

IAS 39 Implementation Guidance Questions and Answers

as of 1 July 2001

*Approved for Issuance by the
IAS 39 Implementation Guidance Committee*



**International
Accounting Standards
Board**

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IAS 39 Implementation Guidance: Questions and Answers

Introduction

Background

IAS 39, Financial Instruments: Recognition and Measurement, establishes principles for recognising, measuring, and disclosing information about financial assets and financial liabilities. When the old IASC Board voted to approve IAS 39 in December 1998, the Board noted that, at about the same time, the United States had adopted new standards on derecognition, derivatives, and hedging, and that other countries did not have comprehensive standards on accounting for financial instruments. Consequently, the IASC Board recognised that there was little experience in applying principles similar to those in IAS 39 in most countries.

The Board instructed its staff to monitor implementation issues and to consider how IASC can best respond to such issues and thereby help financial statement preparers, auditors, financial analysts, and others understand IAS 39 and particularly those preparing to apply it for the first time.

At its meeting in March 2000, the IASC Board approved an approach to publish implementation guidance on IAS 39 in the form of Questions and Answers (Q&A). At that meeting, the Board appointed an IAS 39 Implementation Guidance Committee (IGC) to review and approve the draft Q&A and to seek public comment before approval of final Q&A. In April 2001, the IASB agreed to a continuation of that approach. At 1 July 2001, the IGC had eight members (all experts in financial instruments with backgrounds as accounting standard-setters, auditors, bankers, and preparers, from seven countries) and observers from the Basel Committee, IOSCO, and the European Commission.

Due Process

The Q&A were drafted by the IASB Staff. The questions are based largely on inquiries submitted by financial statement preparers, auditors, regulators, and other interested parties. The draft Q&A were discussed and revised by the IGC, and were approved to be posted on the IASB website for public comment by consensus of the IGC. The IGC reviewed the comments received

from the public, agreed to necessary revisions to the Q&A, and approved the Q&A for publication in final form.

This publication includes all Q&A approved in final form as of 1 July 2001. It includes final versions of the draft Q&A issued for public comment on 8 May 2000, 12 June 2000, 14 July 2000, 19 September 2000, and 20 December 2000.

Status of the implementation guidance

The implementation guidance represents the consensus view of the IGC on the appropriate interpretation and practical application of IAS 39 in a range of circumstances and takes into account comments received during the comment period. The guidance is issued to help financial statement preparers, auditors, financial analysts, and others understand IAS 39 and help ensure consistent application of the Standard.

IAS 1, Presentation of Financial Statements, requires compliance “with all the requirements of each applicable Standard and each applicable Interpretation of the Standing Interpretations Committee” if financial statements are to be described as conforming to IAS. The implementation guidance issued by the IGC does not have the status of such a Standard or Interpretation. It has not been formally considered by the Board and does not necessarily represent the views of the Board, although the Board has been able to provide comments on draft Q&A.

Since the implementation guidance has been developed to be consistent with the requirements and guidance provided in IAS 39, other Standards, Interpretations of the Standing Interpretations Committee, and the IASB Framework, enterprises should consider the guidance as they select and apply accounting policies in accordance with IAS 1.20-22.

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Scope

Paragraph 1**Question 1-1****Scope: financial guarantee contracts**

Financial guarantee contracts, including letters of credit, that provide for payments to be made if the debtor fails to make payment when due generally are excluded from IAS 39. Is a credit rating guarantee contract, under which a payment will be made if an enterprise's credit rating falls below a certain level, excluded?

No. IAS 39.1(f) indicates that to qualify for the scope exclusion, a financial guarantee contract must provide for payments to be made if the debtor fails to make payments when due. Therefore, a financial guarantee contract that provides for payments to be made if a credit rating falls below a certain level is within the scope of IAS 39.

To illustrate: Company ABC owns 100 million of Company XYZ bonds that mature in 20 years. XYZ is rated BBB by the rating agencies. ABC is concerned that XYZ may be downgraded and the value of the bonds decline. To protect against such a decline, ABC enters into a contract with a bank that will pay ABC for any decline in the fair value of the XYZ bonds related to a credit downgrade to B or below during a specified period. ABC pays a fee to the bank for entering into the contract. Because the contract pays ABC in the event of a downgrade and is not tied to any failure by XYZ to pay, it is a derivative instrument within the scope of IAS 39.

However, if ABC had bought a contract that provides for payments in the event of a failure of a debtor to pay when due, the contract is outside the scope of IAS 39 as discussed in Question 1-2.

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Paragraph 1**Question 1-2****Scope: credit derivatives**

Financial guarantee contracts that provide for payments to be made if the debtor fails to make payment when due are excluded from IAS 39. Some credit default derivatives, such as certain credit default swaps and other credit default products, contain similar provisions. Are they also excluded from IAS 39?

Yes, if the credit default derivative cannot be distinguished from a financial guarantee contract that would be excluded from IAS 39.

To illustrate: Bank A has total outstanding loans of 100 million to its largest customer, Company C. Bank A is concerned about concentration risk and enters into a credit default swap contract with Bank B to diversify its exposure without actually selling the loans. Under the terms of the credit default swap, Bank A pays a fee to Bank B at an annual rate of 50 basis points on amounts outstanding. In the event Company C defaults on any principal or interest payments, Bank B pays Bank A for any loss. There is no characteristic of the credit default swap that distinguishes it from a financial guarantee contract. Because the credit default swap provides for payments to a creditor (Bank A) in the event of failure of a debtor (Company C) to pay when due, it is outside the scope of IAS 39. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, deals with recognising and measuring financial guarantees, warranty obligations, and other similar instruments.

On the other hand, a credit derivative is within the scope of IAS 39 if payment by Bank B to Bank A is contingent on an event other than failure by Company C to make payment when due, such as a ratings downgrade or a change in credit spread above an agreed level or Company C's default on debt payable to a third party.

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Paragraph 1**Question 1-3-a****Scope: financial reinsurance**

Rights and obligations under insurance contracts are excluded from the scope of IAS 39. Does this scope exclusion apply to a reinsurance contract?

It depends. A reinsurance contract is excluded from the scope of IAS 39 if it principally transfers insurance risk. IAS 39.1(d) indicates that rights and obligations under insurance contracts as defined in IAS 32.3 are excluded from the scope of IAS 39. IAS 32.3 defines an insurance contract as a contract that exposes an insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death, sickness, disability, property damage, injury to others and business interruption. Moreover, IAS 32.3 indicates that the provisions in the Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks. Therefore, a reinsurance contract is within the scope of IAS 39 if it principally involves the transfer of financial risks (a financial reinsurance contract). Financial risks include currency risk, interest rate risk, market risk, credit risk, liquidity risk, and cash flow risk (IAS 32.43). For instance, a reinsurance contract that simply requires the reinsurer to make a series of fixed payments beginning in five years does not contain any insurance risk and is accounted for under IAS 39. A reinsurance contract that is within the scope of IAS 39 is accounted for as a derivative if it meets the definition of a derivative in IAS 39.10.

Regardless of whether an insurance or reinsurance contract is included within the scope of IAS 39, it may contain an embedded derivative that must be separated and accounted for as a derivative in accordance with IAS 39. However, if the insurance or reinsurance contract is within the scope of IAS 39 and is a derivative, then the entire contract is accounted for as a derivative, and the embedded derivative is not separated.

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Paragraph 1**Question 1-3-b****Scope: insurance contracts**

Question 1-3 specifies that a reinsurance contract is within the scope of IAS 39 if it principally involves the transfer of financial risks. Is an insurance contract that principally involves the transfer of financial risks within the scope of IAS 39?

Yes, a contract that takes the form of an insurance contract but principally involves the transfer of financial risks is within the scope of IAS 39.

To illustrate: Insurance Company A sells an insurance policy for 1,000 to Customer B. In five years, Insurance Company A will pay the policyholder 1,000 multiplied by the change in a securities market index. The amount of the payment is not a reimbursement for a cost or loss incurred as a result of events or circumstances such as death, sickness, disability, property damage, injury to others, or business interruption. In this case, the insurance contract is a financial instrument that is included in the scope of IAS 39.

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Paragraph 1**Question 1-4****Scope: investments in associates**

Are investments in associates that are held exclusively with a view to their disposal in the near future accounted for under IAS 39 in the separate financial statements of an investor that issues consolidated financial statements?

Yes.

IAS 39.1 states that IAS 39 should be applied by all enterprises to all financial instruments with certain specified exceptions. IAS 39.1(a) states that IAS 39 should not be applied to those interests in associates that are accounted for under IAS 28. IAS 28.12 states how an investor that issues consolidated financial statements should account for an investment in an associate in the investor's separate financial statements. This paragraph, as amended by IAS 39, excludes from its scope investments that are held exclusively with a view to their disposal in the near future. Thus, IAS 28 contains no rules about how an investor that issues consolidated financial statements should account for an investment in an associate in the investor's separate financial statements when the investment is held exclusively with a view to its disposal in the near future. Accordingly, such investments are included within the scope of IAS 39.

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Paragraph 1**Question 1-5-a****Scope: financial guarantee contracts**

Company A holds a financial guarantee contract that provides for payments to be made if a debtor fails to make payment when due. However, Company A is not exposed to a loss with respect to non-payment of this debtor (for instance, because Company A does not hold the debt asset that is referenced in the financial guarantee contract). Is the financial guarantee contract excluded from the scope of IAS 39 from the perspective of Company A?

No. Such a financial guarantee contract is not excluded from the scope of IAS 39.

IAS 39.1(f) states that financial guarantee contracts "that provide for payments to be made if the debtor fails to make payments when due" are excluded from the scope of IAS 39. This paragraph refers to a debtor of the holder of the financial guarantee contract (thus, "the debtor"). Therefore, financial guarantee contracts that provide for payments to be made if a debtor fails to make payment when due are only excluded from the scope of IAS 39 if the holder of the financial guarantee contract is exposed to a loss on the debt asset that is referenced in the financial guarantee contract. A financial guarantee contract qualifies for the scope exclusion in IAS 39.1(f) if, and only if, the contract, as a precondition for payment, requires that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.

The guidance in this Question applies also to a credit default derivative that cannot be distinguished from a financial guarantee contract as discussed in Question 1-2.

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Paragraph 1**Question 1-5-b****Scope: issued financial guarantee contract**

Question 1-5-a specifies that from the perspective of the holder of a financial guarantee contract (or credit derivative), for the contract to be excluded from the scope of IAS 39 under IAS 39.1(f), the holder must be exposed to a loss with respect to the non-payment of the debtor. The loss exposure must be from non-payment by a debtor of the holder of the financial guarantee contract. From the perspective of the issuer of the contract, does the contract have to require that the holder be exposed to such a loss in order for the contract to be excluded from the scope of IAS 39?

Yes. As discussed in Question 1-5-a, a financial guarantee contract qualifies for the scope exclusion in IAS 39.1(f) if, and only if, the contract, as a precondition for payment, requires that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.

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Paragraph 1**Question 1-6****Scope: contracts with more than one underlying**

A contract has more than one underlying variable and one of those underlying variables indicates that the contract is excluded from the scope of IAS 39 under IAS 39.1(h) while others indicate that the contract is within the scope of IAS 39, for instance, an interest rate swap for which payment is contingent on heating degree days (a climatic variable). Is that contract within the scope of IAS 39?

Yes. In the example, the contract contains an embedded derivative (an interest rate swap) and a derivative host that is scoped out of IAS 39 by IAS 39.1(h) (a weather derivative). Since the host contract is outside the scope of IAS 39, the enterprise separates the embedded derivative from the host as provided for in IAS 39.23. If the enterprise is unable to separate and separately measure an embedded derivative based on the underlying variables that are within the scope of IAS 39, it treats the entire combined contract as a financial instrument held for trading (IAS 39.26).

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Definitions

Paragraph 8**Question 8-1****Definition of a financial instrument: gold bullion****Is gold bullion a financial instrument (like cash) or is it a commodity?**

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

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Paragraph 10**Question 10-1****Definition of a derivative: examples of derivatives and underlyings****What are examples of common derivative contracts and the identified underlying?**

IAS 39 defines a derivative as follows:

A derivative is a financial instrument:

- (a) *whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying');*
- (b) *that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and*
- (c) *that is settled at a future date.*

<i>Type of contract</i>	<i>Main pricing-settlement variable (Underlying variable)</i>
Interest Rate Swap	Interest rates
Currency Swap (Foreign Exchange Swap)	Currency rates
Commodity Swap	Commodity prices
Equity Swap	Equity prices (equity of another enterprise)
Credit Swap	Credit rating, credit index, or credit price
Total Return Swap	Total fair value of the reference asset and interest rates
Purchased or Written Treasury Bond Option (call or put)	Interest rates
Purchased or Written Currency Option (call or put)	Currency rates
Purchased or Written Commodity Option (call or put)	Commodity prices

<i>Type of contract</i>	<i>Main pricing-settlement variable (Underlying variable)</i>
Purchased or Written Stock Option (call or put)	Equity prices (equity of another enterprise)
Interest Rate Futures Linked to Government Debt (Treasury Futures)	Interest rates
Currency Futures	Currency rates
Commodity Futures	Commodity prices
Interest Rate Forward Linked to Government Debt (Treasury Forward)	Interest rates
Currency Forward	Currency rates
Commodity Forward	Commodity prices
Equity Forward	Equity prices (equity of another enterprise)

The above list provides examples of contracts that normally qualify as derivatives under IAS 39. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of IAS 39 may apply, for instance, if it is a weather derivative (see IAS 39.1 and IAS 39.2) or a commodity contract (see IAS 39.6, IAS 39.7, and IAS 39.14). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

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Paragraph 10**Question 10-2**

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

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

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

To illustrate: Company ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8.00 per cent and receive a variable amount based on three month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a 100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8.00 percent and three month LIBOR. Alternatively, settlement may be on a gross basis.

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

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Paragraph 10**Question 10-3****Definition of a derivative: gross exchange of currencies**

One of the qualifying characteristics of a derivative is that it requires no or little initial net investment (IAS 39.10). Is a currency swap that requires an exchange of different currencies of equal fair values at inception a derivative?

Yes. The definition of a derivative instrument includes such currency swaps. The initial exchange of currencies of equal fair values does not result in an initial net investment in the contract. Instead, it is an exchange of one form of cash for another form of cash of equal value. Also, the contract has underlying variables (the foreign exchange rates) and it will be settled at a future date.

To illustrate: Company A and Company B enter into a five year fixed-for-fixed currency swap on euros and US dollars. The current spot exchange rate is 1 euro per dollar. The five-year interest rate in the United States is 8 per cent, while the five-year interest rate in euro countries is 6 per cent. At the initiation of the swap, Company A pays 20 million euros to Company B, which in return pays 20 million dollars to Company A. During the life of the swap, Company A and Company B make periodic interest payments to each other without netting. Company B pays 6 per cent per year on the 20 million euros it has received (1.2 million euros per year), while Company A pays 8 per cent per year on the 20 million dollars it has received (1.6 million dollars per year). At the termination of the swap, the two parties again exchange the original principal amounts. The currency swap is considered to be a derivative financial instrument under IAS 39 since the contract involves no initial net investment (only an exchange of one currency for another of equal fair values), it has an underlying, and it will be settled at a future date.

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Paragraph 10**Question 10-4-a****Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)**

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

Yes.

To illustrate: Company S enters into a 100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap resets on a quarterly basis to three month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Company S prepays its fixed obligation under the swap of 50 million (100 million x 10 per cent x 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the 100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires little initial net investment relative to other types of contracts that have a similar response to changes in market conditions, such as a variable rate bond. Therefore, the contract fulfils the “no or little initial net investment” provision of IAS 39. Even though Company S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is considered to be a derivative contract.

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

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

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Paragraph 10**Question 10-4-b**

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

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

No, a prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid subsequent to inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the “no or little initial net investment” criterion of a derivative instrument.

To illustrate: Company S enters into a 100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap resets on a quarterly basis to three month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap’s notional amount, that is, 10 million per year. Company S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on 100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Company S knows it will receive 10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the no or little net investment criterion of IAS 39. Therefore, the contract is not accounted for as a derivative under IAS 39. By discharging the obligation to pay variable interest rate payments, Company S effectively extends an annuity loan to Company C. In this situation, the instrument is accounted for as a loan originated by the enterprise unless Company S has the intent to sell it immediately or in the short term (IAS 39.10).

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Paragraph 10

Question 10-5

Definition of a derivative: contract to purchase fixed rate debt

Is a forward contract to purchase a fixed rate debt instrument (such as a mortgage) at a fixed price accounted for as a derivative?

Yes. It meets the definition of a derivative because there is no or little initial net investment, there is an underlying variable (interest rates), and it will be settled in the future. The transaction is accounted for as a regular way transaction, however, if regular way delivery is required (see IAS 39.27 and IAS 39.30). Regular way delivery is discussed in Questions 16-1 and 30-1.

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Paragraph 10**Question 10-6**

Definition of a derivative: settlement amount does not vary proportionately

Is a financial instrument a derivative if its settlement amount can change but not proportionately with the underlying?

Yes, provided that the other characteristics of a derivative are present. For example, the following contract is a derivative: XYZ enters into a contract that requires XYZ to pay 10 million if ABC stock increases by 5 or more per share during a six month period; XYZ will receive 10 million if ABC stock decreases by 5 or more per share during the same six month period; no payment will be made if the price swing is less than 5 up or down. In this example, the underlying is a security price, ABC stock. However, there is no notional amount to determine the settlement amount. Instead, there is a payment provision that is based on changes in the underlying.

As IAS 39.13 states, “a derivative could require a fixed payment as a result of some future event that is unrelated to a notional amount”.

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Paragraph 10**Question 10-7**

Definition of originated loans and receivables: banks’ deposits in other banks

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, and other times not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit be classified as an originated loan?

Such a deposit is an originated loan, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the short term, in which case the deposit is a financial asset held for trading because the definition of an originated loan in IAS 39.10 excludes an instrument intended to be sold immediately or in the short term.

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Paragraph 10**Question 10-8****Definition of a derivative: offsetting loans**

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

Yes. This meets the definition of a derivative (that is, there is an underlying variable, no or little initial net investment, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

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

The same answer would apply if Company A and Company B did not have a netting agreement, because the definition of a derivative instrument in IAS 39.10 does not require net settlement.

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Paragraph 10**Question 10-9****Definition of trading activities: balancing a portfolio**

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

It depends. Company A classifies the securities as trading or available-for-sale depending on its intent and past practice. If the portfolio manager is authorised to buy and sell securities to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the securities are classified as available-for-sale. If the portfolio manager actively buys and sells securities to generate short-term profits, the financial instruments in the portfolio are classified as held for trading. IAS 39.107 states that an enterprise should reclassify a financial asset into the trading category only if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification.

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Paragraph 10**Question 10-10****Definition of a derivative: initial net investment**

One of the defining characteristics of a derivative instrument is that it requires little or no initial net investment relative to other types of contracts that have a similar response to changes in market conditions (subparagraph (b) of the definition of a derivative in IAS 39.10). What constitutes little or no initial net investment?

Professional judgement is required in determining what constitutes little or no initial net investment. IAS 39.15 states that an option contract meets the definition of little or no investment because the premium is significantly less than the investment that would be required to obtain the underlying financial instrument to which the option is linked.

IAS 39.10 and IAS 39.15 require that the phrase “little initial net investment” be interpreted on a relative basis – the initial net investment is less than that needed to acquire a primary financial instrument with a similar response to changes in market conditions. This reflects the inherent leverage features typical of derivative agreements compared to the underlying instruments. If, for example, a ‘deep in the money’ call option is purchased (that is, the option’s value consists mostly of intrinsic value), a significant premium is paid. If the premium is equal or close to the amount required to invest in the underlying instrument, this would fail the “little initial net investment” criterion.

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Paragraph 10**Question 10-11-a****Definition of originated loans and receivables**

Is a debt security, such as a bond, that is purchased at original issuance classified as an originated loan if the funds are transferred directly to the issuer?

