forecast sale occurs).*



- 101. In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100:**
- (a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.**
  - (b) The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.**
  - (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall be recognised in profit or loss. A forecast transaction that is no longer highly probable (see paragraph 88(c)) may still be expected to occur.**
  - (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 97, 98 or 100 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised directly in equity shall be recognised in profit or loss.**

#### **Hedges of a Net Investment**

- 102. Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see HKAS 21), shall be accounted for similarly to cash flow hedges:**
- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised directly in equity through the statement of changes in equity (see HKAS 1); and**
  - (b) the ineffective portion shall be recognised in profit or loss.**

**The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation.**

## Effective Date and Transitional Provisions

103. *An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is not permitted.*
104. *This Standard shall be applied on a prospective basis only.*
105. *When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or available for sale despite the requirement in paragraph 9 to make such designation upon initial recognition. For any such financial asset designated as available for sale, the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to profit or loss. For any financial instrument designated as at fair value through profit or loss or available for sale, the entity shall:*
- (a) restate the financial asset or financial liability using the new designation in the comparative financial statements; and*
  - (b) disclose 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.*
106. *[not used]*
107. *[not used]*
108. *An entity shall not adjust the carrying amount of non-financial assets and non-financial liabilities to exclude gains and losses related to cash flow hedges that were included in the carrying amount before the beginning of the financial year in which this Standard is first applied. At the beginning of the financial period in which this Standard is first applied, any amount recognised directly in equity for a hedge of a firm commitment that under this Standard is accounted for as a fair value hedge shall be reclassified as an asset or liability, except for a hedge of foreign currency risk that continues to be treated as a cash flow hedge.*

## Withdrawal of Other Pronouncements

109. This Standard supersedes SSAP 24 *Accounting for Investments in Securities*.

## **Appendix**

### **Comparison with International Accounting Standards**

This comparison appendix, which was prepared as at 20 April 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 39.

The International Accounting Standard comparable with HKAS 39 is IAS 39, *Financial Instruments: Recognition and Measurement*.

There are no major textual differences between HKAS 39 and IAS 39.

## Appendix A

### Application Guidance

*This appendix is an integral part of the Standard.*

#### Scope (paragraphs 2-7)

- AG1. Contracts that require a payment based on climatic, geological or other physical variables are commonly used as insurance policies. (Those based on climatic variables are sometimes referred to as ‘weather derivatives’.) Under such contracts, the payment made is based on the amount of loss to the insured entity. Rights and obligations under insurance contracts that do not principally involve the transfer of financial risks are excluded from the scope of this Standard by paragraph 2(d). The payout under some contracts that require a payment based on climatic, geological or other physical variables is unrelated to the amount of an insured entity’s loss. Such contracts are excluded from the scope of this Standard by paragraph 2(h).
- AG2. This Standard does not change the requirements relating to employee benefit plans that comply with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans* and royalty agreements based on the volume of sales or service revenues that are accounted for under HKAS 18 *Revenue*.
- AG3. Sometimes, an entity makes what it views as a ‘strategic investment’ in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor entity uses HKAS 28 *Investments in Associates* to determine whether the equity method of accounting is appropriate for such an investment. Similarly, the investor entity uses HKAS 31 *Interests in Joint Ventures* to determine whether proportionate consolidation or the equity method is appropriate for such an investment. If neither the equity method nor proportionate consolidation is appropriate, the entity applies this Standard to that strategic investment.
- AG4. This Standard applies to the financial assets and financial liabilities of insurers other than rights and obligations arising under insurance contracts that are excluded by paragraph 2(d).

#### Definitions (paragraphs 8-9)

##### Effective Interest Rate

- AG5. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.
- AG6. When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate 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. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

- AG7. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- AG8. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss.

## Derivatives

- AG9. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000\* if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.
- AG10. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g. a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g. a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5-7).

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\* In this Standard, monetary amounts are denominated in 'currency units' (CU).

AG11. One of the defining characteristics of a derivative is that it has 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. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

AG12. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38 and AG53-AG56).

### **Transaction Costs**

AG13. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

### **Financial Assets and Financial Liabilities Held for Trading**

AG14. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

AG15. Financial liabilities held for trading include:

- (a) derivative liabilities that are not accounted for as hedging instruments;
- (b) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
- (c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
- (d) financial liabilities that are 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.

The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

### **Held-to-Maturity Investments**

AG16. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

- (a) the entity intends to hold the financial asset for an undefined period;

- (b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
- (c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

- AG17. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.
- AG18. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.
- AG19. A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.
- AG20. For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 9 precludes the use of the exception for a reasonable period of time.
- AG21. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.
- AG22. Sales before maturity could satisfy the condition in paragraph 9—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:
- (a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not

necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 58 and 59), the deterioration in creditworthiness is often regarded as significant.

- (b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).
- (c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).
- (d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.
- (e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.
- (f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

AG23. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

- (a) it does not have the financial resources available to continue to finance the investment until maturity; or
- (b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph AG18.)

AG24. Circumstances other than those described in paragraphs AG16-AG23 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

AG25. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at each subsequent balance sheet date.



## Loans and Receivables

AG26. Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG71) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 9 and AG16-AG25). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

## Embedded Derivatives (paragraphs 10-13)

AG27. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG28. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

AG29. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see HKAS 32 *Financial Instruments: Disclosure and Presentation*) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG30. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
- (b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under HKAS 32, in which case it is excluded from the scope of this Standard).

- (c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under HKAS 32).
- (g) A call, put, surrender or prepayment option embedded in a host debt instrument is not closely related to the host instrument unless the option's exercise price is approximately equal to the debt instrument's amortised cost on each exercise date. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt instrument is made before separating the equity element under HKAS 32.
- (h) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

AG31. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (i.e. the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG27 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG30(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

- AG32. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the balance sheet date if the holder exercised its right to put the instrument back to the issuer.
- AG33. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt instrument is closely related to the host instrument unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
  - (b) An embedded floor or cap on the interest rate on a debt instrument is closely related to the host debt instrument, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the instrument is issued, and the cap or floor is not leveraged in relation to the host instrument. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
  - (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g. a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because HKAS 21 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
  - (d) An embedded foreign currency derivative in a host contract that is not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature and requires payments denominated in one of the following currencies:
    - (i) the functional currency of any substantial party to the contract;
    - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
    - (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(Such a contract is not a host contract with an embedded foreign currency derivative.)

- (e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.

## **Recognition and Derecognition (paragraphs 14-42)**

### **Initial Recognition (paragraph 14)**

AG34. As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG49). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG50).

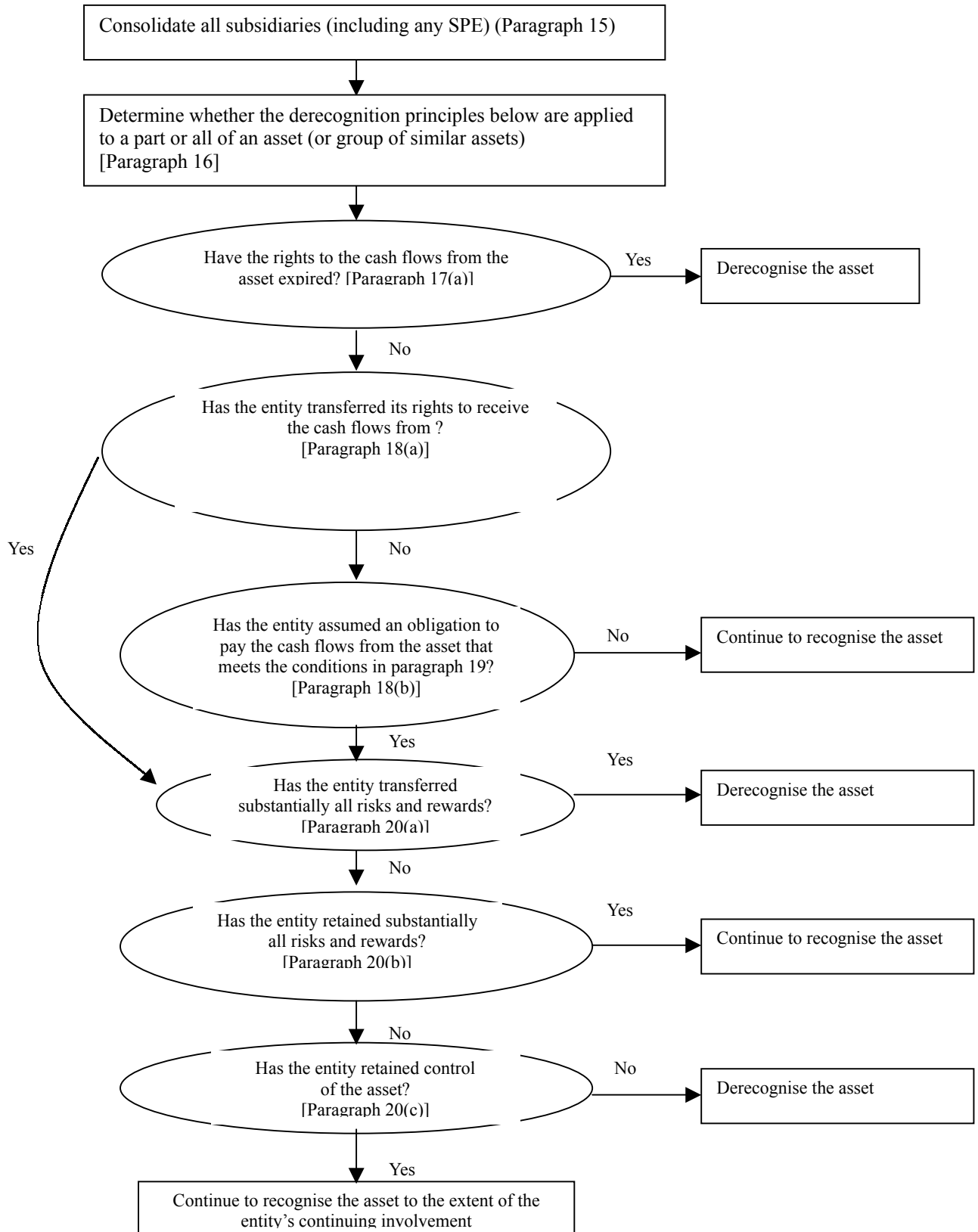
AG35. The following are examples of applying the principle in paragraph 14:

- (a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 5-7, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94).
- (c) a forward contract that is within the scope of this Standard (see paragraphs 2-7) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

- (d) option contracts that are within the scope of this Standard (see paragraphs 2-7) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

## Derecognition of a Financial Asset (paragraphs 15-37)

AG36. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



*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 18(b))*

- AG37. The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.
- AG38. In applying paragraph 19, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

*Evaluation of the transfer of risks and rewards of ownership (paragraph 20)*

- AG39. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) an unconditional sale of a financial asset;
  - (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
  - (c) a sale of a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- AG40. Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
  - (b) a securities lending agreement;
  - (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
  - (d) a sale of a financial asset together with a deep in-the-money put or call option (i.e. an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
  - (e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.
- AG41. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

*Evaluation of the transfer of control*

- AG42. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.
- AG43. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:
- (a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and
  - (b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
    - (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e. it must be a unilateral ability); and
    - (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (e.g. conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).
- AG44. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

**Transfers that Qualify for Derecognition**

- AG45. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph



27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

AG46. In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 48, 49 and AG69-AG82 in addition to paragraph 28.

### **Transfers that Do Not Qualify for Derecognition**

AG47. The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

### **Continuing Involvement in Transferred Assets**

AG48. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

#### *All assets*

- (a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis (see HKAS 18) and the carrying value of the asset is reduced by any impairment losses.

#### *Assets measured at amortised cost*

- (b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (i.e. the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

*Assets measured at fair value*

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 - CU5) and the carrying amount of the transferred asset is CU80 (i.e. its fair value).
- (d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).
- (e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) - CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

**All Transfers**

AG49. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

AG50. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

### Examples

AG51. The following examples illustrate the application of the derecognition principles of this Standard.

- (a) *Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset on its balance sheet, for example, as a loaned asset or repurchase receivable.
- (b) *Repurchase agreements and securities lending—assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
- (c) *Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
- (d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.
- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put

option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph AG44). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.
- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG44 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets).

For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.

- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership

on the transferred asset.

AG52. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining CU9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is CU10,100 and the estimated fair value of the excess spread of 0.5 per cent is CU40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this Standard, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of CU1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that CU9,090 (90 per cent CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 10 per cent part transferred and the 90 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

	<i>Estimated Fair Value</i>	<i>Percentage</i>	<i>Allocated Carrying Amount</i>
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
<b>Total</b>	<u><u>10,100</u></u>		<u><u>10,000</u></u>

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, i.e. CU90 (CU9,090 – CU9,000). The carrying amount of the portion retained by the entity is CU1,000.

In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e. CU1,000 plus the fair value of the subordination of CU65).

The entity uses all of the above information to account for the transaction as follows:

	<i>Debit</i>	<i>Credit</i>
Original asset	-	9,000
Asset recognised for subordination or the residual interest	1,000	-
Asset for the consideration received in the form of excess spread	40	-
Profit or loss (gain on transfer)	-	90
Liability	-	1,065
Cash received	9,115	-
<b>Total</b>	<b>10,155</b>	<b>10,155</b>

Immediately following the transaction, the carrying amount of the asset is CU2,040 comprising CU1,000, representing the allocated cost of the portion retained, and CU1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of CU40).

In subsequent periods, the entity recognises the consideration received for the credit enhancement (CU65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognizes any credit impairment on the recognised assets. As an example of the latter, assume that in the following year there is a credit impairment loss on the underlying loans of CU300. The entity reduces its recognised asset by CU600 (CU300 relating to its retained interest and CU300 relating to the additional continuing involvement that arises from the subordination of its retained interest for credit losses), and reduces its recognised liability by CU300. The net result is a charge to profit or loss for credit impairment of CU300.

### **Regular Way Purchase or Sale of a Financial Asset (paragraph 38)**

AG53. A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs AG55 and AG56. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 9. For this purpose assets that are held for trading form a separate category from assets designated at fair value through profit and loss.

AG54. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

- AG55. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.
- AG56. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in equity for assets classified as available for sale.

### **Derecognition of a Financial Liability (paragraphs 39-42)**

AG57. A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

AG58. If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

AG59. Payment to a third party, including a trust (sometimes called ‘in-substance defeasance’), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

AG60. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG57(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

AG61. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 15-37 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.



- AG62. For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.
- AG63. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:
- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and
  - (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

## **Measurement (paragraphs 43-70)**

### **Initial Measurement of Financial Assets and Financial Liabilities (paragraph 43)**

- AG64. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74-AG79). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- AG65. If an entity originates a loan that bears an off-market interest rate (e.g. 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method.

### **Subsequent Measurement of Financial Assets (paragraphs 45 and 46)**

- AG66. If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability in accordance with paragraph 47.
- AG67. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognised at CU102. The next financial reporting date occurs one day later, when the quoted market price of

the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognised in equity. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

- AG68. Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity.

## **Fair Value Measurement Considerations (paragraphs 48 and 49)**

- AG69. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.
- AG70. This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (e.g. for counterparty credit risk) are not included in the term 'bid-ask spread'.

### **Active Market: Quoted Price**

- AG71. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the balance sheet date in that instrument (i.e. without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.
- AG72. 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. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g. a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not

fair value (e.g. because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

- AG73. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

#### **No Active Market: Valuation Technique**

- AG74. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

- AG75. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

- AG76. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

- AG77. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e. similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable

credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

- AG78. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.
- AG79. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

#### **No Active Market: Equity Instruments**

- AG80. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- AG81. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

#### **Inputs to Valuation Techniques**

- AG82. An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial

instrument will be based on one or more of the following factors (and perhaps others).

- (a) *The time value of money (i.e. interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.
- (b) *Credit risk.* The effect on fair value of credit risk (i.e. the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.
- (c) *Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.
- (d) *Commodity prices.* There are observable market prices for many commodities.
- (e) *Equity prices.* Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.
- (f) *Volatility (i.e. magnitude of future changes in price of the financial instrument or other item).* Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.
- (g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount—see paragraph 49.)
- (h) *Servicing costs for a financial asset or a financial liability.* Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

## **Gains and Losses (paragraphs 55-57)**

AG83. An entity applies HKAS 21 to financial assets and financial liabilities that are monetary items in accordance with HKAS 21 and denominated in a foreign currency. Under HKAS 21, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95-101) or a hedge of a net investment (see paragraph 102). For the purpose of recognising foreign exchange gains and losses under HKAS 21, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in accordance with paragraph 55(b). For available-for-sale financial assets that are not monetary items under HKAS 21 (for example, equity instruments), the gain or loss that is recognised directly in equity under paragraph 55(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

## **Impairment and Uncollectibility of Financial Assets (paragraphs 58-70)**

### **Financial Assets Carried at Amortised Cost (paragraphs 63-65)**

AG84. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

AG85. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

AG86. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range, \* taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date.

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\* HKAS 37, paragraph 39 contains guidance on how to determine the best estimate in a range of possible outcomes.