Yes, unless the intent is to sell the debt instrument immediately or in the short term, in which case the debt instrument is classified as held for trading. IAS 39.10 defines originated loans and receivables as financial assets that are created by the enterprise by providing money, goods, or services directly to a debtor, other than those that are originated with the intent to be sold immediately or in the short term. This definition does not distinguish between loans that take the form of securities and those that do not.

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Paragraph 10**Question 10-11-b****Definition of originated loans and receivables: equity security**

Question 10-11-a specifies that a debt security may potentially be classified as an originated loan if the funds are transferred directly to the issuer. Can an equity security, such as a preferred share, with fixed or determinable payments and fixed maturity be classified as an originated loan by the holder if the funds are transferred directly to the issuer?

Yes. Since the definition of loans and receivables originated by the enterprise in IAS 39.10 refers to a debtor, most equity securities cannot be classified as originated loans. However, if an equity security would be recorded as a liability by the issuer because it has fixed or determinable payments and fixed maturity, it can potentially be classified as an originated loan by the holder. IAS 32.18-22 provide guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an equity security is an equity instrument under IAS 32, it cannot be classified as an originated loan by the holder.

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Paragraph 10**Question 10-12****Definition of amortised cost: debt instruments with stepped interest payments**

Sometimes enterprises purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively (“stepped interest”) over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at 1,250 and has a maturity amount of 1,250, would the amortised cost equal 1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an enterprise uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a level yield to maturity, that is, a constant rate on the carrying amount (IAS 39.10, IAS 39.73, and IAS 39.93).

To illustrate: On 1 January 2000, Company A issues a debt instrument for a price of 1,250. The principal amount is 1,250 and the debt instrument is repayable on 31 December 2004. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 percent in 2000 (75), 8.0 percent in 2001 (100), 10.0 percent in 2002 (125), 12.0 percent in 2003 (150), and 16.4 percent in 2004 (205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 percent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortised cost in each period. In each period, the amortised cost at the beginning of the period is multiplied by the effective interest rate of 10 percent and added to the amortised cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortised cost in each period is as follows:

<i>Year</i>	<i>(a) Amortised cost at the beginning of the year</i>	<i>(b = (a) × 10%) Reported interest</i>	<i>(c) Cash flows</i>	<i>(d) Amortised cost at the end of the year</i>
2000	1,250	125	75	1,300
2001	1,300	130	100	1,330
2002	1,330	133	125	1,338
2003	1,338	134	150	1,322
2004	1,322	133	1,250+205	0

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Paragraph 10**Question 10-13**

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

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

No. Since there are no repayments of principal, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (IAS 39.10).

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Paragraph 10**Question 10-14**

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

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

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

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Paragraph 10**Question 10-15**

Definition of held for trading: purpose of acquisition

If an enterprise acquires a non-derivative financial asset with an intention to hold it for a long period irrespective of short-term fluctuations in price, can it classify it as held for trading?

No, such a financial asset cannot be classified as held for trading. The definition of an asset held for trading in IAS 39.10 requires that the instrument was acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. There is no definition of "short term" in IAS 39. An enterprise should adopt a definition of short term and apply a consistent approach to the definition used. After being designated as held for trading, a single instrument in a portfolio may in fact be held for a longer period of time, for example, a year. IAS 39 requires that there be an intent to profit from short-term price fluctuations, but it does not limit the time period in which an instrument that is designated as being held for trading on acquisition can be held.

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Paragraph 10**Question 10-16****Definition of held-to-maturity investment: high default risk**

Is an enterprise precluded from classifying a bond with fixed or determinable payments and fixed maturity that is particularly vulnerable to default by the borrower due to significant business, financial, or economic uncertainties as a held-to-maturity investment?

No. The definition of a held-to-maturity investment in IAS 39.10 requires that the payments on a held-to-maturity investment be contractually fixed or determinable. IAS 39.80 states that “fixed or determinable payments and fixed maturity means a contractual arrangement that defines the amounts and dates of payment...”. Even if there is a significant risk of non-payment of interest and principal on a bond, for instance, as evidenced by a low-grade rating of the bond issue, the contractual payments on the bond may be fixed or determinable. The likelihood of default is not a consideration in qualifying for the held-to-maturity category as long as there is an intent and ability, considering the credit condition existing at the acquisition date, to hold the instrument to maturity (see Question 83-7).

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Paragraph 10**Question 10-17****Definition of held-to-maturity investment: fixed maturity**

The definition of a held-to-maturity investment requires that the instrument have a fixed maturity (IAS 39.10). Can a perpetual debt instrument with fixed or determinable payments and for which the only cash payments under the terms of the instrument are interest payments during a limited period, for instance, 10 years, be classified as a held-to-maturity investment?

Yes. The amount invested is recovered through fixed or determinable payments, and the rights in liquidation have no present value. Thus, the final date on which interest is paid is in effect the maturity date of such a financial instrument (see Question 10-14). Therefore, the instrument has a fixed maturity and can potentially meet the definition of a held-to-maturity investment. However, if the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as a held-to-maturity investment because there is no maturity date.

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Paragraph 10**Question 10-18****Definition of a derivative: option not expected to be exercised**

The definition of a derivative in IAS 39.10 requires that the instrument “is settled at a future date”. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

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

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Paragraph 10**Question 10-19****Effective interest method: expected future cash flows**

Bank A originates 1,000 10-year loans of 10,000 with 10% stated interest. Prepayments are probable and it is possible to reasonably estimate the timing and amount of prepayments. Bank A determines that the effective interest rate considering loan origination fees is 10.2% based on the contractual payment terms of the loans since the fees received reduce the initial carrying amount. However, if the expected prepayments are considered, the effective interest rate would be 10.4% since the difference between the initial amount and maturity amount is amortised over a shorter period. Should Bank A consider estimates of future principal repayments in the calculation of the effective interest rate on the loans?

Yes. IAS 39.10 defines the effective interest rate as the rate that exactly discounts the expected stream of future cash payments through maturity or the next market-based repricing date to the net carrying amount. Accordingly, the determination of the effective interest rate must be based on expected cash payments rather than contractual cash payments.

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Paragraph 11**Question 11-1****Liability vs. equity classification**

An enterprise issues a put option on its own shares, receiving cash for the option premium. If the put is exercised, the enterprise is required to settle in its own common shares either on a net or gross share basis (in which case the option holder will deliver a fixed number of shares to the enterprise). Is the put (the credit against the cash received) a liability or equity?

Equity. The proceeds of the sale by an enterprise of a put option on its own common shares are classified as equity, providing the issuer is required to settle in shares or net shares. The enterprise does not have an obligation to deliver cash or another financial asset or to exchange financial instruments under conditions that are potentially unfavourable (IAS 39.8) even if the put is in the money. Also, IAS 32.A18 indicates that options are equity instruments if exercise would require the writer to issue common shares.

To illustrate: On 1 January, the price of Company A's shares is 90. On that date, Company A issues a European put option to Company B on 100 of A's own shares with a specified strike price of 95 per share ($95 \times 100 = 9,500$). Company A is required to settle the put in shares on its expiration date (31 March). Company B pays Company A 4.70 per share for the put ($4.70 \times 100 = 470$). Company A records the proceeds as a credit to equity.

On 31 March, the share price is still 90, and B exercises its put option. If the transaction is settled without netting, A receives 100 shares with a total value of 9,000 (90×100) and delivers shares with a total value of 9,500 (95×100), that is, 105.56 shares ($9500/90$). If the transaction is settled net, A delivers 5.56 shares ($105.56 - 100$).

Would the answer change if the enterprise is required to settle in cash, or if the holder of the put has a right to require cash settlement?

Yes. In these circumstances, the issuer is either required to settle in cash or can be compelled by the holder to settle in cash. As a result, the enterprise has an obligation to deliver cash or exchange financial instruments (receive shares and deliver cash) under conditions that are potentially unfavourable.

Therefore, the put option is a liability (IAS 39.8). It is accounted for as a derivative.

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Paragraph 13**Question 13-1****Definition of a derivative: royalty agreements**

XYZ enters into a contract to pay a royalty to A in exchange for XYZ's use of certain property of A. The contract is not exchange traded. The amount of the royalty is based on the volume of sales or service revenues of XYZ. Is the contract accounted for as a derivative under IAS 39?

No. IAS 18, Revenue, provides accounting guidance for royalty agreements.

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Paragraph 13**Question 13-2****Definition of a derivative: foreign currency contract based on sales volume**

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

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), little or no initial net investment, and a payment provision. IAS 39 does not exclude derivatives that are based on sales volume from its scope.

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Paragraph 14**Question 14-1****Practice of settling net: forward contract to purchase a commodity**

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

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if Company XYZ intends to settle the contract by taking delivery and has no history of settling in cash, the contract is not accounted for as a derivative under IAS 39. Instead, it is accounted for as an executory contract.

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Paragraph 14**Question 14-2****Forward contract to purchase a commodity: pattern of net settlement**

Company A enters into a forward contract to purchase a commodity or other non-financial asset that contractually is to be settled by taking delivery. Company A has an established pattern of settling such contracts prior to delivery by contracting with a third party. Company A settles any market value difference for the contract price directly with the third party. Does that pattern of settlement prohibit Company A from qualifying for the exemption based on normal delivery?

Yes, the contract is accounted for as a derivative. IAS 39 applies to a contract to purchase a non-financial asset if the contract meets the definition of a derivative (IAS 39.10) and the contract does not qualify for the exemption for delivery in the normal course of business (IAS 39.14). In this case, Company A does not expect to take delivery. IAS 39.14 notes that a pattern of entering into offsetting contracts that effectively accomplishes settlement on a net basis does not qualify for the exemption for delivery in the normal course of business. The contract would not be accounted for as a derivative, however, if Company A intends to take delivery and taking delivery is consistent with past practice of Company A.

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Paragraph 14-3**Question 14-3****Option to put a non-financial asset**

Company XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for 150 million. The current value of the building is 175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intent and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (IAS 39.7 and IAS 39.14).

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

However, if the contract required physical delivery and the reporting enterprise had no past practice of settling net in cash, the contract would not be accounted for as a derivative.

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Paragraph 15**Question 15-1****Definition of a derivative: prepaid forward**

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

No. The forward contract fails the "no or little initial net investment" test for a derivative.

To illustrate: XYZ Company enters into a forward contract to purchase one million shares of T common stock in one year. The current market price of T is 50 per share; the one-year forward price of T is 55 per share. XYZ is required to prepay the forward contract at inception with a 50 million payment. The initial investment in the forward contract of 50 million is less than the notional amount applied to the underlying, one million shares at the forward price of 55 per share, that is, 55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of 50. Accordingly, the prepaid forward contract does not meet the initial net investment criteria of a derivative instrument.

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Paragraph 15**Question 15-2****Definition of a derivative: initial net investment**

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

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

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Paragraph 16**Question 16-1****“Regular way” contracts: no established market**

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

Yes. IAS 39.16 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the market place concerned. Market place, as that term is used in IAS 39.16, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue securities can be a market place. Another example relating to a bank loan commitment is considered in Question 30-1.

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Paragraph 16**Question 16-2****“Regular way” contracts: forward contract**

Company ABC enters into a forward contract to purchase 1,000,000 shares of M common stock in two months for 10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty 10 million in cash. M's shares trade in an active public securities market at an average of 100,000 shares a day. Regular-way delivery is three days. Is the forward contract considered a regular way contract?

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

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Paragraph 16**Question 16-3****“Regular way” contracts: which customary settlement provisions apply?**

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

The provisions in the market in which the purchase actually takes place.

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

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

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Paragraph 16**Question 16-4****“Regular way” contracts: share purchase by call option**

Company A purchases a call option in a public market permitting it to purchase 100 shares of XYZ Company at any time over the next three months at a price of 100 per share. If Company A exercises its option, it has fourteen days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a “regular way” purchase of shares?

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

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Paragraph 18**Question 18-1****Liabilities held for trading: short sales**

How does an enterprise account for a short sale, such as a sale of a financial asset that it has borrowed under a securities borrowing agreement and that it has not recorded as an asset?

IAS 39.18 indicates that a short seller accounts for the obligation to deliver securities that it has sold as a liability held for trading. Therefore, if an enterprise sells an unrecorded financial asset that is subject to a securities borrowing agreement, the enterprise recognises the proceeds from the sale as an asset, and the obligation to return the asset as a liability held for trading measured at fair value.

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Paragraph 18

Question 18-2

Liability held for trading: short sales of loan assets

If an enterprise sells loan assets that it has borrowed and receives payment, would the obligation to deliver the loan assets to the lender of the loan assets be classified as a liability held for trading?

Yes. IAS 39.18 specifies that liabilities held for trading include derivative liabilities and securities that are sold short. If an enterprise makes a short sale of another type of financial instrument than securities, the obligation would also be classified as a liability held for trading.

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Paragraph 22

Question 22-1

Embedded derivatives: separation of host debt instrument

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

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the enterprise makes its own judgement of the terms. However, an enterprise may not identify a component that is not specified or establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is, it cannot create a cash flow that does not exist. For instance, if a five-year debt instrument has fixed interest payments of 40,000 annually and a principal payment at maturity of 1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays 40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

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

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Paragraph 23

Question 23-1

Embedded derivatives: presentation

In certain cases, IAS 39 requires that an embedded derivative be separated from a host contract. The embedded derivative must then be accounted for separately as a derivative at fair value. Does that require separating them in the balance sheet?

No. IAS 39 does not address the presentation in the balance sheet of embedded derivatives. However, IAS 32.46 and 32.77 require separate disclosure of financial assets carried at cost and financial assets carried at fair value.

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Paragraph 23**Question 23-2****Embedded derivatives: accounting for convertible bond**

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

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

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

If the bond is classified as available-for-sale with fair value changes recognised directly in equity until the bond is sold, the equity conversion option (the embedded derivative) is generally separated. The amount paid for the bond is split between the debt security without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognised in the income statement unless the option is part of a cash flow hedging relationship.

If the convertible bond is carried at fair value with changes in fair value reported in net profit or loss, separating the embedded derivative from the host bond is not permitted (IAS 39.23(c)).

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Paragraph 23**Question 23-3****Embedded derivatives: allocation of carrying amounts**

How should the initial carrying amounts of a host and embedded derivative be determined if separation is required?

Since the embedded derivative must be recorded at fair value with changes in fair value reported in net profit or loss, the initial carrying amount assigned to the host contract on separation is determined as the difference between the cost (fair value of the consideration given) for the hybrid (combined) instrument and the fair value of the embedded derivative. IAS 32.28 suggests, as one method of separating the liability and equity components contained in a compound financial instrument, to allocate the aggregate carrying amount based on the relative fair values of the liability and equity components. However, IAS 32.28 is not applicable to the separation of a derivative from a hybrid instrument under IAS 39. It would be inappropriate to allocate the basis in the hybrid instrument under IAS 39 to the derivative and non-derivative components based on their relative fair values, since that might result in an immediate gain or loss being recognised in net profit or loss on the subsequent measurement of the derivative at fair value.

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Paragraph 23**Question 23-4****Separation of embedded derivatives**

Is an enterprise permitted to separate an embedded derivative and account for it as a derivative under IAS 39, if it is not required to separate the embedded derivative under IAS 39?

No. IAS 39.25 states that an enterprise does not account for the embedded derivative separately if the economic characteristics and risks of the embedded derivative are considered to be closely related to the economic characteristics and risks of the host contract. Thus, IAS 39 does not allow enterprises to separate embedded derivatives where such separation is not required.

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Paragraph 23**Question 23-5****Commodity-indexed interest**

Company A issues a debt instrument on which it pays interest indexed to the price of gold. Is there an embedded derivative that should be separated and accounted for as a derivative under IAS 39?

Yes. IAS 39.24(e) specifies that commodity-indexed interest would not be considered closely related to a host debt instrument. Therefore, Company A separates the embedded derivative, a forward indexed to the price of gold, from the host debt instrument and measures the derivative at fair value.

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Paragraph 23**Question 23-6**

Embedded derivatives: transferable derivative that is attached to a non-derivative financial instrument

A non-derivative financial instrument has an attached derivative instrument that is contractually transferable independently of the non-derivative financial instrument, for instance, an option that can be transferred independently of a bond. Is the derivative instrument treated as a stand-alone derivative under IAS 39 or as an embedded derivative that is accounted for separately only if the conditions in IAS 39.23 are met?

Such a derivative instrument is not a component of a single financial instrument (an embedded derivative), but is a stand-alone derivative instrument. The description of an embedded derivative in IAS 39.23 does not refer to a derivative instrument that may be sold or traded separately and which may have other counterparties than the non-derivative instrument to which it is attached. Therefore, IAS 39.23 is not applied to determine if the derivative should be separated.

For instance, a call option which is attached to a debt instrument and that is transferable by the issuer (or the holder) and thus is potentially exercisable by a party other than the issuer (or the holder) of the bond, can result in different sets of counterparties for the derivative and the bond. Such an option is not considered an embedded derivative.

As discussed in Question 23-7, a derivative that is attached to a contract by a third party is also viewed as a stand-alone derivative.

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Paragraph 23**Question 23-7**

Embedded derivatives: derivative attached to a financial instrument by a third party

A derivative is added to a non-derivative financial instrument by a third party contemporaneously with or subsequent to the issuance of the non-derivative financial instrument, for instance, a put or call option that is added to a debt instrument by a third party. Is the derivative treated as a stand-alone derivative under IAS 39 or as an embedded derivative that is accounted for separately only if the conditions in IAS 39.23 are met?

Such a derivative is treated as a stand-alone derivative under IAS 39. The description of an embedded derivative refers to provisions incorporated in a single contract and not to provisions in separate contracts, which may have different counterparties. Therefore, IAS 39.23 is not applied to determine if the derivative should be separated.

To illustrate: Company A issues a 15-year bond to Investment Bank B for 102. Investment Bank B attaches a call option to the bond and sells the bond with the attached call option to Investor C for 100. The call option is a written option from the perspective of Investor C and a purchased option from the perspective of Investment Bank B. The Investment Bank sells the call option to Company A. Since the option was attached to the bond by a third party, it is treated as a stand-alone derivative under IAS 39.

As discussed in Question 23-6, a derivative that is attached to a non-derivative financial instrument is also viewed as a stand-alone derivative if it is separately transferable by either the issuer or the holder even though it was not attached by a third party.

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Paragraph 23**Question 23-8****Embedded derivatives: more than one embedded derivative****Can a host instrument have more than one embedded derivative that may be required to be separated under IAS 39.23?**

Yes, but only if those embedded derivatives are clearly present in the hybrid instrument as evidenced by the contractual terms and the economic substance of the hybrid instrument, relate to different risk exposures, and are readily separable and independent of each other. Also, any embedded non-option derivative must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument (see Question 22-1). Without these conditions, a single hybrid instrument could be decomposed into an infinite number of combinations of embedded derivatives, for instance, by creating financing components, leverage, asymmetry, or risk exposures not already present in the hybrid instrument. Also, it would be possible to separate embedded derivative features that can only be valued in combination with other embedded derivative features, for instance, because they are mutually exclusive or otherwise interdependent.

In many cases, embedded derivative features should not be separated. As an example, if a debt instrument has a principal amount related to an equity index and that amount doubles if the equity index exceeds a certain level, it is not appropriate to separate both a forward and an option on the equity index because those derivative features relate to the same risk exposure. Instead the forward and option elements are treated as a unit as a single compound, embedded derivative. For the same reason, an embedded floor or cap on interest rates should not be separated into a series of floorlets or caplets. In addition, if a single hybrid instrument contains both a put option and a written call option on the hybrid instrument that are required to be separated, for example, a callable debt instrument with a put to the holder, those options are treated as a single embedded derivative because they are not independent of each other. Furthermore, if a company holds a callable convertible debt instrument for which it is required to separate an embedded derivative, it is not appropriate to separate an equity conversion option and a written call option on the debt instrument separately because the two embedded derivative features should not be valued independently of each other.

On the other hand, if a hybrid debt instrument contains, for instance, two options that give the holder a right to choose both the interest rate index on which interest payments are determined and the currency in which the principal is repaid, those two options may qualify for separation as two separate embedded derivatives since they relate to different risk exposures and are readily separable and independent of each other.

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Paragraph 25**Question 25-1****Embedded derivatives: synthetic instruments**

Company A acquires a five-year floating rate debt instrument issued by Company B. At the same time, it enters into a five-year pay-variable receive-fixed interest rate swap with Bank C. Company A considers the combination of the debt instrument and swap to be a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intent and ability to hold it to maturity. Company A contends that separate accounting for the swap is inappropriate since IAS 39.25(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the company's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ("synthetic instrument" accounting) for the purposes of applying IAS 39. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described herein differ from the transactions discussed in Question 10-8 which had no substance apart from the resulting interest rate swap.

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Paragraph 25**Question 25-2****Embedded derivatives: purchases and sales contracts in foreign currency**

A supply contract provides for payment in a currency other than (a) the currency of the primary economic environment of either party to the contract, and (b) the currency in which the product is routinely priced in international commerce. Is there an embedded derivative that should be separated under IAS 39?

Yes.

To illustrate: A Norwegian company agrees to sell oil to a company in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in international commerce. Neither company carries out any significant activities in Swiss francs. In this case, the Norwegian company regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French company regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each company includes fair value changes on the currency forward in net profit or loss unless the reporting enterprise designates it as a cash flow hedging instrument, if appropriate.

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Paragraph 25**Question 25-3****Embedded derivatives: dual currency bond**

If an enterprise purchases a dual currency bond with principal denominated in the domestic currency and interest payment obligations denominated in a foreign currency and classifies the bond as a held-to-maturity investment (carried at amortised cost), does it separate an embedded derivative?

No. IAS 39.25(c) states that an embedded derivative is not separated from its host contract if “the embedded derivative is a stream of principal or interest payments that are denominated in a foreign currency”. This implies that the principal and interest payments do not necessarily have to be in the same currency. The foreign currency component of the carrying amount of the held-to-maturity investment is reported using the closing rate under IAS 21.

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Paragraph 25**Question 25-4****Embedded foreign currency derivative: unrelated foreign currency provision**

Company A, which measures items in its financial statements based on the euro (its measurement currency), enters into a contract with Company B, which has the Norwegian krone as its measurement currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IAS 39 because it will be settled by making and taking delivery in the normal course of business (IAS 39.6 and IAS 39.14). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under IAS 39.25(d), is that embedded derivative (the leveraged foreign exchange provision) considered closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (IAS 39.23).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the dollar is neither Company A's nor Company B's measurement currency. This foreign currency derivative would not be separated because it follows from IAS 39.25(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IAS 39.23.

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Paragraph 25**Question 25-5**

Embedded foreign currency derivative: currency of international commerce

IAS 39.25(d) refers to the currency in which the price of the related good or service is routinely denominated in international commerce. Could it be a currency that is used for a certain product or service in international commerce within the local area of one of the substantial parties to the contract?

No, the currency in which the price of the related good or service is routinely denominated in international commerce is only a currency that is used for similar transactions all around the world, not just in one local area. For instance, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euros in Europe, neither the US dollar nor the euro is a currency in which the good or service is routinely denominated in international commerce. See also Question 25-6.

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Paragraph 25**Question 25-6**

Foreign currency derivative: currency of primary economic environment

What is the currency of the primary economic environment in which any substantial party to the contract operates for the purpose of applying IAS 39.25(d)?

For the purpose of applying IAS 39.25(d), the currency of the primary economic environment in which any substantial party to the contract operates refers to the currencies used in measuring items in the financial statements of any substantial party to the contract (measurement currency), or the currencies of the countries in which any substantial party to the contract is domiciled. If a contract's payments are denominated in any of those currencies, then that currency is integral to the arrangements and thus considered to be closely related to the terms of the contract. The determination that a contract does not have an embedded derivative does not affect the determination of an enterprise's measurement currency (see SIC-19, Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29).

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Paragraph 25**Question 25-7**

Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recorded investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recorded investment and the issuer does not have such a right (for instance, a puttable debt instrument), does the contract satisfy the condition in IAS 39.25(h) that the holder would not recover substantially all of its recorded investment?

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

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Paragraph 25**Question 25-8**

Embedded derivatives: purchase price subject to a cap and a floor

Can the economic characteristics and risks of an embedded derivative be considered closely related to the economic characteristics and risks of the host contract if the host contract is a sales or purchase contract and the embedded derivative establishes a higher and lower limit on the price of the asset that is subject to the sales or purchase contract?

Yes. IAS 39.25(b) specifies that the economic characteristics and risks of an embedded derivative are considered to be closely related to the economic characteristics and risks of the host contract if the host contract is a debt instrument and the embedded derivative is an out-of-the-money floor or an out-of-the-money cap on interest rates when the instrument is issued. In these circumstances, an enterprise does not account for the embedded derivative separately from the host contract under IAS 39. The same principle applies to contractual provisions in a sales or purchase contract that has a higher and lower limit on the price of the asset that is subject to the sale or purchase contract.

To illustrate: A manufacturer enters into a long-term contract to purchase a specified quantity of a commodity from a supplier. In future periods, the supplier will provide the commodity at the current market price but within a specified range, for example, the purchase price may not exceed 120 per unit or fall below 100 per unit. The current market price at the inception of the contract is 110 per unit. The commodity-based contract is not within the scope of IAS 39 because it will be settled by making and taking delivery in the normal course of business (IAS 39.14).

From the manufacturer’s perspective, the price limits specified in the purchase contract can be viewed as a purchased call on the commodity with a strike price of 120 per unit (a cap) and a written put on the commodity with a strike price of 100 per unit (a floor). At inception, both the cap and floor on the purchase price are out of the money. Therefore, they are considered closely related to the host purchase contract (consistent with IAS 39.25(b)) and are not separately recognised as embedded derivatives.

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Recognition

Paragraph 27**Question 27-1**

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

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

No. IAS 39 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in IAS 39.27-29 and IAS 39.57-65 apply. IAS 39.27 states that financial liabilities are recognised on the date the enterprise “becomes a party to the contractual provisions of the instrument”. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IAS 39. IAS 39.57 specifies that financial liabilities are derecognised only when they are extinguished, that is, when the obligation specified in the contract is discharged, cancelled, or expires.

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Paragraph 27**Question 27-2**

Recognition: cash collateral

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

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Company B can be realised by Company A. Therefore, Company A recognises the cash as an asset and a payable to Company B while Company B derecognises the cash and recognises a receivable from Company A. See also Question 18-1.

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Paragraph 30**Question 30-1****“Regular way” transactions: loan commitments**

Does a bank’s commitment to make a loan at a specified rate of interest during a fixed period of time meet the definition of a derivative under IAS 39? If so, how is it affected by the provisions for “regular way” purchases and sales of financial assets in IAS 39.30?

Yes, such a commitment is a derivative, since it has no initial net investment, it has an underlying variable (interest rates), and it will be settled at a future date. In effect, it is an issued option to the potential borrower to obtain a loan at a specified interest rate.

However, IAS 39 does not require that it be recognised as a derivative if the loan commitment allows draw-down of a loan within the timeframe generally established by regulation or convention in the market place concerned (IAS 39.31). This is the “regular way” exemption of IAS 39. The loan commitment would generally relate to an originated loan that would be carried at amortised cost.

The exemption for ‘regular way’ transactions is intended to apply to purchases and sales commitments relating to financial assets that, because of constraints in the market place, cannot be settled immediately at the trade date or commitment date. The exemption is not available to forward and option contracts that have a term that extends beyond the necessary time to settle the underlying financial asset to take advantage of or protect against potential market movements.

When a bank makes a loan commitment, it may be based on representations of the borrower and preliminary underwriting activities. The commitment period is then intended to allow the bank time to complete its underwriting and provide time for the borrower to schedule and execute the transaction that is the subject of the loan commitment. A loan commitment is considered to be a ‘regular way’ transaction when it is entered into with the intent to settle it by execution of a loan, there is no past practice of settling the commitment based on changes in interest rates, and the commitment period does not extend beyond the period expected to be needed to perform appropriate underwriting, provide for the orderly closing, and to facilitate the scheduling and execution of the transaction that is the subject of the loan.

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Paragraph 30**Question 30-2****Trade date vs. settlement date: net settlement**

Would a contract to purchase or sell a financial asset qualify as a ‘regular way’ purchase or sale of that financial asset under IAS 39 if neither party is required to deliver the asset because the contract allows for or requires net cash settlement?

No. IAS 39.31 describes a ‘regular way’ contract as a contract that requires delivery of the assets that are subject to the contract. Therefore, a contract that allows for or requires net settlement cannot be accounted for as a ‘regular way’ contract. Instead, such a contract is accounted for as a derivative in the period between trade date and settlement date.

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Paragraph 34**Question 34-1****Trade date vs. settlement date: amounts to be recorded for a sale**

IAS 39.34 provides an illustrative example of the application of IAS 39.30-33 to a purchase of a financial asset using trade date accounting or settlement date accounting. What would be recorded if the enterprise instead entered into a contract to sell a financial asset?

To illustrate, on 29 December 20x2 (trade date) an enterprise enters into a contract to sell a financial asset for its current fair value of 1,010. The asset was acquired one year earlier for 1,000 and its amortised cost is 1,000. On 31 December 20x2 (financial year end), the fair value of the asset is 1,012. On 4 January 20x3 (settlement date), the fair value is 1,013. The amounts to be recorded are shown in the two tables below (any interest that might have accrued on the asset is disregarded).

As discussed in Question 106-1, a change in the fair value of a financial asset that is sold on a ‘regular way’ basis is not recorded in the financial statements between trade date and settlement date even if the enterprise applies settlement date accounting.

SETTLEMENT DATE ACCOUNTING			
Balances	Held-to-Maturity Investments – Carried at Amortised Cost	Available-for-Sale Assets – Remeasured to Fair Value with Changes in Equity	Assets Held for Trading and Available-for-Sale Assets – Remeasured to Fair Value with Changes in Profit or Loss
29 December 20x2			
Receivable	--	--	--
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	--	10	--
Retained earnings (through net profit or loss)	--	--	10
31 December 20x2			
Receivable	--	--	--
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	--	10	--
Retained earnings (through net profit or loss)	--	--	10
4 January 20x3			
Equity (fair value adjustment)	--	--	--
Retained earnings (through net profit or loss)	10	10	10

TRADE DATE ACCOUNTING			
Balances	Held-to-Maturity Investments – Carried at Amortised Cost	Available-for-Sale Assets – Remeasured to Fair Value with Changes in Equity	Assets Held for Trading and Available-for-Sale Assets – Remeasured to Fair Value with Changes in Profit or Loss
29 December 20x2			
Receivable	1,010	1,010	1,010
Financial asset	--	--	--
Equity (fair value adjustment)	--	--	--
Retained earnings (through net profit or loss)	10	10	10
31 December 20x2			
Receivable	1,010	1,010	1,010
Financial asset	--	--	--
Equity (fair value adjustment)	--	--	--
Retained earnings (through net profit or loss)	10	10	10
4 January 20x3			
Equity (fair value adjustment)	--	--	--
Retained earnings (through net profit or loss)	10	10	10

When trade date accounting is applied, the receivable from the buyer on a sale of a financial asset is classified as an originated loan by the seller if it qualifies for that classification because the asset to be received in exchange for the financial asset sold is cash or a financial asset that is to be classified as an originated loan which is not held for trading (see Question 106-2).

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Paragraph 35**Question 35-1****Derecognition of a portion of a loan with disproportionate risk sharing**

When a portion of a financial asset is sold and a portion is retained, the transferor often retains custody of the asset and the transferee is unable to sell or pledge it. Further, when a portion of a financial asset is sold, restrictions are generally placed on the sale and use of those assets to protect the interests of all parties that have ownership rights in the assets. Does IAS 39 prohibit derecognition if the transferor retains custody of the loans and neither the transferee nor the transferor have the ability to sell or pledge the loans?

No, derecognition is not necessarily prohibited. IAS 39.35 explicitly provides for the sale of a portion of a financial asset when an enterprise loses control of the contractual rights that comprise it. It states that “an enterprise loses such control if it realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders those rights.” IAS 39.41 states that a transferor “generally” loses control “only if the transferee has the ability to obtain the benefits of the transferred asset”. The examples given of this are if the transferee is free to sell or pledge the financial asset or, if the transferee is a special purpose entity, the holders of the beneficial interests in the SPE have the ability to obtain substantially all of the benefits of the transferred assets. However, IAS 39.41 does not limit sale accounting to only cases where these two conditions are met. IAS 39 recognises that control is not just a physical or custody notion (for instance, IAS 39.42). There are other factors to consider, particularly the ability to realise the beneficial interests.

To illustrate, Company A purchases loans in the marketplace at par with an effective yield at the time of purchase equal to its coupon of 11% and a maturity of ten years. It later sells a portion of those loans to investors. Under the terms of the sales agreement, the investors purchase at par 80% of the total principal amount of the loan with interest at 6%. Company A retains the remaining 20% of the principal with coupon interest at 11%, and the excess interest of 5% due on the underlying loans that were sold to the investors. Company A’s retained interests in the loans are pledged as collateral on a first-loss basis to the investors and, therefore, are subordinated on a first-loss basis to the 80% portion of the loans sold to the investors. Company A also agrees to continue to collect interest and principal payments from the borrowers and remit the payments to the investors for their share of

the cash flows. Since the loans cannot be physically separated, the portion sold cannot be delivered to the investors. As a result, the investors cannot sell or pledge the loans. Company A also retains physical custody of the loans; however, to protect the interests of each of the parties, Company A is prohibited under the agreement from selling or pledging the loans that were the subject of the partial sale.

Company A has relinquished control of the 80% interest in the loans that it sold. Even though Company A retains custody of the loans, it gave up its right to sell or pledge the loans. Company A also realised the benefits of the portion of the loans that were sold, and the investors obtained the risks and rewards of ownership of the portion of the asset that they purchased. Neither Company A nor the investors have the right to sell or pledge the underlying loans, but both Company A and the investors are free to sell or pledge their respective interests. Accordingly, they have control over their respective economic benefits in the interests that they own in the loans.

Although Company A has pledged its 20% portion of the loans on a first-loss basis to the investors and therefore has retained credit risk on 100% of the loans, significant interest rate risk has been transferred to the investors on the 80% portion of the loans that were sold to the investors (see Question 37-1). Therefore, assuming there are no other rights or obligations relating to this transaction that would preclude derecognition, Company A accounts for this transaction as a sale even though it retains custody of the loans and the investors do not have the ability to sell or pledge the loans.

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Paragraph 35

Question 35-2

Factors affecting derecognition of a portion of a loan

What factors should be considered in determining whether and to what extent a transfer of a portion of a financial asset is accounted for as a sale?

IAS 39.35 sets out the basic principle for derecognising a financial asset – losing control of the contractual rights that comprise the financial asset. IAS 39.35-42 contain various factors and examples that should be considered in determining whether a transferor loses control of those rights. However, the factors and examples should not be viewed in isolation and the transfer of control can be demonstrated in other ways.

The following factors suggest that an enterprise loses control of the contractual rights that comprise financial assets when a portion of those assets are sold and the parties to the transaction have rights to the cash flows of the underlying loans and/or obligations relating to the portion of the financial assets sold:

- The transaction is distinguishable from a collateralised borrowing because the transferor has no legal right to reacquire the rights to and benefits from the portion of the asset that is the subject of the transfer. The inability of the transferor to reacquire the rights and benefits is often evidenced by legally documenting the transfer as a sale.

***Rationale** – IAS 39.35 identifies three situations in which an enterprise loses control, namely: when it realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders those rights. Recognition of a transfer of the asset is contemplated only in a situation in which the enterprise surrenders those rights. Although the guidance in IAS 39 does not specify that a transfer must be documented in a particular manner, legal documentation supporting a transfer provides the basis for determining that the transferor has no legal right to reacquire the rights to and benefits from the transferred asset which distinguishes it from being merely a pledge of collateral, for example, in the case of collateralised non-recourse debt whereby the loans are physically*

transferred to the lender. It also serves to preclude the transferor from having the ability to pay off the debt and reacquire the transferred assets without having an explicit forward contract or repurchase agreement. An explicit contract or agreement to repurchase the transferred assets would often preclude derecognition under IAS 39.38.

- The transferor is prohibited by the terms of the transfer contract or documents from selling or pledging the underlying financial assets that are the subject of the transfer and, thereby, relinquishes control of such assets.

Rationale – *In a transfer of a portion of financial assets, neither the enterprise (the transferor) nor the investor (the transferee) generally would have the right to sell the underlying assets because they are jointly owned. It would be difficult to conclude that the enterprise (the transferor) surrenders the rights that comprise the financial asset if the transferor retained the right to sell or pledge assets that are purported to be the subject of the transfer.*

- Even though the transferee is unable to sell or pledge the underlying financial assets that are the subject of the transfer, it has the ability to sell or pledge its interest in the transferred financial assets.

Rationale – *IAS 39.41 states that the ability of the transferee to obtain the benefits of the transferred assets is demonstrated, for example, if the transferee “is free either to sell or to pledge approximately the full fair value of the transferred asset” or, in the circumstance of a sale through a special purpose entity if “the holders of beneficial interests in that entity have the ability to obtain substantially all of the benefits of the transferred asset”. It also states that “that ability may be demonstrated in other ways”. The paragraph does not specifically address the situation in which the rights to and benefits from a portion of financial assets are sold. However, the indicator in the example in IAS 39.41 exists if the transferee is free to sell or to pledge its beneficial interests in the underlying financial assets that are the subject of the transfer. The transferred assets are the rights to and benefits from the portion of the underlying assets that are the beneficial interests now owned by*

the transferee and for which the transferee has the ability to sell or pledge.

- If the transferor retains custody of the loans that are the subject of a partial sale and provides servicing, the transferor is obligated to remit the cash flows it collects on behalf of the investors on a timely basis. The transferor is not entitled to reinvest such cash flows for its benefit, except to provide a return from short-term high quality investments made from the collection date to the date of remittance to the investors.

Rationale – *When the rights to and benefits from a portion of financial assets are sold, the transferor may retain the right and obligation to service the underlying financial assets. If the transferor’s beneficial interest in the underlying financial assets is subordinated to the beneficial interests of the investors, the retention of servicing rights allows the transferor to protect its interests in the financial assets when they become delinquent, are in default, or demonstrate credit deterioration. A transferor’s ability to service financial assets that are the subject of a partial sale may suggest that the transferor has not surrendered control over the contractual rights that comprise the financial assets as required by IAS 39.35. However, a transferor that also provides servicing acts only as an agent for the investors in the beneficial interests that have been transferred if, under the servicing agreement, the transferor does not have use of or benefit from the cash it collects on behalf of the investors and is required to remit to them on a timely basis, as specified in the servicing agreement, the cash it collects representing their beneficial interests in the financial assets.*

The following factors limit the extent to which the transferred portion of the financial assets qualify for derecognition:

- If the assets are not readily obtainable in the market or the reacquisition price is not the fair value at the time of reacquisition, derecognition to the full extent of the repurchase provision is prohibited if the transferor has retained a call option on all or a portion of the transferred assets. Derecognition to the full extent of the repurchase provision is also prohibited if the assets are not readily obtainable in the market and the transferee holds an

unconditional put option or has entered into a total return swap with the transferor on all or a portion of the transferred assets. Similarly, derecognition is prohibited to the extent the transferor and transferee have entered into a forward repurchase agreement on terms that provide the transferee with a lender's return on the assets received in exchange for the transferred assets.