- AG87. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.
- AG88. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.
- AG89. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current 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. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.
- AG90. As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.
- AG91. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

AG92. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g. for smaller balance loans) as long as they are consistent with the requirements in paragraphs 63-65 and AG87-AG91. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

### **Interest Income After Impairment Recognition**

AG93. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

## **Hedging (paragraphs 71-102)**

### **Hedging Instruments (paragraphs 72-77)**

#### **Qualifying Instruments (paragraphs 72 and 73)**

AG94. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

AG95. A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) cannot be designated as a hedging instrument.

AG97. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

### **Hedged Items (paragraphs 78-84)**

#### **Qualifying Items (paragraphs 78-80)**

AG98. A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

AG99. An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge



because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

### **Designation of Financial Items as Hedged Items (paragraphs 81 and 81A)**

AG99A. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g. only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (i.e. principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

AG99B. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (i.e. CU90) and the amount repayable on maturity (i.e. CU100).

### **Designation of Non-Financial Items as Hedged Items (paragraph 82)**

AG100. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 88 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g. a transaction in Brazilian coffee) and the hedging instrument (e.g. a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables

(i.e. between the unit prices of Brazilian coffee and Columbian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in profit or loss during the term of the hedging relationship.

### **Designation of Groups of Items as Hedged Items (paragraphs 83 and 84)**

AG101. A hedge of an overall net position (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm purchase commitment of CU100.

### **Hedge Accounting (paragraphs 85-102)**

AG102. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG103. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e. a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

AG104. A hedge of a firm commitment (e.g. a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 87 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

### **Assessing Hedge Effectiveness**

AG105. A hedge is regarded as highly effective only if both of the following conditions are met:

- (a) At the inception of the hedge 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. Such an expectation can 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 or cash flows of the hedged item and those of the hedging instrument. 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.

- (b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instrument is CU100, offset can be measured by  $120 / 100$ , which is 120 per cent, or by  $100 / 120$ , which is 83 per cent. In this example, assuming the hedge meets the condition in (a) the entity would conclude that the hedge has been highly effective.

AG106. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

AG107. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the 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. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG107A. 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 based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

AG108. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

- (a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
- (b) the fair value of the forward contract at inception is zero; and
- (c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognised in profit or loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

AG109. Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG110. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG111. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

AG112. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

AG113. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

#### **Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk**

AG114. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs AG115-AG132 below.

- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g. the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.
- (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.
- (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG126(b).

- (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g. LIBOR).
- (e) The entity designates one or more hedging instruments for each repricing time period.
- (f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in profit or loss and in one of two line items in the balance sheet as described in paragraph 89A. The change in fair value need not be allocated to individual assets or liabilities.
- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in profit or loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the balance sheet.
- (i) Any ineffectiveness\* will be recognised in profit or loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

AG115. This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG116. The portfolio identified in paragraph AG114(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG117. In applying paragraph AG114(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures

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\* The same materiality considerations apply in this context as apply throughout IFRSs.

and objectives.

AG118. As an example of the designation set out in paragraph AG114(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets).<sup>\*\*\*</sup> The designation is expressed as an ‘amount of a currency’ (e.g. an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—i.e. all of the CU100 of assets in the above example—must be:

- (a) items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because the Standard<sup>\*</sup> specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG126(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 per cent<sup>\*\*</sup> of the liabilities with no demand feature.

AG119. The entity also complies with the other designation and documentation requirements set out in paragraph 88(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity’s policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

- (a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.
- (b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

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<sup>\*\*\*</sup> The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, ie in this example any amount of assets between CU0 and CU100.

<sup>\*</sup> see paragraph 49

<sup>\*\*</sup>  $CU30 \div (CU100 - CU40) = 50$  per cent

- (c) the number and duration of repricing time periods.
- (d) how often the entity will test effectiveness and which of the two methods in paragraph AG126 it will use.
- (e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG126(b).
- (f) when the entity tests effectiveness using the method described in paragraph AG126(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship shall be in accordance with the entity's risk management procedures and objectives. Changes in policies shall not be made arbitrarily. They shall be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

AG120. The hedging instrument referred to in paragraph AG114(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG114(d) (e.g. a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard\* does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG114(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard\*\* does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG121. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG114(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 81 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 81A permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than *contractual*, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g. to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG126. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g. changes in prepayment rates clearly arising from a change in demographic

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\* see paragraphs 77 and AG94

\*\* see paragraph 75

factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

AG122. The Standard does not specify the techniques used to determine the amount referred to in paragraph AG114(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

AG123. Paragraph 89A requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG114(g). Specific allocation to individual assets (or liabilities) is not required.

AG124. Paragraph AG114(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

- (a) actual repricing dates being different from those expected, or expected repricing dates being revised;
- (b) items in the hedged portfolio becoming impaired or being derecognised;
- (c) the payment dates of the hedging instrument and the hedged item being different; and
- (d) other causes (e.g. when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness\* shall be identified and recognised in profit or loss.

AG125. Generally, the effectiveness of the hedge will be improved:

- (a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.
- (b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.
- (c) when the repricing time periods used are narrower (e.g. 1-month as opposed to

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\* The same materiality considerations apply in this context as apply throughout HKFRSs.



3-month repricing time periods). Narrower repricing time periods reduces the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

- (d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g. because of changes in prepayment expectations).

AG126. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

- (a) as the difference between the change in the fair value of the hedging instrument (see paragraph AG114(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or
- (b) using the following approximation. The entity:
  - (i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.
  - (ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.
  - (iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG114(g).
  - (iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG114(h)).

AG127. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG121), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG126(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since its last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG126(b) are then repeated at the next date it tests effectiveness.

AG128. Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG114(g) that relates to the derecognised item shall be removed from the balance sheet, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the

derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG114(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

AG129. In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in profit or loss at that time (see paragraph 89A). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item on the balance sheet was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, CU7 is derecognised from the balance sheet and recognised in profit or loss. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG114(g).

AG130. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU110 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG114(g) that relates to the first time period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

AG131. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph AG114(g) that relates to the reduction shall be amortised in accordance with paragraph 92.

AG132. An entity may wish to apply the approach set out in paragraphs AG114-AG131 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with HKAS 39. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 101(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG114-AG131 prospectively to subsequent accounting periods.

## Appendix B

### Amendments to Other Pronouncements

*The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.*

#### Amendments to HKFRS 1

- B1. HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* is amended as described below.

##### Standard

Paragraphs 25A, 27A, 36A and 47A are added and paragraphs 13, 27 and 30 are amended to read as follows:

- 13 An entity may elect to use one or more of the following exemptions:
- (a) ....
  - (e) compound financial instruments (paragraph 23);
  - (f) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs 24 and 25); and
  - (g) designation of previously recognised financial instruments (paragraph 25A).

##### Designation of previously recognised financial instruments

- 25A HKAS 39 *Financial Instruments: Recognition and Measurement* permits a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss or as available for sale. Despite this requirement, an entity is permitted to make such a designation at the date of transition to HKFRSs.
- 27 Except as permitted by paragraph 27A, a first-time adopter shall apply the derecognition requirements in HKAS 39 prospectively for transactions occurring on or after 1 January 2004. In other words, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities under its previous GAAP as a result of a transaction that occurred before 1 January 2004, it shall not recognise those assets and liabilities under HKFRSs (unless they qualify for recognition as a result of a later transaction or event).
- 27A Notwithstanding paragraph 27, an entity may apply the derecognition requirements in HKAS 39 retrospectively from a date of the entity's choosing, provided that the information needed to apply HKAS 39 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

- 30 If, before the date of transition to HKFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in HKAS 39 the entity shall apply paragraphs 91 and 101 of HKAS 39 to discontinue hedge accounting. Transactions entered into before the date of transition to HKFRSs shall not be retrospectively designated as hedges.

**Exemption from the requirement to restate comparative information for HKAS 39**

- 36A In its first HKFRS financial statements, an entity that adopts HKFRSs before 1 January 2006 shall present at least one year of comparative information, but this comparative information need not comply with HKAS 32 and HKAS 39. An entity that chooses to present comparative information that does not comply with HKAS 32 and HKAS 39 in its first year of transition shall:
- (a) apply its previous GAAP to financial instruments within the scope of HKAS 32 and HKAS 39 in the comparative information;
  - (b) disclose this fact together with the basis used to prepare this information; and
  - (c) disclose the nature of the main adjustments that would make the information comply with HKAS 32 and HKAS 39. The entity need not quantify those adjustments. However, the entity shall treat any adjustment between the balance sheet at the comparative period's reporting date (i.e. the balance sheet that includes comparative information under previous GAAP) and the balance sheet at the start of the first HKFRS reporting period (i.e. the first period that includes information that complies with HKAS 32 and HKAS 39) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)-(f) of HKAS 8. Paragraph 28(f) applies only to amounts presented in the balance sheet at the comparative period's reporting date.

In the case of an entity that chooses to present comparative information that does not comply with HKAS 32 and HKAS 39, references to the 'date of transition to HKFRSs' shall mean, in the case of HKAS 32 and HKAS 39 only, the beginning of the first HKFRS reporting period.

**Disclosure**

- 47A An entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or as available for sale in accordance with paragraph 25A. The entity shall disclose the fair value of any financial assets or financial liabilities designated into each category and the classification and carrying amount in the previous financial statements.

## Appendix A

The following definition is added:

<b>first HKFRS reporting period</b>	The reporting period ending on the <b>reporting date</b> of an entity's <b>first HKFRS financial statements</b> .
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### Guidance on Implementing

The guidance on implementing HKFRS 1 is amended to read as follows:

- IG36 For compound instruments outstanding at the date of transition to HKFRSs, an entity determines the initial carrying amounts of the components on the basis of circumstances existing when the instrument was issued (HKAS 32, paragraph 30). An entity determines those carrying amounts using the version of HKAS 32 effective at the reporting date for its first HKFRS financial statements. If the liability component is no longer outstanding at the date of transition to HKFRSs, a first-time adopter need not separate the initial equity component of the instrument from the cumulative interest accreted on the liability component (paragraph 28 of the HKFRS).
- IG52 An entity recognises and measures all financial assets and financial liabilities in its opening HKFRS balance sheet in accordance with HKAS 39, except as specified in paragraphs 27-30 of the HKFRS, which address derecognition and hedge accounting, and paragraph 36A, which permits an exemption from restating comparative information.

### Recognition

- IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition under HKAS 39 and have not yet qualified for derecognition under HKAS 39, except non-derivative financial assets and non-derivative financial liabilities derecognised under previous GAAP before 1 January 2004, to which the entity does not choose to apply paragraph 27A (see paragraphs 27 and 27A of the HKFRS). For example, an entity that does not apply paragraph 27A does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred beginning before 1 January 2004 if those transactions qualified for derecognition under previous GAAP. However, any further transfers of financial assets to the same securitisation or other transaction that occurred beginning on or after 1 January 2004 qualify for derecognition only if they meet the derecognition criteria of HKAS 39.

### Embedded derivatives

- IG55 When HKAS 39 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in HKAS 39 reflect circumstances at that date (HKAS 39, paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading (HKAS 39, paragraph

12). This results in fair value measurement (except when the entity cannot determine a reliable fair value, see HKAS 39, paragraph 46(c)), with changes in fair value recognised in profit or loss.

### Measurement

IG56 In preparing its opening HKFRS balance sheet, an entity applies the criteria in HKAS 39 to identify those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost. In particular:

- (a) to comply with HKAS 39, paragraph 51, classification of financial assets as held-to-maturity investments relies on a designation made by the entity in applying HKAS 39 reflecting the entity's intention and ability at the date of transition to HKFRSs. It follows that sales or transfers of held-to-maturity investments before the date of transition to HKFRSs do not trigger the 'tainting' rules in HKAS 39, paragraph 9.
- (b) to comply with HKAS 39, paragraph 9, the category of 'loans and receivables' refers to the circumstances when the financial asset first satisfied the recognition criteria in HKAS 39.
- (c) under HKAS 39, paragraph 9, derivative financial assets and derivative financial liabilities are always deemed held for trading (except for a derivative that is a designated and effective hedging instrument). The result is that an entity measures all derivative financial assets and derivative financial liabilities at fair value.
- (d) to comply with HKAS 39, paragraph 50, an entity classifies a non-derivative financial asset or non-derivative financial liability in its opening HKFRS balance sheet as at fair value through profit or loss if, and only if, the asset or liability was:
  - (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
  - (ii) at the date of transition to HKFRSs, part of a portfolio of identified financial instruments that were managed together and for which there was evidence of a recent actual pattern of short-term profit-taking; or
  - (iii) designated as at fair value through profit or loss at the date of transition to HKFRSs.
- (e) to comply with HKAS 39, paragraph 9, available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale and those non-derivative financial assets that are not in any of the previous categories.

### Transition adjustments

IG58A An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings at the date of transition to

HKFRSs only to the extent that it results from adopting HKAS 39. Because all derivatives, other than those that are designated and effective hedging instruments, are classified as held for trading, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives shall be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which HKAS 39 is initially applied (other than for a derivative that is a designated and effective hedging instrument).

IG58B HKAS 8 applies to adjustments resulting from changes in estimates. If an entity is unable to determine whether a particular portion of the adjustment is a transition adjustment or a change in estimate, it treats that portion as a change in accounting estimate under HKAS 8, with appropriate disclosures (HKAS 8, paragraphs 32-30).

IG59 An entity may, under its previous GAAP, have measured investments at fair value and recognised the revaluation gain directly in equity. If an investment is classified as at fair value through profit or loss, the pre-HKAS 39 revaluation gain that had been recognised in equity is reclassified into retained earnings on initial application of HKAS 39. If, on initial application of HKAS 39, an investment is classified as available for sale, then the pre-HKAS 39 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on the available-for-sale financial asset in that separate component of equity until the investment is impaired, sold, collected or otherwise disposed of. On subsequent derecognition or impairment of the available-for-sale financial asset, the entity transfers to profit or loss the cumulative gain or loss remaining in equity (HKAS 39, paragraph 55(b)).

### **Hedge accounting**

IG60 Paragraphs 28-30 of the HKFRS deal with hedge accounting. The designation and documentation of a hedge relationship must be completed on or before the date of transition to HKFRSs if the hedge relationship is to qualify for hedge accounting from that date. Hedge accounting can be applied prospectively only from the date that the hedge relationship is fully designated and documented.

IG60A An entity may, under its previous GAAP, have deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, an entity adjusts the carrying amount of the hedged item at the date of transition to HKFRSs. The adjustment is the lower of:

- (a) that portion of the cumulative change in the fair value of the hedged item that reflects the designated hedged risk and was not recognised under previous GAAP; and
- (b) that portion of the cumulative change in the fair value of the hedging instrument that reflects the designated hedged risk and, under previous GAAP, was either (i) not recognised or (ii) deferred in the balance sheet as an asset or liability.

IG60B An entity may, under its previous GAAP, have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of transition to HKFRSs, the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in equity. Any net cumulative gain or loss that has been reclassified to equity on initial application of HKAS 39 remains in equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects profit or loss or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss that had been recognised directly in equity is recognised in profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge under HKAS 39, hedge accounting is no longer appropriate starting from the date of transition to HKFRSs.

### **Basis for Conclusions**

Paragraph BC17(a) is amended to read as follows:

BC17 (a) A previous version of IAS 39 *Financial Instruments: Recognition and Measurement* prohibited restatement of securitisation, transfer or other derecognition transactions entered into before the beginning of the financial year in which it was initially applied.

Paragraph BC20 is amended to read as follows:

BC20 An entity may have derecognised financial assets or financial liabilities under its previous GAAP that do not qualify for derecognition under IAS 39. ED 1 proposed that a first-time adopter should recognise those assets and liabilities in its opening IFRS balance sheet. Some respondents to ED 1 requested the Board to permit or require a first-time adopter not to restate past derecognition transactions, on the following grounds:

...

- (c) IAS 39 did not, before the improvements proposed in June 2002, require (or even permit) entities to restate past derecognition transactions. Without a similar exemption, first-time adopters would be unfairly disadvantaged.
- (d) Retrospective application would not result in consistent measurement, as entities would need to recreate information about past transactions with the benefit of hindsight.

Paragraphs BC22A and BC22B are added and paragraphs BC22 and BC23 are amended to read as follows:

BC22 Nevertheless, in finalising the IFRS, the Board concluded that it would be premature to require a treatment different from the current version of IAS 39 before completing the proposed improvements to IAS 39. Accordingly, the IFRS originally required the same treatment as the then current version of IAS



39 for derecognition transactions before the effective date of the then current version of IAS 39, namely that any financial assets or financial liabilities derecognised under previous GAAP before financial years beginning on 1 January 2001 remain derecognised. The Board agreed that when it completed the improvements to IAS 39, it might amend or delete this exemption.

BC22A The Board reconsidered this issue in completing the revision of IAS 39 in 2003. The Board decided to retain the transition requirements as set out in IFRS 1, for the reasons given in paragraph BC20. However, the Board amended the date from which prospective application was required to transactions that occur on or after 1 January 2004 in order to overcome the practical difficulties of restating transactions that had been derecognised before that date.