Rationale – IAS 39.38 and IAS 39.40 specify that a transferor has not lost control of a transferred financial asset in situations in which the asset is not readily obtainable in the market and the reacquisition price does not equal fair value at the time of reacquisition if the transferor retains a call option or if the transferee holds an unconditional put option or has entered into a total return swap with the transferor. Similarly, the transferor has not lost control if there is a forward repurchase agreement on terms that provide the transferee with a lender's return on the assets received in exchange for the transferred assets. In these situations the transferor retains both credit and market risk. There is no specific guidance for the situation in which the rights to and benefits from a portion of the transferred assets is subject to being reacquired by the transferor. However, in these circumstances the transferor has retained both credit and market risk to the extent that it may reacquire such rights and benefits.

- If the transferor provides a guarantee to the investors for both credit risk and interest rate risk and there are no other substantive risks, the portion of the transferred financial assets that would otherwise qualify for derecognition is reduced to the extent that both of these risks are not transferred. The reduction is the lower of the maximum amount of the credit guarantee and the percentage of the transferred financial asset that is guaranteed by the transferor against interest rate risk.

Rationale – If a transferor provides a guarantee of both credit and interest rate risk and these risks represent substantively all of the risks of the transferred assets, none of the risks of the underlying assets are in effect being transferred to the transferee. IAS 39.38(c) states that a transferor has not lost control in the situation in which “the asset transferred is not readily obtainable in the market and the transferor has retained substantially all of the risks and returns of

ownership through a total return swap”. Because a total return swap has the economic effect of the transferor retaining both credit and interest rate risk and there are no other substantive risks, the retention of both risks for a portion of the transferred assets suggests that the transferor has not lost control of the benefits of that portion. For instance, if a transferor transfers 80 and retains 20 of an asset of 100, and pledges and subordinates the 20 retained in a credit guarantee to the transferee, the transferred 80 is derecognised. However, if the transferor pledges and subordinates the 20 retained as a guarantee for both credit risk and interest rate risk and there are no other substantive risks, only 60 is derecognised (80-20).

If the underlying financial assets cannot be sold by either party, then the beneficial interests are not considered readily obtainable for the purposes of applying IAS 39.38. In situations in which a portion of financial assets is sold, the underlying assets that are the subject of the transfer may be readily obtainable in the market. However, in these situations it does not matter whether the underlying assets are readily obtainable in the market if neither the transferor nor transferee is permitted to sell or pledge them. Even though both the transferor and transferee have the right to sell or pledge their respective beneficial interests in the underlying financial assets, if such beneficial interests are not readily obtainable in the market, they would also be considered not readily obtainable for purposes of the guidance in IAS 39.38. In these circumstances, a transferee would not be able to sell its beneficial interest if it were subject to a repurchase arrangement because the beneficial interest would not necessarily be available to be repurchased to satisfy the repurchase arrangement.

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Paragraph 35**Question 35-3**

Factors affecting derecognition of financial assets transferred to a special purpose entity

Would the answer change in the same fact situations as are in Questions 35-1 and 35-2, if (1) Company A transferred financial assets in a securitisation transaction to a special purpose entity that it was required to consolidate and (2) the special purpose entity transferred a portion of those financial assets to third-party investors?

No. The evaluation of whether a transfer of a portion of financial assets meets the derecognition criteria under IAS 39 generally will not differ if the transfer is directly to investors or through a special purpose entity that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors. If a transfer by a special purpose entity to a third party investor meets the conditions specified for derecognition in IAS 39.35-42 as elaborated on in Question 35-2, the transfer would be accounted for as a sale by the special purpose entity and those derecognised assets or portions thereof would not be brought back on the balance sheet in the consolidated financial statements of the enterprise.

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Paragraph 35**Question 35-4**

Interaction between recognition and derecognition requirements

If a transfer of a financial asset does not qualify for derecognition because the transferor has retained control over the financial asset in accordance with the provisions in IAS 39.35-42, the transferor does not remove the asset from its balance sheet. In this case, would the transferee recognise the financial asset in its balance sheet?

No. While the transferee is not required to consider the accounting of the transferor, only one of them can have control over the contractual rights that comprise the asset at any point in time. When applying the recognition requirement in IAS 39.27-29, a transferee considers its contractual rights to receive cash. If application of IAS 39.35-42 indicates that the transferor has not lost control over the financial asset, for instance, because the transferor is both entitled and obligated to repurchase the asset on terms that effectively provide the transferee with a lender's return (IAS 39.38(b)), the transferor does not derecognise the asset. This analysis also indicates that the transferee has not gained control and, therefore, the transferee does not recognise the asset.

If a transferee concludes that it does not have the rights to the cash flows of the transferred financial assets because, for example, the transferor retained a call option and the assets are not readily obtainable, the transferee records a receivable from the transferor for the repayment of the cash proceeds or other consideration.

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Paragraph 35**Question 35-5****Derecognition: “wash sale” transaction**

What is the impact of transactions whereby a financial asset is purchased immediately before or soon after the sale of the same asset (a “wash sale” transaction) on the transferor’s ability to derecognise the financial asset subject to the “wash sale”?

Absent any agreement to repurchase it, the asset is derecognised even though the same asset is purchased immediately before or after the sale of that asset, that is, the sale and the purchase are treated as two separate transactions under IAS 39. The fact that a transferor expects to reacquire an asset is not a sufficient basis for concluding that the transferor has retained control over that asset in the absence of any contractual commitment (see IAS 39.38).

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Paragraph 36**Question 36-1****Derivatives that serve as impediments to the derecognition of a financial asset**

If the existence of a derivative instrument (whether stand-alone or embedded in another contract) indicates that a transferor has not lost control of a financial asset and the value of the derivative is based solely on changes in the value of that financial asset, is the derivative instrument accounted for as a derivative instrument at fair value under IAS 39?

No. A derivative would not be recognised if recognising both the derivative and either the transferred asset or the liability arising from a transfer would result in counting the same thing twice in the transferor’s balance sheet.

For instance, if a transferor is both entitled and obligated to repurchase transferred assets on terms that effectively provide the transferee with a lender’s return on the assets received in exchange for the transferred assets, the transferred assets are not derecognised (IAS 39.38(b)). In this case, although the repurchase agreement meets the definition of a derivative in IAS 39.10 (it can be viewed as a forward contract), it follows from IAS 39.36 that it is not separately recognised as a derivative and measured at fair value under IAS 39. Also, if for instance a retained call option prevents a transfer of financial assets from being accounted for as a sale under IAS 39.38(a), the call option would not be separately recognised but would be accounted for as a component of the borrowing, since exercising the call option would result in the extinguishment of the debt.

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Paragraph 37 (also paragraph 51)**Question 37-1****Derecognition: full recourse**

Does an enterprise derecognise receivables if it “sells” them and provides a guarantee to the “buyer” to pay for any credit losses that may be incurred on the receivables as a result of the failure of the debtor to pay when due and other substantive benefits and risks of the receivables have been transferred to the “buyer”, such as interest rate risk?

Yes. IAS 39.37 specifies that if the position of either enterprise indicates that the transferor has retained control, the financial asset is not derecognised. In this case, the transferor has lost control over the receivables because the transferee has the ability to obtain the benefits of the transferred assets (IAS 37.41) and the risk retained by the transferor is limited to credit risk in the case of default. IAS 39.53 indicates that the guarantee is treated as a separate financial instrument to be recognised as a financial liability by the transferor.

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Paragraph 38**Question 38-1****Derecognition: right of first refusal**

Is derecognition appropriate if the transferor retains a right of first refusal that permits the transferor to purchase the transferred assets at their fair value at the date of reacquisition should the transferee decide to sell them?

Yes, IAS 39.38(a)(ii) is clear. Derecognition is appropriate since the reacquisition price is the fair value at the time of the reacquisition.

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Paragraph 38

Question 38-2

Derecognition: put option

A company sells receivables (that are not readily obtainable in the market) due in six months, with a carrying amount of 100,000, for a cash payment of 95,000 subject to full right of recourse. Under the right of recourse, the transferor is obligated to compensate the transferee for the failure of the underlying debtors to pay when due. In addition, the recourse provision entitles the transferee to sell the receivables back to the transferor at a fixed price in the event of unfavourable changes in interest rates or credit ratings of the underlying debtors. How should this transaction be accounted for?

This transaction is accounted for as a collateralised borrowing by the enterprise since it does not qualify for derecognition. IAS 39.37 states that “if the position of either enterprise indicates that the transferor has retained control”, the financial asset is not derecognised. IAS 39.41(a) would support that the transferor has lost control since the transferee has the ability to obtain the benefits of the transferred asset and is free to sell or pledge approximately the full fair value of the transferred asset. However, the transferor has granted the transferee a put option on the transferred asset since the transferee may sell the receivables back to the transferor in the event of both actual credit losses and changes in underlying credit ratings or interest rates. This is similar to the situation described in IAS 39.38(c) in which a transferor has not lost control and therefore a financial asset is not derecognised if the transferor retains substantially all the risks of ownership through an unconditional put option on the transferred assets held by the transferee.

The transferor recognises the 95,000 received as a liability. The liability is measured at amortised cost with interest expense of 5,000 being recognised over its six-month maturity. The transferor continues to recognise the receivables as assets. Cash received on the receivables either by the transferor or the transferee reduces both the receivables and the liability. If uncollectable receivables are returned to the transferor for cash, the liability is reduced and an impairment loss recognised if not previously recognised.

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Paragraph 38

Question 38-3

Derecognition: repo or securities lending transaction and right of substitution

Would the transferor derecognise an asset that is readily obtainable in the market and that has been transferred under a sale and repurchase (repo) agreement or securities lending transaction if the transferee has a right to substitute similar assets of equal fair value at the repo date for the transferred asset?

No. IAS 39.38(b) indicates that the asset should not be derecognised if the transferor is both entitled and obligated to repurchase or redeem the transferred asset on terms that effectively provide the transferee with a lender's return on the assets received in exchange for the transferred asset. Therefore, the asset sold or lent under a repo or securities lending transaction is not derecognised. If the transferee uses its option to return an asset other than that transferred to the transferor, the transferor derecognises the transferred asset and recognises the returned asset.

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Paragraph 38**Question 38-4****Derecognition: deep-in-the money put option held by transferee**

What is the impact of a deep-in-the money put option held by a transferee on the transferor's ability to derecognise the financial asset subject to the option at the time of the transfer of the financial asset?

If the transferred asset is not readily obtainable in the market and the transferor has retained substantially all of the risks of ownership through an unconditional put option on the transferred assets held by the transferee, the transferor would not derecognise the financial asset (IAS 39.38(c)).

However, if the put option is conditional and the condition is met, for example, it is exercisable if interest rates are above 5%, and it is deep in the money, for example, current interest rates are 12% and the strike rate on the put option is 5%, it acts more like a forward repurchase agreement than an option because it has both upside and downside potential. The retention of upside and downside risk suggests that the transferor has not given up control of the asset.

If the transferred asset is readily obtainable in the market, for instance, a financial instrument traded in an active market, the transferor derecognises the transferred asset and recognises the put option as a financial liability measured at fair value regardless of whether the option is in the money, at the money or out of the money.

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Paragraph 38**Question 38-5****Derecognition: "clean-up call"**

What is the impact of an option held by a servicer to purchase transferred financial assets when the amount of outstanding financial assets falls to a level at which the cost of servicing those financial assets becomes burdensome (a "clean-up call option") on the servicer's ability to derecognise the financial assets subject to the clean-up call?

The existence of a clean-up call option held by a transferor is not of itself a sufficient basis for concluding that the transferor has maintained control over the transferred assets because the call option is conditional on the cost of servicing those financial assets. However, it may suggest that a portion of the transferred assets does not qualify for derecognition. See Question 35-2 as it relates to a sale of a portion of a financial asset.

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Paragraph 41**Question 41-1****Derecognition: call option on beneficial interest in SPE**

IAS 39.41 indicates that derecognition may be appropriate when assets are transferred to a Special Purpose Entity (SPE). Company A transfers a portfolio of receivables that are not readily obtainable in the market to a SPE created for the purpose of securitising these receivables and selling the securities to investors. Company A retains call options on the securities issued by the SPE. The strike price is equal to the face value of the securities plus two per cent. Should the receivables be derecognised?

No. It follows from IAS 39.38(a) that control of the transferred receivables has not been surrendered since the transferor has the right to reacquire the securitised receivables, the assets are not readily obtainable in the market, and the reacquisition price is not specified as the fair value of the assets at the time of reacquisition. In addition, it follows from IAS 39.41(b) that control has not been transferred since the holders of the beneficial interest in the SPE (other than Company A) do not have the ability to obtain the benefits of the transferred assets. The issue of whether to consolidate an SPE is addressed in IAS 27 and SIC-12.

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Paragraph 47**Question 47-1****Estimating fair values when a portion of financial assets is sold – bonds**

If a portion of an investment in bonds is sold, how is the carrying amount allocated between the portion sold and the portion retained?

The best evidence of the fair value of the retained interest in the bonds is obtained by reference to market quotations. Valuation models are generally used when market quotations do not exist.

To illustrate: Company A purchases bonds that are traded in the marketplace having an effective yield at the time of purchase and coupon of 11%. It later sells a portion of the total principal amount of the bonds to investors. Under the terms of the sales agreement, the investors purchase at par 80% of the principal with interest at 6%. Company A retains the remaining 20% of the principal and the excess interest of 5% due on the underlying bonds that were not sold to the investors. Company A's retained interests in the bonds are pledged as collateral on a first loss basis to the investors and, therefore, are subordinated to the 80% portion of the bonds sold to the investors. The transaction meets the criteria for derecognition and Company A accounts for the transaction as a sale.

IAS 39.47 states that "if an enterprise transfers a part of a financial asset to others while retaining a part, the carrying amount of the financial asset should be allocated between the part retained and the part sold based on their relative fair values on the date of sale. A gain or loss should be recognised based on the proceeds for the portion sold."

In this example, the fair value of the portion of the bonds sold is the proceeds paid by the investors, that is 80% of the principal amount. There is no market for the residual interests in the bonds that are retained by Company A and Company A has not previously sold any similar residual interests to serve as a basis for estimating the fair value of such retained interests. Market quotations on bonds that are similar to the bonds that are the subject of the sale are available. Two alternative methods for estimating the fair value of the retained interests in the bonds for purposes of allocating the basis in the bonds between the portion sold and the portion retained are described below.

Method 1

Company A estimates the future cash flows of the underlying bonds based on their contractual payments and reduces those cash flows for estimates of prepayments and credit losses. It then discounts the cash flows by its estimate of the appropriate risk-adjusted interest rate. This method produces a fair value of the retained interests in the bonds equal to 25% of the principal amount.

Under this method, Company A would recognise a gain on sale equal to 3.81% of the principal amount determined by subtracting from the proceeds of 80% of the principal amount the amount allocated to the basis sold of 76.19% [80% proceeds divided by (80% proceeds plus 25% retained interest)].

Method 2

On the date of the sale, Company A obtains market quotations on bonds that are similar to the bonds it acquired previously and are the subject of the current sale. Those similar bonds are quoted at 101% of par. Company A estimates the value of the retained portion of the bonds to be 21% of par based on the difference between the quoted price of the whole of 101% of par and the proceeds it received of 80% of par.

Under this method, Company A would recognise a gain on sale equal to 0.8% of the principal amount determined by subtracting from the proceeds of 80% of the principal amount the amount allocated to the basis sold of 79.2% (80% proceeds divided by the fair value of the bonds of 101%).

Company A uses Method 2 to account for the derecognition of the portion of the bonds that are sold.

IAS 39 does not provide explicit guidance for estimating the fair value of a retained interest in the situation in which a portion of the bonds are sold, and it recognises that it may be determined by one of several generally accepted methods. However, IAS 39.99 states that “the existence of published price quotations in an active market is normally the best evidence of fair value”. IAS 39.100 recognises that in circumstances in which a quoted market price is not available, estimation techniques may be used to determine fair value. IAS

39.101 deals with the situation in which a market price does not exist for a financial instrument in its entirety but does exist for its component parts and when a market does not exist for a financial instrument but does exist for a similar financial instrument. In these instances the guidance specifies that fair value can be constructed on the basis of the relevant market prices.

Although the guidance in IAS 39 does not specifically deal with the valuation of the retained component in the situation in which a market quotation can be obtained for a similar instrument and for the component that is sold, the existence of such quotations provides a basis for constructing the market value of the retained component based on such a market quotation.

Valuation models are used generally when market quotations do not exist, and Method 1 would be appropriate if there was no market evidence of the fair value of the bonds as a whole. If, however, there was an active market for the retained interests in the bonds or if Company A had a prior history of selling similar retained interests, those transactions may provide a more objective basis for estimating the fair value of the retained interests in the bonds.

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Paragraph 47**Question 47-2****Estimating fair values when a portion of financial assets is sold - loans**

Assume the same facts as in Question 47-1, except Company A originates the loans that are the subject of the partial sale. Which method should Company A use to determine the fair value of the beneficial interests in the loans that it retains?

Company A uses Method 2 with certain modifications. In the situation in which loans are originated and are the subject of a partial transfer, unlike the bonds in Question 47-1, an active market in which the loans are traded generally does not exist. However, the transactions between Company A and its borrowers are market transactions. Reference to actual lending transactions as a means of estimating the fair value of the retained beneficial interests in the loans provides a more objective and reliable estimate of fair value than the cash flow model described for Method 1 because it is based on actual market transactions. Although market interest rates may have changed between the origination dates of the loans and the subsequent sales date of a portion of the loans, the corresponding change in the value of the loans might be determined by reference to current market interest rates being charged by Company A or perhaps its competitors for similar loans (that is, loans with similar remaining maturity, cash flow pattern, currency, credit risk, collateral, and interest basis). Alternatively, providing there is no change in the credit risk of the borrowers subsequent to the origination of the loans, an estimate of the current market interest rate might be derived, by using a benchmark interest rate of a higher quality than the loans, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination dates to the subsequent sales date.

Estimating fair value, in this instance, based on actual market transactions provides an objective market-based valuation for the loans as a whole and, accordingly, provides the better estimate of fair value for the portion of the loans that are retained than Method 1 which is based on an estimate of cash flows and may not fully consider the option-like nature of the subordination. The credit enhancement provided by Company A by subordinating its retained beneficial interest in the loans to the 80% interest sold to investors is akin to a written option because the retained beneficial interest is subject to considerable downside risk from credit exposure and limited upside. From this perspective, an option pricing model may provide a better estimate of the

value of the credit risk than the estimated cash flow model described in Method 1. However, if Company A had a history of selling beneficial interests in similar loans, those sales would provide a more objective basis for estimating fair value than either Method 1 or Method 2.

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Paragraph 50**Question 50-1**

Derecognition of part of a financial asset: interest-only strips and servicing assets

If an enterprise transfers receivables and retains the right to a portion of the interest payments, how is that retained interest spread allocated between any servicing asset or liability and any retained interest-only strip receivable?

The amount allocated to the servicing asset or liability is the portion of the interest payments that the servicer would lose upon termination or transfer of the servicing contract. The portion of the interest payments that the servicer would not lose is an interest-only strip receivable. For example, if the servicer would not lose any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For purposes of applying IAS 39.47, the fair values of the servicing asset and interest-only strip receivable so determined are used in the allocation of the carrying amount of the receivables between the part of the assets transferred and the part retained. If there is no servicing fee specified, a liability is recorded for the servicing obligation.

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Paragraph 57**Question 57-1**

Derecognition of financial liabilities: third party receives a fee to assume the obligation

Company B borrows from Company A. Company B pays a fee to a third party (Company C) to assume the liability, and the original creditor (Company A) agrees to accept Company C as the new primary obligor, even though Companies B and C have contracted that Company B must continue to make interest and principal payments on behalf of Company C. Should Company B (the original primary obligor) derecognise the financial liability to Company A?

Yes. It follows from IAS 39.58(b) that Company B has extinguished its liability to Company A since Company A has released Company B from its primary responsibility for the liability and Company A can look only to the new primary obligor (Company C) in the event the original primary obligor (Company B) fails to make the required interest and principal payments. Presumably, Company A would agree to do this only if Company C is a better credit than Company B. While Company B derecognises its liability to Company A, at the same time it will recognise its new liability to Company C. Also, Company C will recognise both a receivable from Company B and a liability to Company A. Company C is not permitted to offset its liability to Company A against its receivable from Company B unless a binding legal agreement among the three parties gives Company C the right of offset and Company C has the intent to settle on a net basis or simultaneously (see IAS 32.33 and IAS 32.36).