BC22B The Board also noted that financial statements that include financial assets and financial liabilities that would otherwise be omitted under the provisions of the IFRS would be more complete and therefore more useful to users of financial statements. The Board therefore decided to permit retrospective application of the derecognition requirements. It also decided that retrospective application should be limited to cases when the information needed to apply the IFRS to past transactions was obtained at the time of initially accounting for those transactions. This limitation prevents the unacceptable use of hindsight.

BC23 The Board removed from IAS 39 the following consequential amendments to IAS 39 made when IFRS 1 was issued, because, for first-time adopters, these clarifications are clear in paragraphs IG26-IG31 and IG53 of the guidance on implementing IFRS 1. These were:

- (a) the clarification that an entity is required to apply IAS 39 to all derivatives or other interests retained after a derecognition transaction, even if the transaction occurred before the effective date of IAS 39; and
- (b) the confirmation that there are no exemptions for special purpose entities that existed before the date of transition to IFRSs.

Paragraph BC30 is amended to read as follows:

BC30 An entity may elect to use one or more of the following exemptions:

- (a) ....
- (e) compound financial instruments (paragraphs BC56-BC58);
- (f) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs BC59-BC63); and

- (g) designation of previously recognised financial instruments (paragraph BC63A).

Paragraph BC63A is added:

BC63A IAS 39 (as revised in 2003) permits an entity to designate, on initial recognition only, a financial instrument as (a) a financial asset or financial liability at fair value through profit or loss or (b) available for sale. Despite this requirement, an entity that had already applied IFRSs before the effective date of IAS 39 (as revised in 2003) may, on initial application of IAS 39 (as revised in 2003), so designate a previously recognised financial instrument. The Board decided to treat first-time adopters in the same way as entities that already apply IFRSs. Accordingly, a first-time adopter of IFRSs may similarly designate a previously recognised financial instrument at the date of transition to IFRSs. Such an entity is required to disclose the amount of previously recognised financial instruments that it so designates.

Paragraph BC77 is amended to read as follows:

BC77 ED 1 included a redrafted version of the transitional provisions in IAS 39 and related *Questions and Answers* (Q&As) developed by the IAS 39 Implementation Guidance Committee. The Board confirmed in the Basis for Conclusions published with ED 1 that it did not intend the redrafting to create substantive changes. However, in the light of responses to ED 1, the Board decided in finalising IFRS 1 that the redrafting would not make it easier for first-time adopters and others to understand and apply the transition provisions and Q&As. However, the project to improve IAS 32 and IAS 39 resulted in certain amendments to the transition requirements. In addition, this project incorporated selected other Q&As (i.e. not on transition) into IAS 39. The Board therefore took this opportunity to consolidate all the guidance for first-time adopters in one place, by incorporating the Q&As on transition into IFRS 1.

Paragraph BC82 is amended to read as follows:

BC82 IAS 39 confirmed the proposal in the Exposure Draft of June 2002 to give an entity that already applies IFRSs an option to designate any financial asset as at fair value through profit or loss when it first applies the proposed improvements. Although this requirement could increase the risk of selective classification by first-time adopters of the kind discussed in the previous paragraph, the Board noted that an entity could achieve a similar result by selective disposal of some assets before the date of transition to IFRSs. Therefore, the Board concluded that it should treat first-time adopters in the same way as entities that already apply IFRSs by requiring retrospective application.

Paragraph BC89 is amended to read as follows and paragraph BC89A is added:

BC89 Some respondents to ED 1 suggested that it would be onerous to prepare comparative information under IAS 32 and IAS 39 about financial instruments. They suggested that an entity should be able to apply IAS 39 prospectively from the beginning of the year of its first IFRS financial statements (e.g. 1 January 2005 for many first-time adopters). They noted that US companies were not required to restate comparatives on the introduction of SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. However, given the Board's emphasis on comparability within the first IFRS financial statements (paragraph BC10) and the assumption of timely planning (paragraph BC27), the Board introduced no general exemption in this area.

BC89A Nevertheless, the Board noted that the revised IAS 32 and IAS 39 were not issued until December 2003. Additionally, the Board's decision to re-expose its proposals for portfolio hedges of interest rate risk had the effect that some of the requirements will not be finalised until early 2004. The Board was sympathetic to concerns that entities that will be required to comply with IFRSs for the first time in 2005 could not make a timely transition to IFRSs because IAS 39 will not be issued in final form until after the start of 2004. Therefore, the Board decided to exempt entities adopting IFRSs for the first time before 1 January 2006 from producing comparative information that complies with IAS 32 and IAS 39, as revised in 2003, in their first IFRS financial statements. The disclosures in paragraph 36A inform users of the lack of comparability.

Paragraph BC97 of the Basis for Conclusions is deleted.

## Amendments to HKAS 12

B2. HKAS 12 *Income Taxes* is amended as described below.

The first sentence of paragraph 20 is amended to read as follows:

20. HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment*, HKAS 38 *Intangible Assets*, HKAS 39 *Financial Instruments: Recognition and Measurement* and HKAS 40 *Investment Property*).

Example 9 of Appendix A is amended to read as follows:

9. The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see HKAS 32 *Financial Instruments: Disclosure and Presentation*). The discount is not deductible in determining taxable profit (tax loss).

## Amendments to HKAS 18

B3. HKAS 18 *Revenue* is amended as described below.

Paragraph 30 is amended to read as follows:

30. ***Revenue shall be recognised on the following bases:***
- (a) ***interest shall be recognised using the effective interest method as set out in HKAS 39, paragraphs 9 and AG5-AG8;***
  - (b) ***royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and***
  - (c) ***dividends shall be recognised when the shareholder's right to receive payment is established.***

Paragraph 31 is deleted.

Example 5 of the Appendix is amended to read as follows:

5. ***Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase, by the seller, of the goods.***

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, HKAS 39 *Financial Instruments: Recognition and Measurement* applies.

Example 8 of the Appendix is amended to read as follows:

8. ***Instalment sales, under which the consideration is receivable in instalments.***

Revenue attributable to the sale price, exclusive of interest, is recognised at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The interest element is recognised as revenue as it is earned, using the effective interest method.

Example 14 of the Appendix is amended to read as follows:

14. ***Financial service fees.***

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

- (a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognised in profit or loss the fees are recognised as revenue when the instrument is initially recognised.

- (i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under HKAS 39 is classified as a financial asset at fair value through profit or loss.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related direct costs, are deferred and recognised as an adjustment to the effective interest rate.

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of HKAS 39.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of HKAS 39, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related direct costs, is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of HKAS 39 are accounted for as derivatives and measured at fair value.

- (b) *Fees earned as services are provided.*

- (i) *Fees charged for servicing a loan.*

Fees charged by an entity for servicing a loan are recognised as revenue as the services are provided.

- (ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of HKAS 39.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of HKAS 39, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of HKAS 39 are accounted for as derivatives and measured at fair value.

(c) *Fees that are earned on the execution of a significant act.*

The fees are recognised as revenue when the significant act has been completed, as in the examples below.

(i) *Commission on the allotment of shares to a client.*

The commission is recognised as revenue when the shares have been allotted.

(ii) *Placement fees for arranging a loan between a borrower and an investor.*

The fee is recognised as revenue when the loan has been arranged.

(iii) *Loan syndication fees.*

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognised as revenue when the syndication has been completed.

B4. [Not used]

B5. [Not used]

## **Amendments to HKAS 36**

B6. HKAS 36 *Impairment of Assets* is amended as described below:

### **Standard**

Paragraph 1 is amended to read as follows:

**1. This Standard shall be applied in accounting for the impairment of all assets, other than:**

...

**(e) financial assets that are included in the scope of HKAS 39 Financial Instruments: Recognition and Measurement;**

...

## **Amendments to HKAS 37**

B7. HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is amended as described below.

Paragraphs 1 and 2 are amended to read as follows:

1. ***This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:***
  - (a) ***those resulting from executory contracts, except where the contract is onerous;***
  - (b) ***those arising in insurance entities from contracts with policyholders; and***
  - (c) ***those covered by another Standard.***
2. This Standard does not apply to financial instruments (including guarantees) that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*. For financial guarantees excluded from the scope of HKAS 39, this Standard applies as set out in paragraph 2(f) of HKAS 39.

Example 9 is amended to read as follows:

#### **Example 9: A Single Guarantee**

On 31 December 1999, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 2000, the financial condition of Entity B deteriorates and at 30 June 2000 Entity B files for protection from its creditors.

- (a) At 31 December 1999

**Present obligation as a result of a past obligating event** – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits in settlement** – No outflow of benefits is probable at 31 December 1999.