IAS 18, Revenue, deals with accounting for the fee received by Company C.

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Paragraph 57**Question 57-2**

Derecognition of financial liabilities: buy-back of bond obligation with intention to resell

If an industrial enterprise buys back one of its own bonds and has the intention to resell it, should it nevertheless derecognise the liability and take any gain or loss to net profit or loss?

Yes. In this case it is clear that the debtor has discharged the liability by paying the creditor. The enterprise does not have a liability to itself. The intention to resell the bonds does not create a contractual obligation to deliver cash or another financial asset. Therefore, the liability is derecognised.

This is consistent with the treatment of treasury shares as a deduction from equity, even if the enterprise has the intention to resell those shares (SIC-16).

If an enterprise repurchases its own debt, any difference between the carrying amount and the amount paid is included in net profit or loss (IAS 39.63).

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Paragraph 57**Question 57-3**

Derecognition of a financial liability: joint responsibility for debt

Enterprise A issues bonds that have a carrying amount and fair value of 1,000,000. Enterprise A pays 1,000,000 to Enterprise B for Enterprise B to assume responsibility for paying interest and principal on the bonds to the bondholders. The bondholders are informed that Enterprise B has assumed responsibility for the debt. However, Enterprise A is not legally released from the obligation to pay interest and principal by the bondholders. Accordingly, if Enterprise B does not make payments when due, the bondholders may seek payment from Enterprise A. Should Enterprise A derecognise the financial liability for the bonds and recognise a guarantee to pay if Enterprise B does not pay?

No. IAS 39.58(b) specifies that the derecognition condition in IAS 39.57 is met when the debtor is legally released from primary responsibility for the liability either by process of law or by the creditor. In this case, Enterprise A has not been legally released from the obligation to pay interest and principal on the bonds to the bondholders. Therefore, Enterprise A continues to recognise the liability for the bonds and recognises a receivable from Enterprise B of 1,000,000. Enterprise B recognises a liability of 1,000,000 since it has assumed an obligation to pay interest and principal to the bondholders.

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Paragraph 62**Question 62-1****Extinguishment of debt: substantially different terms**

When calculating present values for purposes of determining whether the 10 per cent limit under IAS 39.62 has been exceeded, would the present values be determined based on the effective interest rate of the old debt that is being modified or exchanged or on the effective interest rate of the new debt?

Neither method is addressed by IAS 39.62. Accordingly, the remaining cash flows of the original debt instrument and the cash flows under the new terms are discounted using the effective interest rate either under the old terms or under the new terms. An enterprise chooses one of the methods and applies that method consistently to all modifications and exchanges of debt instruments. The present values are compared to determine whether the present value of the cash flows under the new terms is at least 10 per cent different from the present value of the remaining cash flows under the old terms. If the difference in present values is at least 10 per cent, the transaction is accounted for as an extinguishment of the old debt. A gain or loss is recorded, unless the fair value of the modified debt equals the carrying amount of the old debt. If the difference in present values is less than 10 per cent, the difference between the present values under the old and new terms is amortised over the remaining term of the debt instrument.

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Measurement

Paragraph 66**Question 66-1****Initial measurement: transaction costs**

Transaction costs should be included in the initial measurement of financial assets and financial liabilities. How should this requirement be applied in practice?

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for instance fees and commissions, are added to the amount originally recognised. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognised.

For financial instruments that are carried at amortised cost, such as held-to-maturity investments, originated loans, and most financial liabilities, transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through the income statement over the life of the instrument. For financial instruments that are carried at fair value, such as available-for-sale investments and instruments held for trading, transaction costs are not included in the fair value measurement subsequent to acquisition.

For available-for-sale financial assets, the timing of recognising transaction costs in net profit or loss depends on the enterprise's policy for reporting fair value changes and whether an asset is a debt or equity investment. If the enterprise has elected to follow IAS 39.103(b)(i), the transaction costs are included in net profit or loss at initial remeasurement to fair value. If the enterprise has elected to follow IAS 39.103(b)(ii) and the financial asset has fixed or determinable payments and a fixed maturity (a "debt" investment), the transaction costs are amortised to net profit or loss using the effective interest method (see Question 103-1). If the enterprise has elected to follow IAS 39.103(b)(ii) and the financial asset does not have fixed or determinable payments and a fixed maturity (an "equity" investment), the transaction costs are recognised in income at the time of sale. For trading assets, the transaction costs are included in net profit or loss at initial remeasurement to fair value.

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

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Paragraph 66
Question 66-2
Transaction costs

IAS 39.66 specifies that on initial recognition a financial asset or financial liability is recognised at its cost, including transaction costs. Does this imply that transaction costs that would be incurred on the disposal of a financial asset are included in the initial measurement of a financial asset or financial liability?

No. On initial recognition only transaction costs that are directly attributable to the acquisition of a financial asset or financial liability are included in the initial measurement of that asset or liability (IAS 39.17).

To illustrate: Company A acquires an equity security at a price of 100 and pays a purchase commission of 2. If the asset was sold, a sales commission of 3 would be payable. In this case, the initial measurement of the asset is 102, that is, the sum of the purchase price and the purchase commission. The commission payable on sale is not considered for the purposes of determining the initial measurement. The subsequent treatment of transaction costs is discussed in Question 66-1.

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Paragraph 66
Question 66-3
Initial measurement: interest-free loan

Company A lends 1,000 to Company B for five years and classifies the asset as an originated loan. The loan carries no interest. Instead, Company A expects other future economic benefits, such as an implicit right to receive goods or services at favourable prices or influence over the activities of Company B. On initial recognition, the market rate of interest for a similar five-year loan with payment of interest at maturity is 10 per cent per year. On initial recognition, is the carrying amount of this loan equal to the amount lent, that is, 1,000?

No. The consideration given of 1,000 is for two assets. On initial recognition, the carrying amount of the loan is the fair value of the consideration given to obtain the right to a payment of 1,000 in five years. The fair value of that right is the present value of the future payment of 1,000 discounted using the market rate of interest for a similar loan of 10 percent for five years, that is, 620.92. The difference between the consideration for the loan of 620.92 and the principal amount of 1,000, that is, 379.08, is accreted over the term of the loan asset using the effective interest method. Company A also obtains other future economic benefits that have a fair value of 379.08 (the difference between the total consideration given of 1,000 and the consideration given for the loan of 620.92). The difference is not a financial asset, since it is paid to obtain expected future economic benefits other than the right to receive payment on the loan asset. Company A expenses that amount unless it qualifies for recognition as an asset under other applicable International Accounting Standards.

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Paragraph 70**Question 70-1****Reliability of fair value measurement**

An enterprise acquires a complex stand alone derivative that is based on several underlying variables, including commodity prices, interest rates, and credit indices. There is no active market or other price quotation for the derivative and no active markets for some of its underlying variables. The enterprise contends that the fair value of the derivative cannot be reliably measured. Can it measure the derivative at cost or amortised cost in accordance with IAS 39.73?

No. IAS 39.69 and IAS 39.93 require derivatives to be carried at fair value if their fair value can be reliably determined. For financial assets, there is a presumption that fair value of derivatives can be reliably determined with the exception only of derivatives that are linked to and must be settled by delivery of an unquoted equity instrument (IAS 39.70). Similarly, derivative liabilities are always measured at fair value unless they are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably determined (IAS 39.93). The fair value of the instrument is estimated by reference to appropriate market prices, prices of similar instruments, or discounted cash flow or other pricing models

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Paragraph 70**Question 70-2****Fair value measurement for an unquoted equity instrument**

Sometimes estimates of fair value of an unquoted equity instrument exist, but there is no appropriate or workable method to select a single estimate of fair value because the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed. Can an enterprise nevertheless measure the equity instrument at fair value in its financial statements, for instance, by selecting a reasonable fair value estimate by judgementally picking an estimate within the range?

No. If the fair value of an unquoted equity instrument cannot be reliably determined, IAS 39 precludes measuring that equity instrument at fair value (IAS 39.69). IAS 39.95 states that the variability in the range of reasonable estimates of fair value may be so great and the probabilities of the various outcomes so difficult to assess that the usefulness of a single estimate of fair value is negated. In such a case, the equity instrument is measured at cost after deduction for any impairment in accordance with IAS 39.73. Also, the enterprise discloses the fact that the equity investment could not be measured reliably and other related information (IAS 39.170(b)). In most cases, an enterprise will be able to make an estimate of the fair value that is sufficiently reliable by applying generally accepted methodologies in a consistent manner based on reasonable assumptions.

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Paragraph 70
Question 70-3

Reliable determination of fair value: embedded derivatives

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

No. In this case, the entire combined contract is treated as a financial instrument held for trading (IAS 39.26). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The enterprise might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment (IAS 39.73).

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Paragraph 73
Question 73-1

Example of calculating amortised cost: financial asset

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

Under IAS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the cash flows associated with the financial instrument through maturity or the next repricing date to the net carrying amount at initial recognition. The computation includes all fees and points paid or received.

To illustrate: Bank A purchases a debt instrument with five years remaining to maturity for its fair value of 1,000 (including transaction costs). The instrument has a principal amount of 1,250 and carries fixed interest of 4.7 percent that is paid annually ($1,250 \times 4.7\% = 59$ per year). It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 percent annually. The table below provides information about the amortised cost, interest income, and cash flows of the debt instrument in each reporting period.

<i>Year</i>	<i>(a) Amortised cost at the beginning of the year</i>	<i>(b = a x 10%) Interest income</i>	<i>(c) Cash flows</i>	<i>(d = a + b - c) Amortised cost at the end of the year</i>
20x0	1,000	100	59	1,041
20x1	1,041	104	59	1,086
20x2	1,086	109	59	1,136
20x3	1,136	113	59	1,190
20x4	1,190	119	1,250+59	-

If the debt instrument becomes impaired, say, at the end of year 20x2, the impairment loss is calculated as the difference between the carrying amount

(1,136) and the present value of expected future cash flows discounted at the original effective interest rate (10%).

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Paragraph 76

Question 76-1

Amortised cost: variable rate debt instrument

Under IAS 39, held-to-maturity financial assets and originated loans are measured at amortised cost using the effective interest method. If a debt instrument investment that requires interest payments at a variable rate is purchased at a discount or premium, should the discount or premium be amortised to maturity or to the next repricing date?

It depends generally on whether, at the next repricing date, the fair value of the financial asset will be its par value. Two potential reasons for the discount or premium are:

- a) The timing of interest payments, for instance, because interest payments are in arrears or have otherwise accrued since the most recent interest payment date or market rates of interest have changed since the debt instrument was most recently repriced to par.
- b) The market's required yield differs from the stated variable rate, for instance, because the credit spread required by the market for the specific instrument is higher or lower than the credit spread that is implicit in the variable rate.

A discount or premium that reflects interest that has accrued on the instrument since interest was last paid or changes in market rates of interest since the debt instrument was most recently repriced to par (case a above) is amortised to the date that the accrued interest will be paid and the variable interest rate is reset to market. To the extent the discount or premium results from a change in the credit spread over the variable rate specified in the instrument (case b above), however, it is amortised over the remaining term to maturity of the instrument. In this case, the date the interest rate is next reset is not a market-based repricing date of the entire instrument, since the variable rate is not adjusted for changes in the credit spread for the specific issue.

To illustrate, a twenty-year bond is issued at 100, has a principal amount of 100, and requires quarterly interest payments equal to current three-month LIBOR plus one percent over the life of the instrument. The interest rate reflects the market-based required rate of return associated with the bond issue at issuance. Subsequent to issuance, the credit quality of the bond

deteriorates resulting in a rating downgrade. Therefore, the bond trades at a significant discount. Company A purchases the bond for 95 and classifies it as held-to-maturity. In this case, the discount of 5 is amortised to net profit or loss over the period to the maturity of the bond. The discount is not amortised to the next date interest rate payments are reset. At each reporting date, Company A assesses the likelihood that it will not be able to collect all amounts due (principal and interest) according to the contractual terms of the instrument.

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Paragraph 78 (and paragraph 94)

Question 78-1

Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

If an enterprise designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognised in net profit or loss (IAS 21.15) while the exchange differences on the hedging instrument would be recognised in equity until the repayment of the liability (IAS 39.158)?

No. Exchange differences on the monetary asset and the monetary liability are both recognised in net profit or loss in the period in which they arise (IAS 21.15). IAS 39.78 and IAS 39.94 specify that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are reported in net profit or loss.

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Paragraph 80**Question 80-1****Held-to-maturity financial assets: index-linked principal**

Company A purchases a five-year equity-index-linked note with an original issue price of 10 at a market price of 12 at the time of purchase. The note requires no interest payments prior to maturity. At maturity, the note requires payment of the original issue price of 10 plus a supplemental redemption amount that depends on whether a specified stock price index exceeds a predetermined level at the maturity date. If the stock index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the stock index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the stock index at maturity and the level of the stock index at original issuance. Company A has the positive intent and ability to hold the note to maturity. Can Company A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of 10 and fixed maturity and Company A has the positive intent and ability to hold it to maturity (IAS 39.10). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under IAS 39.23. The purchase price of 12 is allocated between the host debt instrument and the embedded derivative. For instance, if the fair value of the embedded option at acquisition is 4, the host debt instrument is measured at 8 on initial recognition. In this case, the discount of 2 that is implicit in the host bond (principal of 10 minus the original carrying amount of 8) is amortised to net profit or loss over the term to maturity of the note using the effective interest method.

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Paragraph 80**Question 80-2****Held-to-maturity financial assets: index-linked interest**

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

Yes. However, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IAS 39.23). IAS 39.26 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

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Paragraph 83**Question 83-1****Held-to-maturity financial assets: permitted sales**

An enterprise may not classify any financial asset as held-to-maturity unless it has the positive intent and ability to hold it to maturity. If a sale of a held-to-maturity asset occurs, it calls into question the enterprise's intent to hold all other held-to-maturity financial assets to maturity. Exceptions are allowed for sales "close enough to maturity" and after collection of "substantially all" of the original principal. How should these conditions be interpreted?

These conditions relate to situations in which an enterprise can be expected to be indifferent whether to hold or sell a financial asset because movements in interest rates after substantially all of the original principal has been collected or when the instrument is close to maturity will not have a significant impact on its fair value. Accordingly, in such situations, a sale would not affect reported net profit or loss and no price volatility would be expected during the remaining period to maturity.

The condition "close enough to maturity" addresses the extent to which interest rate risk is substantially eliminated as a pricing factor. To illustrate application of this principle, if an enterprise sells a financial asset less than three months prior to maturity, that would generally qualify for use of this exception because the impact on the fair value of the instrument for a difference between the stated interest rate and the market rate generally would be small for an instrument that matures in three months relative to an instrument that matures in several years.

The condition of having collected "substantially all" of the original principal provides guidance as to when a sale is for not more than an insignificant amount. If an enterprise sells a financial asset after it has collected 90 per cent or more of the financial asset's original principal through scheduled payments or prepayments, that would generally qualify for this exception. However, if the enterprise has collected, say, only 10 per cent of the original principal, then that condition clearly is not met.

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Paragraph 83**Question 83-2**

Held-to-maturity financial assets: change of intent or ability – permitted sales

IAS 39.90 requires that a held-to-maturity investment must be reclassified (to either available-for-sale or trading) and remeasured at fair value if there is a change of intent or ability. Does such reclassification call into question the classification of other held-to-maturity investments?

Yes. IAS 39.83 applies not only to sales of held-to-maturity investments, but also to transfers of such investments. The term “transfer” comprises any reclassification out of the held-to-maturity category. Thus, the transfer of more than an insignificant portion of held-to-maturity investments into the available-for-sale or trading category would not be consistent with an intent to hold other held-to-maturity investments to maturity.

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Paragraph 83**Question 83-3**

Held-to-maturity financial assets: insignificant exercises of put options and insignificant transfers

IAS 39.83 prohibits held-to-maturity classification if an enterprise has sold, transferred, or exercised a put option on more than an insignificant amount of held-to-maturity investments, but it provides in subparagraphs (a), (b), and (c) for exceptions for certain sales. Do those exceptions also apply to transfers and exercises of put options in similar circumstances?

Yes. “Sales” as that term is used in IAS 39.83(a), (b), and (c) includes exercises of puts and transfers (see Question 83-2).

IAS 39.82 permits an enterprise to classify a puttable debt instrument as held to maturity provided that the investor has the positive intent and ability to hold the investment until maturity and does not intend to exercise the put option. However, the use of such classification requires great care as it seems inconsistent with the likely intent of purchasing a puttable debt instrument because the investor paid for the put option and it would seem counterintuitive that the investor would be willing to represent that he will not exercise the option.

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Paragraph 83**Question 83-4****Held-to-maturity financial assets: “tainting”**

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

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held-to-maturity (HTM) results in the conditions in IAS 39.83 and IAS 39.86 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as either available-for-sale or held for trading. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under IAS 39.90. IAS 39.83 makes it clear that at least two full financial years must pass before an enterprise can again classify financial assets as HTM.

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Paragraph 83**Question 83-5****Held-to-maturity investments: sub-categorisation for the purposes of applying the ‘tainting’ rule**

Can an enterprise apply the conditions in IAS 39.83 separately to different categories of held-to-maturity financial assets, such as, separately to debt securities denominated in US dollars and to debt securities denominated in euros?

No. The ‘tainting rule’ in IAS 39.83 is clear. If an enterprise has sold, transferred, or exercised a put option on more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

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Paragraph 83**Question 83-6**

Held-to-maturity investments: application of the ‘tainting’ rule on consolidation

Can an enterprise apply the conditions in IAS 39.83 separately to held-to-maturity financial assets held by different companies in a consolidated group, for instance, if those group companies are in different countries with different legal or economic environments?

No. If an enterprise has sold, transferred, or exercised a put option on more than an insignificant amount of investments classified as held to maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in IAS 39.83 are met.

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Paragraph 83**Question 83-7**

Held-to-maturity financial assets: sale following rating downgrade

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

Not necessarily. A downgrade will likely indicate a decline in the issuer’s creditworthiness. IAS 39.86(a) specifies that a sale due to a significant deterioration in the issuer’s creditworthiness could satisfy the condition in IAS 39.83 and therefore not raise a question about the enterprise’s intent to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the enterprise classified the investment as held to maturity in order to meet the condition in IAS 39.83(c). A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class often could be considered reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be considered significant. See also Question 10-16.

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Paragraph 86

Question 86-1

Held-to-maturity financial assets: permitted sales

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

Yes. A change in management is not identified under IAS 39.86 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held-to-maturity. Sales in response to such a change in management would, therefore, call into question the enterprise's intent to hold investments to maturity.

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

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Paragraph 86

Question 86-2

Sales of held-to-maturity investments: entity-specific capital requirements

In some countries, regulators of banks or other industries may set capital requirements on an *entity-specific basis* based on an assessment of the risk in that particular entity. IAS 39.86(e) indicates that an enterprise that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the *industry's* capital requirements may do so under IAS 39 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in entity-specific capital requirements imposed by regulators (that is, capital requirements applicable to a particular enterprise, but not to the industry), raise such doubt?

Yes, such sales "taint" the enterprise's intent to hold other financial assets as held-to-maturity unless it can be demonstrated that the sales fulfil the condition in IAS 39.83(c) in that they result from an increase in capital requirements which is an isolated event that is beyond the enterprise's control and that is non-recurring and could not have been reasonably anticipated by the enterprise.

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Paragraph 87**Question 87-1**

Held-to-maturity financial assets: pledged collateral, repurchase agreements (repos) and securities lending agreements

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

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

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Paragraph 93**Question 93-1**

Amortising discount and premium on liabilities

IAS 39.73 states that held-to-maturity financial assets should be carried "at amortised cost using the effective interest method". However, with respect to financial liabilities, IAS 39.93 states they should be carried "at amortised cost" without mentioning the effective interest method. In amortising discount and premium on liabilities, does IAS 39 require use of the effective interest method?