**Conclusion** – The guarantee is recognised at fair value (see paragraph 2(f) of HKAS 39).

- (b) At 31 December 2000

**Present obligation as a result of a past obligating event** – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits in settlement** – At 31 December 2000, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

**Conclusion** – The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 14 and 23), and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with HKAS 18 *Revenue*.

Note: Where an entity gives guarantees in exchange for a fee, revenue is recognised under HKAS 18 *Revenue*.

B8. [Not used]

## Basis for Conclusions

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

HKAS 39 is based on IAS 39 *Financial Instruments: Recognition and Measurement*. In approving HKAS 39, the Council of the Hong Kong Society of Accountants considered and agreed with the IASB's basis for conclusions on IAS 39 (as amended in March 2004). Accordingly, there are no significant differences between HKAS 39 and IAS 39. The IASB's basis for conclusions is reproduced below for reference. The paragraph numbers of IAS 39 referred to below generally correspond with those in HKAS 39.

- 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 roundtable 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 roundtable 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 roundtable discussions.

BC11A. Some of the comment letters on the June 2002 Exposure Draft and participants in the roundtables 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.

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(i) 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 in the same way as financial guarantees (see paragraph BC23). 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.

### **Financial Guarantee Contracts (paragraphs 2(f) and 3)**

- BC21. The Exposure Draft proposed that financial guarantee contracts that provide for specified payments to be made to reimburse the holder for a loss it has incurred because a specified debtor fails to make payment when due should be initially recognised and measured by the issuer in accordance with IAS 39. Subsequently, they should be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* at the amount an entity would rationally be expected to pay to settle the obligation or to transfer it to a third party. This amendment would have clarified that an issued financial guarantee contract meets the definition of a liability and should be recognised as such.
- BC22. Some of the comments received on the Exposure Draft expressed concern that applying IAS 37 after initial recognition would result in individual financial guarantees being measured at nil immediately after initial recognition if the probability threshold in IAS 37 was not met, and thus the entity would recognise an immediate gain.

BC23. To address this concern, the Board decided to clarify that financial guarantees are 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*.

**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.

## 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 (e.g. 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.

### **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, i.e. 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*).

## 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 (e.g. transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (e.g. 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 CU100\* 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 interpretive 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 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;

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\* In this Basis for Conclusions, monetary amounts are denominated in ‘currency units’ (CU).



- (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 (e.g. 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 (e.g. 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?

- BC56. To address these issues, the Exposure Draft of proposed amendments to IAS 39 included guidance to clarify under which conditions passthrough 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*, 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 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). 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 (i.e. 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 (e.g. 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), i.e. 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 (e.g. 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**

### **Fair Value Measurement Option (paragraph 9)**

- BC71. The Board concluded that it could simplify the application of IAS 39 for some entities by permitting the use of fair value measurement for any financial instrument. With one exception (see paragraph BC82), 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. The previous version of IAS 39 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 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 to permit entities to designate irrevocably on initial recognition any financial instrument as one 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 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.
- BC74. The change 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 where 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 interpretive issues around what constitutes trading.
- BC75. Permitting entities to designate at inception any financial instrument at fair value through profit or loss reduces the need for hedge accounting for hedges of fair value exposures and the resulting complexity in accounting for such hedges. Rather than being designated as a hedged item, the item could be designated at fair value through profit or loss to achieve recognition of offsetting fair value gains and losses in the same periods.

- BC76. Permitting classification by designation also reduces the burden of separating embedded derivatives from hybrid instruments into host instruments and embedded derivative contracts. For example, under the previous version of IAS 39, an entity did not separate embedded derivatives in financial instruments that were held for trading. The Board noted that many preparers, auditors and others find the requirements to separate embedded derivatives difficult to apply in practice. For example, when applying these requirements an entity will need to carry out a detailed analysis of its financial instruments to identify embedded derivatives. Often it may be easier for the entity to determine the fair value of the combined instrument as a whole rather than to identify the terms of the embedded derivative and separately measure the embedded derivative at fair value, if, for example, the combined instrument is traded in an active market.
- BC77. An additional benefit of permitting classification by designation is that the choice in the original IAS 39 of recognising fair value gains and losses on available-for-sale financial assets either in equity or in profit or loss is no longer necessary. An entity can achieve recognition of gains and losses on such assets in profit or loss by designating the asset at fair value through profit or loss. It also increases comparability across entities in how gains and losses on available-for-sale financial assets are recognised. Accordingly, the Board decided that the choice that was in the original IAS 39 should be removed and that gains and losses on available-for-sale financial assets should be recognised in equity.
- BC78. Permitting designation at fair value through profit or loss mitigates problems arising from a mixed measurement model when assets are measured at fair value and related liabilities are measured at amortised cost. For example, the inability to classify non-derivative liabilities as held for trading under IAS 39 creates problems for entities with matched asset and liability positions. Under IAS 39, an entity is not permitted to designate non-derivative financial assets or non-derivative financial liabilities as hedging instruments, except for foreign currency exposures, and thus cannot use hedge accounting to eliminate such a mismatch. Because financial liabilities may now be designated at fair value through profit or loss, an entity can consistently recognise fair value changes on matched financial asset and financial liability positions.
- BC79. The fair value measurement option enables (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 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 this project to improve IAS 39.
- BC80. Some comments received on the Exposure Draft suggested limiting the scope of the fair value option (e.g. to instruments that are traded in an active market or to exclude financial liabilities—see paragraphs BC87-BC92). The Board concluded it should not restrict the fair value option because to do so would limit its main benefits, discussed above.
- BC81. Comments received on the Exposure Draft 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 32 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 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 Measurement Option to a Portion (Rather than the Entirety) of a Financial Asset or a Financial Liability**

- BC85. Some comments received on the Exposure Draft argued that the fair value measurement option should be extended so that it could also be applied to a portion of a financial asset or a financial liability (e.g. one risk). 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 measurement option to portions of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the portion because of ordering issues and joint effects (i.e. if the portion is affected by more than one risk, it may be difficult to isolate accurately and measure the portion); (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 portion may move the carrying amount of an instrument away from its fair value. The Board agreed to address separately the issue of cash instrument hedging.

#### **Own Credit Risk**

- BC87. The Board discussed the issue of including changes in own credit risk in the fair value measurement of financial liabilities. It considered responses to the Exposure Draft 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 because doing so would negate some of the benefits of the fair value option set out in paragraph BC74.

- 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 an entity's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in own 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 liability 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 own 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 (i.e. the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects the credit risk relating to that liability. 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 portion 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 separately presenting or disclosing such changes would often not be practicable because it might not be possible to separate and measure reliably that part of the change in fair value. However, it noted that disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided in IAS 32 to require disclosure of the changes in fair value of a financial liability that is not attributable to changes in a benchmark rate. 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.

- 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.

### **Measurement of Financial Liabilities with a Demand Feature**

- BC93. Some comments received on the Exposure Draft requested clarification of how to determine fair value for financial liabilities with a demand feature (e.g. demand deposits), when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the 'demand amount'), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believe that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.
- BC94. The Board agreed that this issue should be clarified in IAS 39. It confirmed that the fair value of a financial 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 conclusion is the same as in the original IAS 32. The Board noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—i.e. the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the Board believes is inappropriate.

### **Fair Value Measurement Guidance (paragraphs AG69-AG82)**

- 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). The Board decided that it is desirable to provide clear and reasonably detailed 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 (e.g. 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 defined 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 (i.e. without modification or repackaging) in the most advantageous active market 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. 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.

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.

**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 hierarchy 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 (i.e. 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 value. The Board also noted that its decision achieved convergence with US GAAP.

## **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 instruments 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 (i.e. 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 (e.g. 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.

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). 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.
- (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 94, 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 (e.g. 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 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 equity (see paragraph 55(b)).

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 (e.g. 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 (i.e. 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 (i.e. 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, i.e. 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 roundtable 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 (e.g. 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 short-cut 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 or 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 (i.e. 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 (i.e. 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, i.e. 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, i.e. 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 redesignated 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. 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.

*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 or between segments in the *separate reporting* of those entities or segments. 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 equity 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 roundtables 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 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 (i.e. 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 or transactions between segments in individual or separate financial statements of those entities or reporting segments because they are not internal to the entity (i.e. the individual entity or segment).

## **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 roundtable 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 39\* 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

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\* see Q&A F.6.1 and F.6.2

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, i.e. 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, i.e. 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.\* Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement<sup>?</sup> that a group of hedged assets or liabilities must be "similar" and the related requirement<sup>+</sup> 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 39<sup>◇</sup> prohibits the designation of an overall net position (e.g. 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 re-designation 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.\*\* 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.<sup>†</sup> This, too, gives rise to significant systems needs.