Yes. Although IAS 39.93 does not mention the effective interest method, IAS 39.10 describes the effective interest method with respect to the determination of amortisation for both financial assets and financial liabilities. Moreover, IAS 32.61 and IAS 32.62 require disclosure of effective interest rates for financial liabilities.

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Paragraph 99**Question 99-1****Fair value measurement considerations for investment funds**

IAS 39.99 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors based on mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets based on mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in IAS 39.99 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values reported on its balance sheet and the prices used for the net asset value calculation.

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Paragraph 100**Question 100-1****Fair value measurement: large holding**

Company A holds 15 per cent of the share capital in Company B. The shares are publicly traded in an active market. The currently quoted price is 100. Daily trading volume is 0.1 per cent of outstanding shares. Because Company A believes that the fair value of the Company B shares it owns, if sold as a block, is greater than the quoted market price, Company A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Company A would be able to obtain a price of 105, that is, a 5 per cent premium above the quoted price. Which figure should Company A use for measuring its holding at fair value?

Under IAS 39.99, there is a presumption that a published price quotation in an active market is the best estimate of fair value. Therefore, Company A uses the published price quotation (100). Company A cannot depart from the quoted market price solely because independent estimates indicate that Company A would obtain a higher (or lower) price by selling the holding as a block. However, if Company A could present objective, reliable evidence validating a higher (or lower) amount, IAS 39.98 and IAS 39.100 provide for an adjustment to the quoted price. For instance, if Company A has entered into a contract with a third party to sell the shares at a fixed price in the immediate future, that might justify an adjustment to the quoted price.

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Paragraph 103**Question 103-1****Amortisation of premium or discount: classification**

If an investment in bonds is classified as available-for-sale, and if the enterprise has adopted the policy of reporting fair value changes in equity until the investment is sold, should amortisation of premium or discount on such an investment be reported (a) in net profit or loss as part of interest income or expense or (b) in equity as part of the recognised fair value change?

In net profit or loss. IAS 39.170(c)(i) requires disclosure of total interest income and total interest expense on a historical cost basis. Under other provisions of IAS 39 (IAS 39.10 and IAS 39.73) as well as IAS 18 and IAS 32, these amounts are measured using the effective interest method, which means that the amortisation of premium or discount is part of interest income or interest expense and, therefore, included in determining net profit or loss.

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Paragraph 103**Question 103-2****Available-for-sale financial assets: exchange of shares**

Enterprise A holds a small number of shares in Company B. The shares are classified as available for sale. Enterprise A has a policy of reporting gains and losses on available-for-sale financial assets in equity. On 20 December 2000, the fair value of the shares is 120 and the cumulative gain included in equity is 20. On the same day, Company B is acquired by Company C, a large public company. As a result, Enterprise A receives shares in Company C in exchange for those it had in Company B of equal fair value. Under IAS 39.103, should Enterprise A recognise the cumulative gain of 20 included in equity in net profit or loss for the period?

Yes. The transaction qualifies for derecognition under IAS 39.35 because Enterprise A gave up control of Company B's shares in exchange for Company C's shares. IAS 39.103(b)(ii) requires that the cumulative gain or loss that has been included in equity on an available-for-sale financial asset be included in net profit or loss when the asset is sold, collected, or otherwise disposed of. In the exchange of shares, Enterprise A disposes of the shares it had in Company B and receives shares in Company C.

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Paragraph 106**Question 106-1****Settlement date accounting: fair value changes on sale of financial asset**

If an enterprise recognises sales of financial assets using settlement date accounting, is any change in the quoted market price or other market-determined measure of fair value of an asset that is sold on a “regular way” basis recognised in the period between trade date and settlement date?

Generally no. An enterprise is not exposed to changes in the quoted price or other market-determined measure of fair value of the asset subsequent to trade date unless the transaction is not settled, for example, because of the default of the transferee. IAS 39.98 states that “the fair value of a financial asset that an enterprise has decided to sell in the near future is determined by the amount that it expects to receive from such a sale.” Therefore, a change in the quoted market price or other market-determined measure of fair value of a financial asset that is sold generally is not recognised in the financial statements between trade date and settlement date even if the enterprise does not derecognise the asset until settlement date. If there is a risk that the transaction will not be settled or payment will not be received, the transferor assesses whether there is impairment (IAS 39.109). Question 34-1 illustrates the application of trade date accounting and settlement date accounting to a sale of a financial asset.

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Paragraph 106**Question 106-2****Settlement date accounting: exchange of non-cash financial assets**

If an enterprise recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the financial asset that is sold be recognised in accordance with IAS 39.106 if the financial asset to be received is not cash?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under IAS 39.106 if the enterprise applies settlement date accounting for that category of financial assets. However, if the enterprise classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in IAS 39.32. In that case, the enterprise recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate, on 29 December 20x2 (trade date) Company A enters into a contract to sell Note Receivable A, which is carried at amortised cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of 1,010 on 29 December, while the amortised cost of Note Receivable A is 1,000. Company A uses settlement date accounting for originated loans and trade date accounting for assets held for trading. On 31 December 20x2 (financial year end), the fair value of Note Receivable A is 1,012 and the fair value of Bond B is 1,009. On 4 January 20x3, the fair value of Note Receivable A is 1,013 and the fair value of Bond B is 1,007. The following entries are made:

29 December 20x2	Debit	Credit
Bond B	1,010	
Payable		1,010
31 December 20x2	Debit	Credit
Trading loss	1	
Bond B		1
4 January 20x3	Debit	Credit
Payable	1,010	

Trading loss	2	
Note Receivable A		1,000
Bond B		2
Realisation gain		10

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Paragraph 107

Question 107-1

Reclassification from available-for-sale to trading

If there is evidence of a recent actual pattern of short-term profit taking, an enterprise should reclassify a financial asset into the trading category. How should gains and losses on an equity investment that have been deferred in equity be recognised?

IAS 39.107 does not provide any specific guidance in respect of the appropriate recognition of gains and losses that have been deferred in equity following a transfer from the available-for-sale category to the trading category. However, IAS 39.92 deals with another reclassification situation and precludes immediate gain or loss recognition. That guidance should be looked to in applying IAS 39.107. Consequently, under IAS 39.107, where the changes in fair value subsequent to initial recognition have been recognised directly in equity for the available-for-sale equity investment, it is inappropriate to recognise a gain or loss on the transfer since this would allow too much flexibility in the timing of revenue recognition in net profit or loss. Instead, the gain or loss on transfer is recognised in accordance with the principle set out in IAS 39.92(b). As a result, the cumulative prior fair value change on that asset that had been recognised directly in equity is left in equity until the financial asset is sold or otherwise disposed of, at which time it enters into the determination of net profit or loss.

This treatment is also consistent with IAS 39.163(b), which requires that the cumulative prior fair value change that was reported in equity remains in equity until the forecasted transaction occurs for cash flow hedging relationships. In any event, if there is evidence of a recent actual pattern of short-term profit taking that justifies reclassification, the turnover in the portfolio would often result in the gains or losses being recognised in net profit or loss within a reasonably short period after reclassification.

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Paragraph 107**Question 107-2****Reclassification to trading: decision to sell**

If an enterprise decides to sell a financial asset that is not classified as held for trading in the near future, should it reclassify that asset into the held-for-trading category?

No. IAS 39.107 specifies that the designation of a financial asset as held for trading is based on the objective for initially acquiring it. A decision to sell a financial asset does not make that asset a financial asset held for trading. On the other hand, if the asset is part of a portfolio of similar assets for which there is a recent pattern of trading, for instance, a portfolio of treasury notes classified as available-for-sale financial assets, they would be reclassified into the trading category.

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Paragraph 109**Question 109-1****Objective evidence of impairment**

Does IAS 39 require that an enterprise be able to identify a single, distinct past causative event to conclude that it is probable that it will not be able to collect all amounts due on a financial asset?

No. For instance, IAS 39.110 states that “a downgrade of an enterprise’s credit rating is not, of itself, evidence of impairment, though it may be evidence of impairment when considered with other available information”. Other factors that an enterprise considers in determining whether it has objective evidence that an impairment loss has occurred include information about the debtors’ or issuers’ liquidity, solvency, and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may either individually or taken together provide sufficient objective evidence that an impairment loss has occurred in a financial asset or group of financial assets.

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Paragraph 110**Question 110-1****Impairment: future losses**

Does IAS 39 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Bank A lends 1,000 to Customer B, can it recognise an immediate impairment loss of 10 if Bank A, based on historical experience, expects that 1% of the principal amount of loans given will not be collected?

No. IAS 39.66 requires that a financial asset initially be measured at cost, which is the fair value of the consideration given. For a loan asset, the fair value of the consideration given is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges, see Question 66-3). It is inconsistent with IAS 39.66 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

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Paragraph 111**Question 111-1****Assessment of impairment: principal and interest**

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

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

IAS 39.111 indicates that an impairment loss has occurred if it is probable that an enterprise will not be able to collect all amounts due according to the contractual terms of a loan. Therefore, if the amount and timing of payments has changed, as is the case in each of (a) through (e) above, impairment must be assessed based on current expectations regarding collection of principal and interest. In cases (a) through (d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate (that is, the recoverable amount) will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognised in those cases.

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

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Paragraph 111 (also paragraph 137)**Question 111-2****Assessment of impairment: fair value hedge**

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

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

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the expected future cash flows of the loan discounted at the adjusted effective interest rate.

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Paragraph 111**Question 111-3****Impairment: provisioning matrix**

A financial institution calculates impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies fixed provisioning rates for the number of days a loan has been classified as non-performing (0% if less than 90 days, 20% if 90-180 days, 50% if 180-365 days, and 100% if more than 365 days). Can the results be considered to be appropriate for the purposes of calculating the recoverable amount of originated loans and receivables under IAS 39.111?

Not necessarily. IAS 39.111 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate.

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Paragraph 111**Question 111-4****Impairment: excess losses**

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

No. IAS 39 does not permit an enterprise to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of similar financial assets (IAS 39.112) based on objective evidence about the existence of impairment in those assets (IAS 39.110). Amounts that an enterprise might want to set aside for additional, possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under IAS 39.

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Paragraph 112

Question 112-1

Recognition of impairment on a portfolio basis

IAS 39.111 requires that impairment be recognised for financial assets carried at amortised cost. IAS 39.112 states that impairment may be measured and recognised individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortised cost, does IAS 39 allow non-recognition of the impairment of the first asset?

No. If an enterprise knows that an individual financial asset carried at amortised cost is impaired, IAS 39.111 requires that the impairment of that asset be recognised. It states: “the amount of the loss is the difference between *the asset’s* carrying amount and recoverable amount” (emphasis added). Measurement of impairment on a portfolio basis under IAS 39.112 is applied when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

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Paragraph 112

Question 112-2

Impairment: portfolio assessment for individually impaired asset

If an enterprise concludes that a financial asset carried at amortised cost is impaired, can that asset be included in a group of similar financial assets for which impairment is recognised and measured on a portfolio basis?

No. A financial asset that has been individually identified as impaired should not be included in a group of similar financial assets for which impairment is recognised and measured on a portfolio basis. Recognition and measurement of impairment on a portfolio basis can only be made for groups of similar financial assets that are not individually identified as impaired (IAS 39.112). If there is objective evidence that an identified financial asset is impaired, impairment is recognised and measured on an individual basis in accordance with IAS 39.111. See also Question 112-1.

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Paragraph 113**Question 113-1****Impairment: consideration of the value of collateral**

If an impaired financial asset is secured by collateral, should the collateral be taken into account in measuring the recoverable amount of the asset?

Yes. The estimation of the recoverable amount of a collateralised financial asset reflects the cash flows that may result from foreclosure whether or not foreclosure is probable. If foreclosure is probable, impairment is measured based on the fair value of the collateral less costs of obtaining the collateral. Similarly, the estimation of the recoverable amount for a financial asset that is secured by a guarantee takes into account the value of the guarantee.

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Paragraph 113**Question 113-2****Impairment: recognition of collateral**

If an impaired financial asset is secured by collateral and foreclosure is probable, is the collateral recognised as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral would generally not meet the recognition criteria until it is transferred to the lender. Accordingly, the collateral is not recognised as an asset separate from the impaired financial asset prior to foreclosure.

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Paragraph 113**Question 113-3****Impairment: observable market price**

Does IAS 39 permit measuring impairment of a fixed rate financial asset carried at amortised cost based on the asset's observable market price?

No. IAS 39.113 states that “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 ...”. IAS 39.113 permits using an observable market price for measuring impairment in a variable rate financial instrument because the amortised cost and fair value of a variable rate instrument can be expected to be approximately equal. For a fixed rate asset, if interest rates have not increased subsequent to the acquisition or origination of the asset, the observable market price may provide evidence of credit deterioration and an impairment which should be recognised.

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Paragraph 117**Question 117-1****Impairment of available-for-sale financial assets**

The market value of an equity security that is classified as available-for-sale falls below cost. Is this evidence of impairment?

Not necessarily. If the enterprise reports fair value changes on available-for-sale financial assets in equity in accordance with IAS 39, it continues to do so until there is objective evidence of impairment, such as the circumstances identified in IAS 39.110. If objective evidence of impairment exists, any cumulative net loss that has been recognised directly in equity is removed and recognised in net profit or loss for the period.

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Paragraph 117**Question 117-2****Impairment of non-monetary available-for-sale financial asset**

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses reported in equity becomes impaired, should the cumulative net loss included in equity, including any portion attributable to foreign currency changes, be recognised in net profit or loss for the period?

Yes. IAS 39.117 states that if a loss on a financial asset carried at fair value has been recognised directly in equity and there is objective evidence that the asset is impaired (recoverable amount is below original acquisition cost), the cumulative net loss that had been recognised directly in equity should be removed from equity and recognised in net profit or loss for the period even though the asset has not been derecognised. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been included in equity is also included in net profit or loss for the period. Any subsequent losses, including any portion attributable to foreign currency changes, are also included in net profit or loss until the asset is derecognised or is restored to unimpaired status. If the fair value or recoverable amount increases and the increase can be objectively related to an event occurring after the loss was recognised in net profit or loss, IAS 39.119 requires the impairment loss to be reversed, with the amount of the reversal included in net profit or loss for the period.

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Paragraph 118**Question 118-1****Impairment: debt instrument remeasured to fair value**

IAS 39.118 states that the recoverable amount of a debt instrument remeasured to fair value is the present value of expected future cash flows discounted at the current market rate for a similar financial asset. What is the current market rate of interest for a similar financial asset?

IAS 39 does not define the current market rate of interest for a similar financial asset. However, care must be taken not to include expected defaults in both the discount rate and expected future cash flows, that is, the discount rate must be consistent with the assumptions made about expected defaults in the expected future cash flows. The current market rate of interest for an otherwise comparable financial asset is its effective yield. That yield reflects the impairment loss the marketplace expects.

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Paragraph 121**Question 121-1****Hedge accounting: management of interest rate risk in financial institutions**

Banks and other financial institutions often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the enterprise about their financial assets, financial liabilities, and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many financial institutions use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If a financial institution manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under IAS 39?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecasted cash inflows, or forecasted cash outflows giving rise to the net exposure (IAS 39.133 and IAS 39.143). It is not possible to designate a net position as a hedged item under IAS 39 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to objectively determine the period in which such gains and losses should be recognised in net profit or loss.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in IAS 39.142 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the enterprise's net profit or loss (IAS 39.149) and the enterprise designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The key factors an enterprise must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question 121-2.

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Paragraph 121
Question 121-2

Hedge accounting considerations when interest rate risk is managed on a net basis

If an enterprise manages its exposure to interest rate risk on a net basis, what are the key issues the enterprise should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues 121-2-a to 121-2-l below address the key issues. First, Issues 121-2-a and 121-2-b discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues 121-2-c to 121-2-l expand on various aspects of the accounting for cash flow hedges. Issues 121-2-c to 121-2-f consider the application of the hedge accounting criteria for cash flow hedges in IAS 39, while Issues 121-2-g to 121-2-h discuss the required accounting treatment. Finally, Issues 121-2-i to 121-2-l elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue 121-2-a: Can a derivative that is used to manage interest rate risk on a net basis be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure under IAS 39?

Both types of designation are possible under IAS 39. An enterprise may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets or liabilities or as a cash flow hedge of forecasted transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability. Firm commitments to purchase or sell assets at fixed prices create fair value exposures, but are accounted for as cash flow hedges (IAS 39.137(b)).

In economic terms, it does not matter whether the derivative instrument is considered a fair value hedge or a cash flow hedge. Under either perspective

of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offsets the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue 121-2-b.

To illustrate: a bank has the following assets and liabilities with a maturity of two years:

	<i>Variable interest</i>	<i>Fixed interest</i>
Assets	60	100
Liabilities	(100)	(60)
Net	(40)	40

The bank takes out a 2-year swap with a notional principal of 40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be considered and designated either as a fair value hedge of 40 of the fixed-rate assets or as a cash flow hedge of 40 of the variable-rate liabilities.

Issue 121-2-b: What are critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of the derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses differ for each of these categories. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the probability test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (IAS 39.142(b)). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan, and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. However, for accounting purposes, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. The fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecasted cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (IAS 39.142(c)) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the

hedged item and hedging instrument (IAS 39.142(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecasted transaction. If the hedge is established for risk management purposes on a net basis, an enterprise may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecasted transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting differs for fair value hedges and cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective yield of the hedged item (IAS 39.153). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the hedged assets or liabilities being hedged in order to be able to recompute their effective yield, determine the subsequent amortisation of the fair value adjustment to net profit or loss, and determine the amount that should be recognised in net profit or loss when assets are sold or liabilities extinguished (IAS 39.153 and IAS 39.157). To comply with the requirements for fair value hedge accounting, it generally will be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective yield of the hedged items, and amortise the changes to net profit or loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecasted transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognised in equity (IAS 39.158). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the adjustments to equity from changes in the fair value of a hedging instrument should be recognised in net profit or loss (IAS 39.162-163). For

cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling out the changes in the cash flows of the derivative and the recognition of such changes in net profit or loss.

The timing of the recognition in earnings can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecasted transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced each of which create a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rate are matched with the derivative hedging instrument. IAS 39.162 specifies that the amounts recognised in equity should be included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss.

Issue 121-2-c: If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by IAS 39.142(a)?

The following would be included in the documentation:

The hedging relationship - The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The enterprise's risk management objective and strategy for undertaking the hedge - The enterprise's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge - The hedge is documented as a cash flow hedge.

The hedged item - The hedged item is documented as a group of forecasted transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for instance, scheduled on a monthly

basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue 121-2-e, the forecasted transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk - The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based off of the same yield curve as the derivative hedging instrument.

The hedging instrument - Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecasted transactions occurring in the specified future periods designated as being hedged.

The method of assessing effectiveness - The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecasted transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue 121-2-d: If the hedging relationship is designated as a cash flow hedge, how does an enterprise satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in IAS 39.142(b)?

An enterprise may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue 121-2-e: If the hedging relationship is designated as a cash flow hedge, how does an enterprise demonstrate a high probability of the forecasted transactions occurring as required by IAS 39.142(c)?

An enterprise may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecasted transactions that are designated as being hedged are highly probable of occurring. Such a schedule should be supported by management's stated intent and past practice of reinvesting cash inflows and refinancing cash outflows.

For instance, an enterprise may forecast aggregate gross cash inflows of 100 and aggregate gross cash outflows of 90 in a particular time period in the near future. In this case, it may wish to designate the forecasted reinvestment of gross cash inflows of 10 as the hedged item in the future time period. If more than 10 of the forecasted cash inflows are contractually specified and have low credit risk, the enterprise has very strong evidence to support an assertion that gross cash inflows of 10 are highly probable of occurring and support the designation of the forecasted reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecasted transactions occurring may also be demonstrated under other circumstances.