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\* see IAS 39, paragraph AG105

? see IAS 39, paragraph 78

+ see IAS 39, paragraph 83

◇ see IAS 39, paragraph AG101

\*\* see IAS 39, paragraph 89(b)

† see IAS 39, paragraph 92

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;<sup>\*</sup> and
- (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 (i.e. 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, i.e. 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 34, 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 (e.g. 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.

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<sup>\*</sup> Subject to the same materiality considerations that apply in this context as throughout IFRSs.

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 (i.e. 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 (e.g. 0-10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, i.e. 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 39\* requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (i.e. 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 39<sup>†</sup> 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 (e.g. several years). Rather, these deposits are usually expected to be withdrawn within a short time (e.g. 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

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\* see IAS 39, paragraph AG76

† see IAS 39, paragraph 49

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 (e.g. 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 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, i.e. 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*, i.e. 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, i.e. 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 (e.g. 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 39\* that "the fair value of a financial liability with a demand feature (e.g. 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.

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

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\* see IAS 39, paragraph 49

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<sup>\*\*</sup>, whereas designating an overall net position is not. IAS 39<sup>†</sup> 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, i.e. there is no cash flow exposure to interest rates.<sup>⌘</sup> 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.

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<sup>\*\*</sup> see IAS 39, paragraph 84

<sup>†</sup> see IAS 39, paragraph AG101

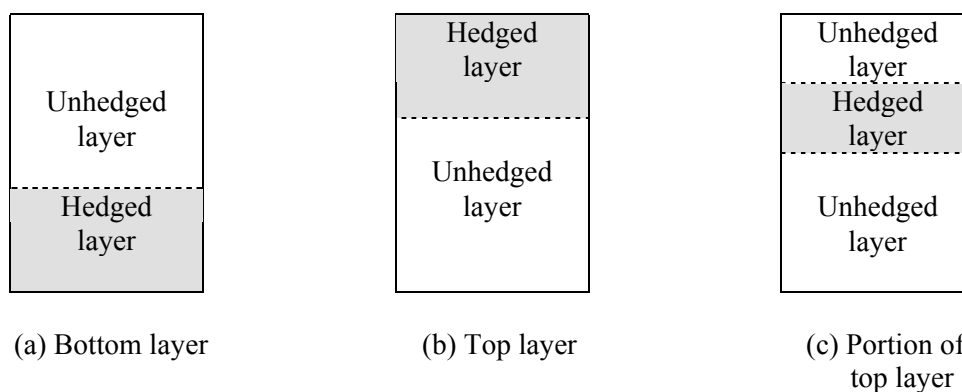
<sup>⌘</sup> see Guidance on Implementing IAS 39, Question and Answer F.6.3.

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.

*Layer approach*

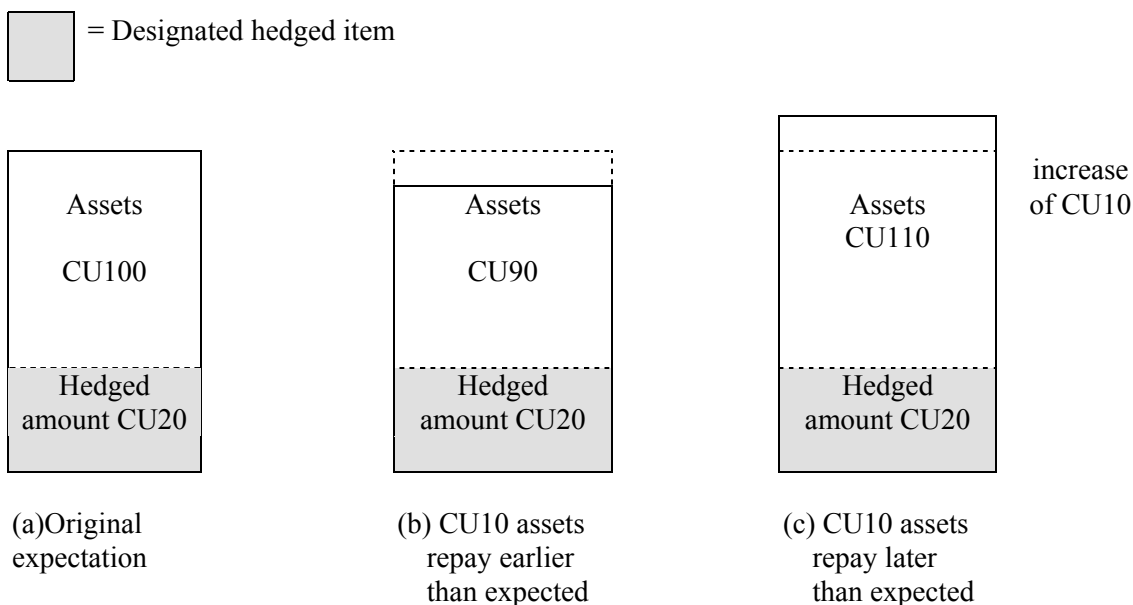
BC196. The first of these approaches, illustrated in figure 1, designates the hedged item as a 'layer' (e.g. (a) the bottom layer, (b) the top layer or (c) a portion of the top layer) of the assets (or liabilities) in a repricing time period. In this approach, the portfolio of CU100 in the above example 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**

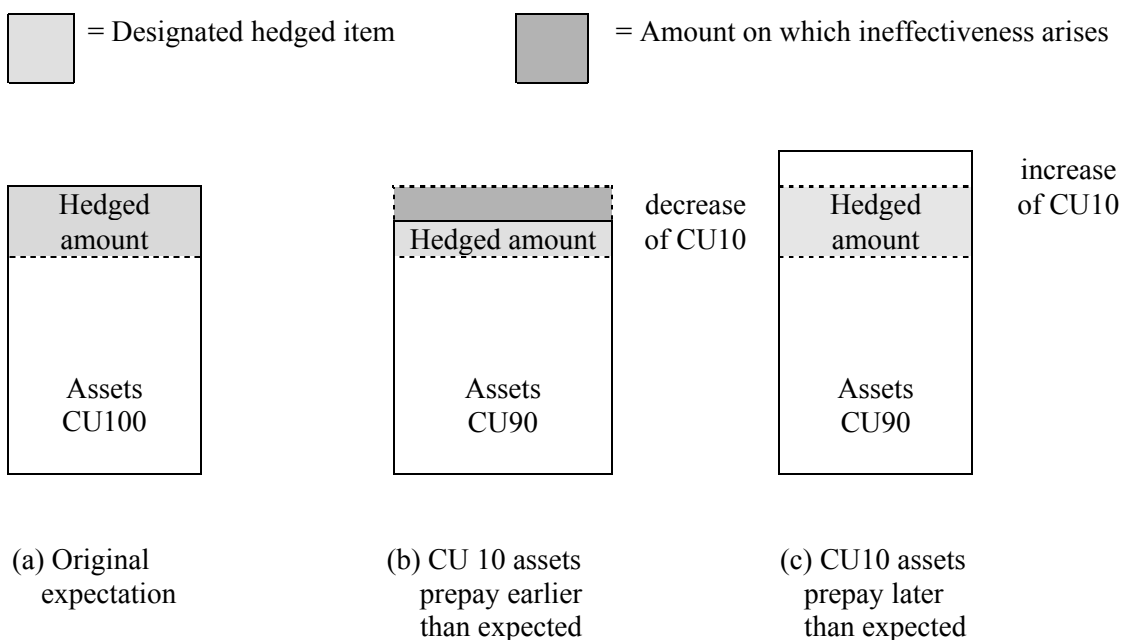


BC197. The Board noted that the layer approach does not result in the recognition of ineffectiveness in all cases when the estimated amount of assets (or liabilities) changes. For example, in a bottom layer approach (see figure 2), if some assets prepay earlier than expected so that the entity revises downward its estimate of the amount of assets in the repricing time period (e.g. 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**