Issue 121-2-f: If the hedging relationship is designated as a cash flow hedge, how does an enterprise assess and measure effectiveness under IAS 39.142(d) and (e)?

Effectiveness is required to be measured at a minimum at the time an enterprise prepares its annual or interim financial reports. However, an enterprise may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in net profit or loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are

compared with computations of changes in the cash flows of the forecasted transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognised initially in equity are reclassified out of equity and recognised in net profit or loss.

Issue 121-2-g: If the hedging relationship is designated as a cash flow hedge, how does an enterprise account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in IAS 39.158-162, as follows:

- (a) the portion of gains and losses on hedging derivatives determined to result from effective hedges is recognised in equity whenever effectiveness is measured; and
- (b) the ineffective portion of gains and losses resulting from hedging derivatives is recognised in net profit or loss.

IAS 39.162 specifies that the amounts recognised in equity should be included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss. Accordingly, when the forecasted transactions occur, the amounts previously recognised in equity are recognised in net profit or loss. For instance, if an interest rate swap is designated as a hedging instrument of a series of forecasted cash flows, the changes in the cash flows of the swap are recognised in net profit or loss in the periods when the forecasted cash flows and the cash flows of the swap offset each other.

Issue 121-2-h: If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognised in equity if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecasted transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for instance, the

forecasted transactions are no longer highly probable, the net cumulative gain or loss reported in equity remains in equity until the forecasted transaction occurs (IAS 39.163(a) and (b)). If the hedged forecasted transactions are no longer expected to occur, the net cumulative gain or loss is reported in net profit or loss for the period (IAS 39.163(c)).

Issue 121-2-i: *IAS 39.145 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does IAS 39.145 preclude redesignating the hedging instrument?*

No. IAS 39.145 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. IAS 39.145 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognised immediately in net profit or loss (IAS 39.158) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (IAS 39.163). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue 121-2-j: *For cash flow hedges, IAS 39.160 states that “if the hedged firm commitment or forecasted transaction results in the recognition of an asset or liability, then at the time the asset or liability is recognised the associated gains or losses that were recognised directly in equity ... should enter into the initial measurement of the ... carrying amount of the asset or liability” (so-called “basis adjustment”). If a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecasted interest cash flows or portions thereof on a gross basis, is there a basis adjustment when the forecasted cash flow occurs?*

No. In the hedging relationship described in Issue 121-2-c, the hedged item is a group of forecasted transactions consisting of interest cash flows in specified future periods. There is no basis adjustment because the hedged forecasted transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is

recognised in net profit or loss in the period in which the forecasted transactions occur. Although the types of hedges described herein would not result in basis adjustment, if instead the derivative is designated as a hedge of a forecasted purchase of a financial asset or issuance of a liability, the derivative gain or loss would be an adjustment to the basis of the asset or liability upon the occurrence of the transaction (IAS 39.160).

Issue 121-2-k: *In the answer to Issue 121-2-c above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does IAS 39 permit a portion of a cash flow exposure to be designated as a hedged item?*

Yes. IAS 39 does not specifically address a hedge of a portion of a cash flow exposure for a forecasted transaction. However, IAS 39.128 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecasted reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by IAS 39.129, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the risks attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecasted transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue 121-2-l: *In the answer to Issue 121-2-c above it was indicated that the hedged item is documented as a group of forecasted transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities, and option features, how can an enterprise satisfy the tests in IAS 39.127 and IAS 39.132 requiring that the hedged group have similar risk characteristics?*

IAS 39.127 provides for hedging a group of assets, liabilities, firm commitments, or forecasted transactions with similar risk characteristics. IAS 39.132 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the

portfolio share the same risk for which they are designated and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an enterprise associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecasted transactions. For hedges of cash flow exposures relating to a group of forecasted transactions, the overall exposure of the forecasted transactions and the assets or liabilities that are repricing may have very different risks. The exposure from forecasted transactions may differ based on the terms that are expected as they relate to credit exposures, maturities, option, and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (that is, the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit-rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (IAS 39.144). For example, if a portfolio of assets consists of assets rated A, BB, and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points, and LIBOR+60 basis points, respectively, an enterprise may use a swap that pays fixed interest rate and for which variable interest payments are made based on LIBOR to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being

hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

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Paragraph 122

Question 122-1

Hedging instrument: hedging using more than one derivative

Does IAS 39 permit designating two or more derivatives that are acquired at the same or different times as hedging instruments for the same hedged item?

Yes. Two or more derivatives, or proportions thereof, may be viewed in combination and jointly designated as a unit as the hedging instrument. However, two derivatives that are combined and result in a net written option do not qualify as a hedging instrument (see Question 124-1). If the derivative contracts are with different counterparties, the carrying amounts of the derivatives cannot be offset in the balance sheet unless the offsetting criteria in IAS 32 are met.

IAS 39.127 does not provide for a derivative to be a hedged item, except in the limited circumstances of a written option offsetting a purchased option (IAS 39.124).

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Paragraph 122

Question 122-2

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

Company J, whose measurement currency is the Japanese yen, has issued 5 million 5-year US dollar fixed rate debt. Also, it owns a 5 million 5-year fixed rate US dollar bond which it has classified as available for sale. Company J has a policy of reporting gains and losses on available-for-sale financial assets directly in equity. Can Company J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. IAS 39.122 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Company J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

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

Yes. However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates (see Question 153-1). Regardless of whether Company J designates the relationship as a cash flow hedge or a fair value hedge, the effect on net profit or loss is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognised in net profit or loss to correspond with the recognition of the change in spot rate on the hedged item in net profit or loss as required by IAS 21.

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Paragraph 122**Question 122-3****Hedging with a non-derivative financial asset or liability**

Company J's measurement currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of US dollar 5 million. It has also entered into a 5 million US dollar fixed price sales commitment that matures in two years and that is not accounted for as a derivative because it meets the exemption for normal sales in IAS 39.14. Can Company J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting.

No. IAS 39.122 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk. Also, IAS 39.137 does not permit a hedge of an unrecognised forward contract to be designated as a fair value hedge.

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

Yes. IAS 39 permits the designation of a non-derivative asset or liability as a hedging instrument in a cash flow hedge of the exposure to changes in foreign exchange rates of a firm commitment (IAS 39.122 and IAS 39.137). Any gain or loss on the non-derivative hedging instrument that is recorded in equity during the period preceding the occurrence of the future sale is recognised in net profit or loss when the sale occurs (IAS 39.162).

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

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under IAS 39.23 and IAS 39.25(d), it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt

attributable to foreign currency risk. The foreign currency component would be separated if (a) the US dollar is not the currency of the primary economic environment of the counterparty to the sales commitment, and (b) the good or service that is delivered is not routinely denominated in US dollars in international commerce.

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Paragraph 124**Question 124-1**

Hedge accounting: use of written options in combined hedging instruments

Does IAS 39.124 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IAS 39.124 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

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

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

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

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Paragraph 127 (also paragraph 132)**Question 127-1****Hedge accounting: netting of assets and liabilities**

May an enterprise group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An enterprise's hedging strategy and risk management practices may assess cash flow risk on a net basis but IAS 39.132 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IAS 39.133 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

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Paragraph 127**Question 127-2****Held-to-maturity investments: hedging variable rate interest rate payments**

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

No, it is inconsistent with the designation of a debt investment as being held-to-maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. IAS 39.127 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk "because designation of an investment as held-to-maturity involves not accounting for associated changes in interest rates".

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Paragraph 127**Question 127-3****Hedged items: purchase of held-to-maturity investment**

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

Yes. With respect to interest rate risk, IAS 39 prohibits hedge accounting for financial assets that are classified as held to maturity (IAS 39.127). However, even though the enterprise intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

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Paragraph 127**Question 127-4****Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments**

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

Yes. IAS 39.127 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question 127-2 specifies that this applies not only to fair value hedges, that is, hedges of the exposure to “fair value interest rate risk” associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, that is, hedges of the exposure to “cash flow interest rate risk” associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecasted future interest receipts on debt instruments resulting from the forecasted reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecasted to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecasted future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

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Paragraph 127**Question 127-5****Whether a derivative can be designated as a hedged item**

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

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses reported in net profit or loss unless they are designated and effective hedging instruments (IAS 39.10). As an exception, IAS 39.124 permits the designation of a purchased option as the hedged item in a fair value hedge.

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Paragraph 127**Question 127-6****Hedge of prepayment risk of a held-to-maturity investment**

An enterprise holds an investment with prepayment risk, for instance, a mortgage-backed pass-through security whose payments are based on a portion of an underlying pool of loans that are subject to prepayment risk. Assuming that the investment qualifies as a held-to-maturity investment, can the enterprise designate it as a hedged item with respect to prepayment risk?

No. IAS 39.127 permits the designation of a held-to-maturity investment as a hedged item in a hedge of exposures to changes in foreign currency exchange rates or credit risk. It does not allow the designation of a held-to-maturity investment as a hedged item in a hedge of interest rate risk. Because prepayment risk is primarily a function of interest rate changes, that risk is more akin to interest rate risk than foreign currency risk or credit risk.

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Paragraph 128**Question 128-1****Hedge accounting: prepayable financial asset**

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

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are highly probable (IAS 39.142). For instance, cash flows after the prepayment date may qualify as “highly probable” if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out-of-the-money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

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Paragraph 128**Question 128-2****Partial term hedging**

IAS 39.145 indicates that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Company A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Company A classifies the bond as available-for-sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year five, Company A acquires a five-year pay-fixed receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year five and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

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Paragraph 128

Question 128-3

Hedge accounting: risk components

Does IAS 39 permit hedge accounting for components of risk, such as the risk free interest rate or credit spreads, for a particular asset or liability?

Yes. IAS 39 does not restrict hedge accounting to hedges of the entire risk of changes in fair value or the entire exposure to interest rate risk, currency risk, counterparty credit risk or other risks. It permits risk components to be designated as hedged risks, for instance, the exposure to changes in fair value due to changes in three-month interbank offered rates associated with a debt instrument, provided hedge effectiveness can be measured and the other hedge accounting conditions in IAS 39.142 are met.

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Paragraph 128

Question 128-4

Hedged items: hedge of foreign currency risk of publicly traded shares

Enterprise A acquires shares in Company B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. Enterprise A has a policy of reporting gains and losses on available-for-sale financial assets in equity. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC 750. Enterprise A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or other established market place) on which trades are denominated in the same currency as the measurement currency of Enterprise A and (b) dividends to Enterprise A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the measurement currency of the reporting enterprise, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to 750 in foreign currency?

Yes. IAS 39 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (IAS 39.128). Therefore, Enterprise A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC 750 associated with the shares or as a cash flow hedge of a forecasted sale of the shares provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below 750.

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Paragraph 131**Question 131-1****Hedges of more than one type of risk**

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

No. For example, companies commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the reporting currency. IAS 39.131 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in IAS 39.131 are met.

If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

IAS 39.169 requires disclosures separately for designated fair value hedges, cash flow hedges, and hedges of a net investment in a foreign entity. The instrument in question would be reported in the IAS 39.169 disclosures separately for each type of hedge.

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Paragraph 131**Question 131-2****Hedging instrument: cross-currency interest rate swap**

Company A's measurement currency is the Japanese yen. Company A has a five-year floating rate US dollar liability and a 10 year fixed rate pound sterling-denominated note receivable. Company A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Company A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Company A?

Yes. IAS 39.128 permits hedge accounting for components of risk, if effectiveness can be measured (see Question 128-3). Also, IAS 39.131 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be clearly identified, effectiveness can be demonstrated, and specific designation of the hedging instrument and the risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and dollars. The swap is measured at fair value with changes in fair value reported in net profit or loss. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under IAS 21 and the changes to their carrying amounts included in net profit or loss.

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Paragraph 131**Question 131-3****Hedging instrument: dual foreign currency forward exchange contract**

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

Yes. IAS 39.131 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions:

- (a) The risks hedged can be clearly identified. The risks are the exposures to changes in the exchange rates between dollars and yen and yen and pounds, respectively.
- (b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pounds sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward only protects it for the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question 128-2.
- (c) It is possible to ensure that there is a specific designation of the hedging instrument and the different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

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Paragraph 132**Question 132-1****Hedge accounting: stock index**

An enterprise may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IAS 39 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, IAS 39.132 states that the change in fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) cannot be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

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Paragraph 134**Question 134-1****Internal hedges**

Some enterprises use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. Does IAS 39.134 prohibit hedge accounting in such cases?

Yes. IAS 39 does not specify how an enterprise should manage its risk, however, it does state that internal hedging transactions do not qualify for hedge accounting. This applies both (1) in consolidation for intra-group hedging transactions, and (2) in consolidation and in the separate financial statements of a legal entity for intra-company hedging transactions. The principles of preparing consolidated financial statements require “intragroup balances and intragroup transactions and resulting unrealised profits to be eliminated in full” (IAS 27.17).

On the other hand, an intra-group hedging transaction may be designated as a hedge in the separate financial statements of a group company, since the intra-group transaction is an external transaction from the perspective of the group company. In addition, if the internal contract is offset with an external party the external contract may be considered to be the hedging instrument and the hedging relationship may qualify for hedge accounting.

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

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

- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with an external party to the consolidated group.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group companies and divisions using internal contracts must be reversed in consolidation.

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

If a hedging instrument is not acquired from an external party, IAS 39 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions. IAS 39.134 indicates that only derivatives that involve a party external to the enterprise can be designated as hedging instruments and, further, that any gains or losses on intra-group or intra-company transactions should be eliminated on consolidation. Therefore, transactions between different divisions within Bank A do not qualify for hedge accounting treatment in the financial statements of Bank A. Similarly, transactions between different companies within a group do not qualify for hedge accounting treatment on consolidation.

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

loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions thereof that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under IAS 39, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the banking division are identified and the other conditions for hedge accounting are met. It should be noted, however, that IAS 39.127 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

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Paragraph 134

Question 134-1-a

Offsetting internal derivative contracts used to manage interest rate risk

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

No. An internal contract designated at the subsidiary level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in net profit or loss (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in equity (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There also is no basis for including the gain or loss on the internal derivative in equity for one entity and recognising it in net profit or loss by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the subsidiary or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other in consolidation. Accordingly, since IAS 39.122 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties must be reversed in consolidation.

It should be noted, however, that there will be no income statement impact of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the subsidiary or division level. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group also will result in the offset of the fair value amounts recognised in net profit or loss and their use as cash flow hedges by two separate entities or divisions

within the consolidated group also will result in the fair value amounts being offset against each other in equity. However, to the extent one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, the impact in net profit or loss would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be reported in net profit or loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be reported in equity. Also, there would be no offset if the gain or loss on an internal contract used in a cash flow hedge is transferred out of equity as a basis adjustment of the hedged forecasted transaction when it occurs.

Question 134-1 describes the application of IAS 39 to internal hedging transactions.

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Paragraph 134

Question 134-1-b

Offsetting internal derivative contracts used to manage foreign currency risk

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

It depends. As discussed in Question 134-1-a, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and that are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other in consolidation. There is no income statement impact if the internal derivatives are used in the same type of hedge relationship (that is, fair value or cash flow hedges) because the gains and losses reported in net profit or loss or in equity will offset in consolidation. There may be an income statement impact if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges.

Provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IAS 39.122 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for hedge accounting in the consolidated financial statements even if they are offset against each other.

However, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability under IAS 39.160 (basis adjustment) would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability, because an unrecognised firm commitment or forecasted transaction does not qualify as a hedging instrument.

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Paragraph 134**Question 134-2****Intra-group and intra-company hedging transactions**

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

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

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Paragraph 134

Question 134-3

Internal contracts: single offsetting external derivative

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

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. IAS 39.133 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An enterprise follows the approach outlined in IAS 39.133 to designate part of the underlying cash flows as the hedged position.

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Paragraph 134

Question 134-4

Internal contracts: external derivative contracts that are settled net

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

Generally yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty provided the hedge accounting criteria in IAS 39 are met. See also Question 137-15.

Treasury observes that by entering into the external offsetting contracts and including them in the centralised portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the enterprise. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external

derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally yes. The purpose of structuring the external derivative contracts in this manner is consistent with the enterprise's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. Moreover, the answer to Question 137-15 specifies that hedge accounting is not precluded simply because the enterprise has entered into a swap that has the exact mirror terms of another swap with the same counterparty if there is a substantive business purpose for structuring the transactions separately.

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Paragraph 137**Question 137-1****Fair value hedge: risk that could affect reported income****Is fair value hedge accounting permitted for exposure to interest rate risk in originated fixed rate loans?**

Yes. Under IAS 39, originated loans are carried at amortised cost. Banking institutions in many countries hold the bulk of their originated loans until maturity. Thus, changes in the fair value of such loans that are due to changes in market interest rates will not affect reported net income. IAS 39.137 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that will affect reported net income. Therefore, this paragraph may appear to preclude fair value hedge accounting for originated loans. However, it follows from IAS 39.127 that originated loans can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The enterprise could sell them and the change in fair values would affect earnings. Thus, fair value hedge accounting is permitted for originated loans.

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Paragraph 137**Question 137-2****Cash flow hedge: anticipated fixed rate debt issuance****Is hedge accounting allowed for a hedge of an anticipated fixed rate debt issuance?**

Yes. This would be a cash flow hedge of a forecasted transaction that will affect reported net profit or loss (IAS 39.137(b)) provided that the conditions in IAS 39.142 are met.

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

For example, in August 2000 Company R decided it would issue 200 million 7-year bonds in January 2001. Company R performed historical correlation studies and determined that a 7-year treasury bond adequately correlates to the bonds Company R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Company R hedged the anticipated issuance of the bonds by selling (shorting) 186 million worth of futures on 7-year treasury bonds. From August 2000 to January 2001 interest rates increased. The short futures positions were closed in January 2001, the date the bonds were issued, and resulted in a 1.2 million gain which will offset the increased interest payments on the bonds and, therefore, will affect net profit or loss over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecasted debt issuance.

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Paragraph 137**Question 137-3****Hedge accounting: unrecognised assets****Is hedge accounting treatment permitted for a hedge of the fair value exposure of unrecognised core deposit intangibles?**

No. Core deposit intangibles are not recognised as assets (or negative liabilities) under current IASC standards. Because the intangible asset is unrecorded, it cannot be designated as a hedged item.

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Paragraph 137**Question 137-4****Hedge accounting: hedging of future foreign currency revenue streams**

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

Yes, if the revenues are highly probable. Under IAS 39.137(b) a hedge of an anticipated sale may qualify as a cash flow hedge. For instance, an airline company may use sophisticated models based on past experience and economic data to project its revenues in various currencies. If it can demonstrate that forecasted revenues for a period of time into the future in a particular currency are “highly probable”, as required by IAS 39.142(c), it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised directly in equity through the statement of changes in equity until the revenues occur.

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

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Paragraph 137**Question 137-5****Cash flow hedges: “all in one” hedge**

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

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

For instance, if an enterprise enters into a fixed-price contract to sell a commodity and that contract is accounted for as a derivative under IAS 39 because, for example, it does not meet the exception for a normal sale, the enterprise may designate the fixed-price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed-price contract is the contract under which the asset will be sold. Also, if a company enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the market place, the company may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction) even though the derivative is the contract under which the debt instrument will be acquired.

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Paragraph 137**Question 137-6****Hedge relationships: enterprise-wide risk**

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

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

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Paragraph 137**Question 137-7****Cash flow hedge: fixed interest rate cash flows**

An enterprise issues a fixed rate debt security and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt security. Can the enterprise designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt security?

No. IAS 39.137(b) states that a cash flow hedge is “a hedge of the exposure to variability in cash flows”. In this case, the issued debt security does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The enterprise may designate the swap as a fair value hedge of the debt security, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt security.