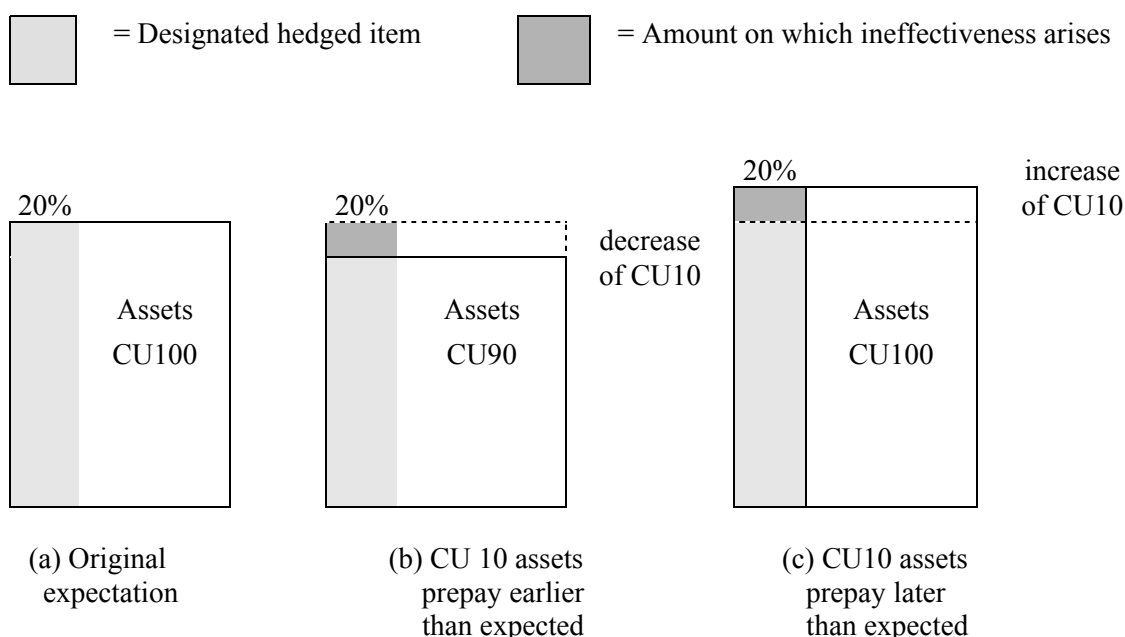


BC198. Finally, if some assets prepay *later* than expected so that the entity revises *upward* its estimate of the amount of assets in this repricing time period (e.g. from CU100 to CU110, see figures 2(c) and 3(c)), no ineffectiveness arises no matter how the layer is designated, on the grounds that 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 (e.g. 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 (e.g. 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:

- (a) 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.
- (b) 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.
- (c) 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.

- (d) 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.
- (e) 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 (i.e. the derivative exceeds the hedged item) and when it becomes underhedged (i.e. 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— i.e. 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 39<sup>\*\*\*</sup> 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 (e.g. 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.

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 contract<sup>\*</sup> (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for trading<sup>\*\*</sup>). 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.

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<sup>\*\*\*</sup> see IAS 39, paragraph 79

<sup>\*</sup> see IAS 39, paragraphs 11 and AG30(g)

<sup>\*\*</sup> see IAS 39, paragraph 12

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 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, i.e. 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 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 39\* 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.

#### *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 tests\*\* 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 (i.e.

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\* see paragraph 92

\*\* see paragraph AG105

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.

## **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. 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 (i.e. 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.

*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 (i.e. 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, i.e. any subsequent increase in fair value is recognised in equity.

*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 (i.e. ‘basis adjustment’ is prohibited), but remains in 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.

*Transition*

- (s) 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 32 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.
- (t) 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.

**Dissenting Opinions****Dissent of Anthony T Cope, James J Leisenring and Warren J McGregor**

- 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 27 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 applies 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.

**Dissent of John T Smith**

- 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.

## Illustrative Example

*This example accompanies, but is not part of, the Standard.*

### 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 (i.e. it has 60 separate monthly time periods).<sup>\*</sup> 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, i.e. 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 million 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 swap<sup>\*\*</sup> 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.

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<sup>\*</sup> 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.

<sup>\*\*</sup> The Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

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

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 (i.e. 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)\* (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.

- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20,000 ÷ CU100,000).
- (b) 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.

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\* See paragraph IE8

- (c) 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 (CU47,408<sup>+</sup> × (CU19.2 million ÷ CU20 million))

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

Dr	Cash	CU172,097	
Cr	Income statement (interest income)*		CU172,097

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

Dr	Income statement (interest expense)	CU179,268	
Cr	Income statement (interest income)		CU179,268
Cr	Cash		Nil

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

Dr	Income statement (loss)	CU47,408	
Cr	Derivative liability		CU47,408

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

Dr	Separate balance sheet line item	CU45,511	
Cr	Income statement (gain)		CU45,511

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

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 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 1/3 per cent of the assets allocated to the three-month time period, i.e. CU8 million (8 1/3 per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.\*\* On derecognition of the assets, Entity A also removes from the separate balance sheet line item an amount that represents the change in the fair value of the hedged assets that it has now sold. This is 8 1/3 per cent of the total line item balance of CU45,511, i.e. CU3,793.

<sup>+</sup> i.e. CU20,047,408 – CU20,000,000. See paragraph IE7

\* This Example does not show how amounts of interest income and interest expense are calculated.

\*\* 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.

- 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 balance sheet line item.

Dr	Cash	CU8,018,400	
Cr	Asset		CU8,000,000
Cr	Separate balance sheet line item		CU3,793
Cr	Income statement (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.<sup>+</sup> 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.\*
- IE21. As at 1 February 20x1 and after accounting for the sale of assets, the separate balance sheet line item is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6<sup>+</sup> 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.\* The remaining separate balance sheet line item of CU22,755<sup>++</sup> 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, i.e. it amortises CU22,755 over two months.
- 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)<sup>⊙</sup> (the swap is a liability).

<sup>+</sup> CU47,408 × 40 per cent

\* 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.

<sup>+</sup> CU19.2 million – (8 % × CU19.2 million)

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

<sup>++</sup> CU41,718 – CU18,963

<sup>⊙</sup> CU23,795 [see paragraph IE8] × (CU8 million ÷ CU20 million)

Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at 28 February 20x1 is CU8,009,518<sup>✕</sup>.

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

Dr	Cash	CU71,707	
Cr	Income statement (interest income)		CU71,707

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

Dr	Income statement (interest expense)	CU71,707	
Cr	Income statement (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	Income statement (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	Income statement (loss)	CU9,445	
Cr	Separate balance sheet line item		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	Income statement (loss)	CU11,378	
Cr	Separate balance sheet line item		CU11,378*

*To recognise the amortisation charge for the period.*

*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.

<sup>✕</sup> CU20,023,795 [see paragraph IE7] × (CU8 million ÷ CU20 million)

\* CU22,755 ÷ 2



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

Dr	Cash	CU8,071,707	
Cr	Asset (balance sheet)		CU8,000,000
Cr	Income statement (interest income)		CU71,707

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

Dr	Income statement (interest expense)	CU71,707	
Cr	Income statement (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	Income statement (gain)		CU9,518

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

Dr	Income statement (loss)	CU9,518	
Cr	Separate balance sheet line item		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	Income statement (loss)	CU11,377	
Cr	Separate balance sheet line item		CU11,377*

*To recognise the amortisation charge for the period.*

### Summary

IE31. The tables below summarise:

- changes in the separate balance sheet line item;
- the fair value of the derivative;
- the profit or loss effect of the hedge for the entire three-month period of the hedge; and
- interest income and interest expense relating to the amount designated as hedged.

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\* CU22,755 ÷ 2

Description	1 Jan 20x1	31 Jan 20x1	1 Feb 20x1	28 Feb 20x1	31 Mar 20x1
	CU	CU	CU	CU	CU
<b>Amount of asset hedged</b>	<b>20,000,000</b>	<b>19,200,000</b>	<b>8,000,000</b>	<b>8,000,000</b>	<b>8,000,000</b>

**(a) Changes in the separate balance sheet line item**

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)
<b>Carried forward:</b>					
<b>Balance to be amortised</b>	<b>Nil</b>	<b>Nil</b>	<b>22,755</b>	<b>11,377</b>	<b>Nil</b>
<b>Remaining balance</b>	<b>Nil</b>	<b>45,511</b>	<b>18,963</b>	<b>9,518</b>	<b>Nil</b>

**(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	Nil	-	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	-	18,963	9,518	Nil
<b>Total</b>	<b>Nil</b>	<b>47,408</b>	<b>47,408</b>	<b>9,518</b>	<b>Nil</b>

Continued...

**(c) Profit or loss effect of the hedge**

	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
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
<b>Net effect</b>	<b>Nil</b>	<b>(1,897)</b>	<b>N/A</b>	<b>Nil</b>	<b>Nil</b>
<b>Amortisation</b>	<b>Nil</b>	<b>Nil</b>	<b>N/A</b>	<b>(11,378)</b>	<b>(11,377)</b>

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**

<b>Profit or loss recognised for the amount hedged</b>	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
<b>Interest income</b>					
- on the asset	Nil	172,097	N/A	71,707	71,707
- on the swap	Nil	179,268	N/A	62,115	62,115
<b>Interest expense</b>					
- on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)