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Paragraph 137**Question 137-8****Cash flow hedge: reinvestment of fixed interest rate cash flows**

An enterprise manages interest rate risk on a net basis. On 1 January 2001, it forecasts aggregate cash inflows of 100 on fixed rate assets and aggregate cash outflows of 90 on fixed rate liabilities in the first quarter of 2002. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecasted net cash inflow of 10. The enterprise designates as the hedged item the first 10 of cash inflows on fixed rate assets in the first quarter of 2002. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 2002 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The enterprise could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the enterprise could also hedge the interest rate exposure associated with the forecasted reinvestment of the interest and principal it receives on fixed rate assets (see Question 121-2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for instance, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, it potentially could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

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Paragraph 137**Question 137-9****Foreign currency hedge**

Company A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

- (a) a fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year end both recognised in the income statement; or
- (b) a cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in equity?

IAS 39 does not preclude either one of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the hedged item are recognised immediately in net profit or loss. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognised in equity, that amount is included in net profit or loss in the same period or periods during which the hedged item (the liability) affects net profit or loss, that is, when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to net profit or loss in the same periods during which the liability is remeasured; not when the payment occurs. See Question 137-10.

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Paragraph 137**Question 137-10****Foreign currency cash flow hedge**

An enterprise exports a product at a price denominated in a foreign currency. At the date of the sale, the enterprise obtains a receivable for the sale price payable in ninety days and takes out a ninety-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under IAS 21, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the ninety-day period for changes in exchange rates with the difference being taken to net profit or loss (IAS 21.11 and IAS 21.15).

If the foreign exchange contract is designated as a hedging instrument, does the enterprise have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the enterprise designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in net profit or loss and the gain or loss on remeasuring the receivable is also recognised in net profit or loss.

If the enterprise designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognised directly in equity, and the ineffective portion in net profit or loss (IAS 39.158). The amount recognised directly in equity is transferred to net profit or loss in the same period or periods during which changes in the measurement of the receivable affects net profit or loss (IAS 39.162).

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Paragraph 137**Question 137-11****Fair value hedge: variable rate debt instrument**

Does IAS 39 permit an enterprise to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For instance, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

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Paragraph 137

Question 137-12

Fair value hedge: inventory

IAS 39.137 states that a fair value hedge is “a hedge of the exposure to changes in the fair value of a recognised asset or liability ... that is attributable to a particular risk and that will affect reported net income”. Can an enterprise designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost or net realisable value under IAS 2?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect net profit or loss when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under IAS 2. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

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Paragraph 137

Question 137-13

Intra-group monetary item that will affect consolidated net income

Can an intra-group monetary item be designated at the consolidated level as the hedged item in a foreign currency fair value hedge or cash flow hedge even though the intra-group monetary item is eliminated on consolidation?

Yes, but only if the intra-group monetary item results in an exposure to exchange differences that cannot be eliminated on consolidation. As indicated in IAS 21.34, intra-group monetary items may give rise to exchange differences that cannot be eliminated in consolidated net profit or loss. Under IAS 21, exchange differences on intra-group monetary items affect consolidated net profit or loss when (1) the intra-group monetary item is transacted between two group companies that have different measurement currencies, and (2) the intra-group monetary item is denominated in one of those two measurement currencies. Such exchange differences may arise if at least one of the two counterparties to the internal transaction is classified as a foreign entity under IAS 21, since a foreign operation that is integral to the operations of the reporting enterprise has the same measurement currency as the reporting enterprise (see SIC-19).

To illustrate: Group A consists of Parent Company A and Subsidiary Company B and Subsidiary Company C. Group A and Parent Company A have the euro as their measurement currency. Company B also has the euro as its measurement currency, while Company C, which is classified as a foreign entity under IAS 21, has the US dollar as its measurement currency. On 31 March, Company C purchases goods from Company B for 110 US dollars, payable on 30 June. In this case, Company B and Group A may designate the intra-group monetary item of 110 US dollars as a hedged item in a foreign currency fair value hedge or cash flow hedge. While Company B's foreign currency receivable is eliminated against Company C's foreign currency payable on consolidation, the exchange differences that arise for Company B cannot be eliminated since Company C has no corresponding exchange differences. Thus, the intra-group monetary item results in an exposure to variability in the foreign currency amount of the intra-group monetary item that will affect reported net income in the consolidated financial statements. Therefore, the intra-group monetary item may be

designated as a hedged item in a foreign currency fair value or cash flow hedge.

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Paragraph 137

Question 137-14

Forecasted intra-group foreign currency transactions that will affect consolidated net income

In Question 137-13, it was indicated that an intra-group monetary item may be designated at the consolidated level as the hedged item in a foreign currency fair value hedge or cash flow hedge if it exposes the group to exchange differences that cannot be eliminated in consolidated net profit or loss. Can a forecasted intra-group transaction be designated as a hedged item in a foreign currency cash flow hedge if it relates to an intra-group monetary item that would qualify as a hedged item?

Yes, a forecasted intra-group transaction may be designated as the hedged item in a foreign currency cash flow hedge provided the transaction is highly probable, meets all other hedge accounting criteria, and will result in the recognition of an intra-group monetary item for which exchange differences cannot be eliminated in consolidated net profit or loss.

Continuing the example in Question 137-13, if Company B on 1 January agrees to sell goods to Company C for delivery on 31 March at a price of 110 US dollars, payable on 30 June, Company B and Group A may designate that committed transaction as a hedged item in a foreign currency cash flow hedge.

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Paragraph 137**Question 137-15****Concurrent offsetting swaps and use of one as hedging instrument**

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

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

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

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

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Paragraph 137**Question 137-16****Cash flow hedge: forecasted transaction related to an enterprise's equity**

Can a forecasted transaction in the enterprise's own equity securities or forecasted dividend payments to shareholders be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecasted transaction must expose the enterprise to a particular risk that can affect net profit or loss (IAS 39.137). The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are reported in net profit or loss (IAS 32 and SIC-16). For instance, distributions to holders of a financial instrument classified as an equity instrument are debited by the issuer directly to equity (IAS 32.30). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend that has not yet been paid and that is recognised as a financial liability may qualify as a hedged item, for instance, for foreign currency risk if it is denominated in a foreign currency.

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Paragraph 142**Question 142-1****Hedge accounting: forecasted transaction**

For cash flow hedges, a forecasted transaction that is subject to a hedge must be highly probable. How should the term “highly probable” be interpreted?

The term “highly probable” indicates a significantly greater likelihood of occurrence than the term “more likely than not”. An assessment of the likelihood that a forecasted transaction will take place is not based solely on management’s intent because intent is not verifiable. A transaction’s probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, consideration should be given to the following circumstances:

- (a) the frequency of similar past transactions;
- (b) the financial and operational ability of the entity to carry out the transaction;
- (c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
- (d) the extent of loss or disruption of operations that could result if the transaction does not occur;
- (e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering); and
- (f) the enterprise’s business plan.

The length of time until a forecasted transaction is projected to occur is also a consideration in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecasted to occur in five years may be less likely to occur than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecasted transaction in proportion to the enterprise’s transactions of the same nature, the less likely it is that the transaction would be considered highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecasted sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past 3 months.

A history of having designated hedges of forecasted transactions and then determining that the forecasted transactions are no longer expected to occur would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

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Paragraph 142**Question 142-2****Hedging on an after-tax basis**

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

IAS 39 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

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Paragraph 142**Question 142-3****Hedge effectiveness: assessment on cumulative basis**

IAS 39.142(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated and that is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognised in earnings as it occurs.

To illustrate: A company designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25 to 50 basis points, while LIBOR changes daily. Over a one to two year period, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

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Paragraph 142**Question 142-4****Retroactive designation of hedges**

Does IAS 39 permit an enterprise to retroactively designate hedge relationships?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IAS 39.142 are met. In particular, hedge accounting can only be applied from the date the enterprise has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the enterprise will assess hedge effectiveness.

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Paragraph 142**Question 142-5****Hedge accounting: identification of hedged forecasted transaction**

Can a forecasted transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No, the hedged forecasted transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecasted transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they occur. For the same reason, a forecasted transaction cannot be specified solely as a percentage of sales or purchases during a period.

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Paragraph 142**Question 142-6****Hedge effectiveness: counterparty credit risk**

Must an enterprise consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An enterprise cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the enterprise considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the enterprise. For a cash flow hedge, if it becomes probable that a counterparty will default, an enterprise would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

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Paragraph 142**Question 142-7****Hedge accounting: designation at the inception of the hedge**

Does IAS 39 permit an enterprise to designate and formally document a derivative contract as a hedging instrument subsequent to entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, IAS 39 requires that a hedging instrument be designated and formally documented as such from the inception of the hedge relationship (IAS 39.142), that is, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period in which the hedging instrument will remain outstanding (IAS 39.145). However, it does not require that the hedging instrument be acquired at the inception of the hedge relationship.

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Paragraph 142**Question 142-8****Cash flow hedge: documentation of timing of forecasted transaction**

For a hedge of a forecasted transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on or time period in which the forecasted transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (IAS 39.149) and it must be possible to measure its effectiveness reliably (IAS 39.142). Also, the hedged forecasted transaction must be highly probable (IAS 39.142). To meet these criteria, an enterprise is not required to predict and document the exact date a forecasted transaction is expected to occur. However, it is required to identify and document the time period in which the forecasted transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with IAS 39.142(b), it may be necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecasted transaction is no longer expected to occur, hedge accounting is discontinued in accordance with IAS 39.163(c).

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Paragraph 144**Question 144-1****Combination of written and purchased options**

In most cases, IAS 39.124 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an enterprise split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. IAS 39.144 specifies that a hedging relationship is designated by an enterprise for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question 124-1 addresses the issue of whether and when a combination of options is considered as a written option.

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Paragraph 144**Question 144-2****Delta-neutral hedging strategy**

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

Yes. IAS 39.144 states that “a dynamic hedging strategy that assesses both the intrinsic and the time value of an option can qualify for hedge accounting”. For instance, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the enterprise must document how it will monitor and update the hedge and measure hedge effectiveness, be able to properly track all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in IAS 39.142 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

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Paragraph 146**Question 146-1****Hedge effectiveness: effectiveness tests**

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

IAS 39 does not provide specific guidance about how effectiveness tests are performed. IAS 39.146 specifies that a hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the enterprise can expect that the change in fair values or cash flows of the hedging instrument and the hedged item will “almost fully offset”. In addition, IAS 39.146 requires that actual results are within a range of 80%-125%.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An enterprise is required to document at the inception of the hedge how effectiveness will be assessed and then apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, that is, a comparison of hedging gains and losses to the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity’s documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

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Paragraph 146**Question 146-2****Hedge effectiveness: less than 100 per cent offset**

If a cash flow hedge is considered to be highly effective because the actual risk offset is within the allowed 80%-125% range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge reported in equity?

No. IAS 39.158(a) indicates that only the effective portion is recognised directly in equity. IAS 39.158(b) requires that the ineffective portion be reported in net profit or loss or in accordance with IAS 39.103 in the limited circumstances in which the hedging instrument is not a derivative.

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Paragraph 146**Question 146-3****Hedge effectiveness: “underhedging”**

According to IAS 39.146, actual results must be within a range of 80 per cent to 125 per cent throughout the life of the hedge for a hedge to be regarded as highly effective. Is it permitted to purposely hedge less than 100 per cent of the exposure to losses, such as 85 per cent, and designate the hedge as a hedge of 100 per cent of the exposure?

No. IAS 39.128 allows hedge accounting for the risks associated with only a portion of the cash flows or fair value of a hedged item. Therefore, designating as a hedged item only 85 per cent of the exposure to loss would be permitted. However, once that designation is made, the 85 per cent exposure becomes the entire hedged item and the basis for assessing hedge effectiveness. In other words, the 80 per cent to 125 per cent range would apply to the designated 85 per cent portion of the exposure.

To qualify for hedge accounting, the hedge must be “expected to be highly effective” in achieving offsetting changes (IAS 39.142(b)). IAS 39.146 defines “expected to be highly effective” as an expectation that the hedging instrument will “almost fully offset” the exposure to losses on the hedged item. The 80 per cent to 125 per cent threshold in IAS 39.146 is for comparing outcome to expectation. The expected outcome at inception should be nearly 100 per cent effectiveness in relation to the 85 per cent of the exposure being hedged.

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Paragraph 147**Question 147-1****Assuming perfect hedge effectiveness**

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecasted transaction are the same, can an enterprise assume perfect hedge effectiveness without further effectiveness testing?

No. IAS 39.142(e) requires an enterprise to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (IAS 39.148). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

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Paragraph 149**Question 149-1****Hedge accounting: risk of a transaction not occurring**

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

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is only permitted for risks associated with recognised assets and liabilities, and highly probable forecasted transactions (IAS 39.137).

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Paragraph 153**Question 153-1**

Fair value hedge: measurement of a non-derivative hedging instrument

IAS 39.153 specifies that in a fair value hedge the gain or loss from remeasuring the hedging instrument at fair value should be recognised in net profit or loss. If a non-derivative instrument classified as a held-to-maturity asset, originated loan, or non-trading liability is designated as a hedging instrument, would it also be remeasured at fair value?

No. A non-derivative financial instrument may only be designated as a hedge of an exposure to foreign currency risk (IAS 39.122). Such an instrument would be remeasured for changes in its fair value attributable to changes in foreign exchange rates under IAS 21, but not for other changes in its fair value that do not affect its amortised cost.

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Paragraph 157**Question 157-1**

Fair value hedge: amortisation of the adjustment to the carrying amount of a hedged interest bearing financial instrument

Can an enterprise start amortising the fair value adjustment to the carrying amount of a hedged interest bearing financial instrument before the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged?

Yes. IAS 39.157 requires amortisation to begin no later than when the hedged item ceases to be adjusted. Theoretically, amortisation should start as soon as a fair value adjustment exists since the adjustment of the carrying amount affects the calculation of the effective interest of the hedged item. Nevertheless, an enterprise may defer amortising the adjustment until the hedged item ceases to be adjusted because it may be administratively burdensome to amortise the adjustment at the same time as the carrying amount is being adjusted for changes in its fair value that are attributable to interest rate risk (the risk being hedged). The enterprise applies the same amortisation policy for all debt instruments, that is, an enterprise cannot defer amortising fair value adjustments on a selective basis. The amortisation is based on a recalculated effective interest at the date amortisation commences (IAS 39.10).

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Paragraph 158
Question 158-1
Cash flow hedges: performance of hedging instrument

Enterprise A has a floating rate liability of 1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of 49 in the fair value of the swap. This increase consists of a change of 50 resulting from an increase in market interest rates and a change of minus 1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by 50. Assuming that Enterprise A determines that the hedge is still highly effective, is there ineffectiveness that should be reported in net profit or loss?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is due to the counterparty's credit risk (IAS 39.148). However, because Enterprise A determines that the hedge relationship is still highly effective, it credits the effective portion of the change in fair value of the swap, that is, the net change in fair value of 49 to equity. There is no debit to net profit or loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, that is, 50, exceeds the cumulative change in value of the hedging instrument, that is, 49 (see Question 158-2).

	Debit	Credit
Swap	49	
Equity		49

If Enterprise A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with IAS 39.163.

Would the answer change if the fair value of the swap instead increases to 51 of which 50 results from the increase in market interest rates and 1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to net profit or loss of 1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, that is 51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, that is 50. The difference of 1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is reported in net profit or loss.

	Debit	Credit
Swap	51	
Equity		50
Net profit or loss		1

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Paragraph 158

Question 158-2

Cash flow hedges: performance of hedging instrument

On 30 September 2001, Enterprise A hedges the anticipated sale of 24 tonnes of pulp on 1 March 2002 by entering into a short forward contract on 24 tonnes of pulp. The contract requires net settlement in cash determined as the difference between the future spot price of pulp on a specified commodity exchange and 1,000. Enterprise A expects to sell the pulp in a different, local market. Enterprise A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On 31 December, the spot price of pulp has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is 1,100. The fair value of Enterprise A's forward contract is a negative 80. Assuming that Enterprise A determines that the hedge is still highly effective, is there ineffectiveness that should be reported in net profit or loss?

No. In a cash flow hedge, ineffectiveness is not recognised in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is 80, while the fair value of the cumulative change in expected future cash flows on the hedged item is 100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognised in net profit or loss (IAS 39.158(b)). Because Enterprise A determines that the hedge relationship is still highly effective, it debits the entire change in fair value of the forward contract (80) to equity.

	Debit	Credit
Equity	80	
Forward		80

If Enterprise A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with IAS 39.163.

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Paragraph 160**Question 160-1****Cash flow hedge: forecasted issuance of debt in foreign currency**

Company A has the euro as its measurement currency. On 1 November 2001, it expects to borrow 1,000 US dollars on 1 April 2002. To offset the exposure to changes in foreign exchange rates, it takes out a forward exchange contract to buy 1,100 euros and sell 1,000 US dollars on 1 April 2002. The relationship meets the criteria for hedge accounting. Company A designates the forward exchange contract as a cash flow hedge of the forecasted borrowing. On 1 April 2002, Company A borrows 1,000 US dollars and settles the forward exchange contract. Since the dollar has depreciated, the forward exchange contract has a cumulative gain that has been reported in equity. Is the initial carrying amount of the US dollar borrowing adjusted for the cumulative gain on the forward exchange contract?

Yes. IAS 39.160 states that “if the hedged ... forecasted transaction results in the recognition of ... a liability, then at the time the ... liability is recognised the associated gains or losses that were recognised directly in equity ... should be removed from equity and enter into the initial measurement of the acquisition cost or other carrying amount of the ... liability.”

The effective interest rate on the US dollar borrowing reflects the adjustment to its initial carrying amount. It is expressed as an interest rate in the currency of the denomination of the borrowing. Accordingly, for the purpose of applying the effective interest method the adjustment is treated as an adjustment expressed in US dollars rather than in euros.

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Paragraph 163**Question 163-1****Cash flow hedges: forecasted transaction that is not highly probable, but is expected to occur**

If a forecasted transaction is no longer highly probable, would it automatically be considered “no longer expected to occur” with recognition in net profit or loss for the period of any net cumulative gain or loss that had been reported directly in equity under IAS 39.163(c)?

No. The term “highly probable” represents a higher degree of probability than “expected to occur”. Therefore, even though a forecasted transaction is no longer highly probable, it may still be expected to occur. If it is expected to occur, IAS 39.163(b) applies, hedge accounting is discontinued, and the net cumulative gain or loss that had been reported directly in equity remains in equity.

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Paragraph 164**Question 164-1****Hedge accounting: premium or discount on forward exchange contract**

A forward exchange contract is designated as a hedging instrument, for instance, in a hedge of a net investment in a foreign entity. Is it permitted to amortise the discount or premium on the forward exchange contract to net profit or loss over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortised to net profit or loss under IAS 39. Derivatives are always measured at fair value in the balance sheet. The gain or loss resulting from a change in the fair value of the forward exchange contract is always reported in net profit or loss unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign entity in which case the effective portion of the gain or loss is included in equity. In that case, the amounts included in equity are released to net profit or loss when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under IAS 39.144, the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are included in net profit or loss.

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Disclosure

Paragraph 170**Question 170-1****Disclosure of changes in fair value**

IAS 39 requires that financial assets classified as available-for-sale (AFS) and financial assets and liabilities classified as trading be remeasured to fair value. Unless a financial asset or liability is designated as a cash flow hedging instrument, fair value changes for trading assets and liabilities are reported in net profit or loss, and fair value changes for AFS assets are reported either in net profit or loss or in equity depending on the accounting policy choice made by the enterprise under IAS 39.103(b). What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IAS 39.170(c) requires that significant items of income, expense, gain, and loss be disclosed whether reported in net profit or loss or in equity. This disclosure requirement encompasses significant items of income, expense, gain, and loss that arise on remeasurement to fair value. Therefore, an enterprise provides disclosures of significant fair value changes distinguishing between changes that are reported in net profit or loss and changes that are included in equity. Further breakdown is provided of changes that relate to:

- AFS assets,
- trading assets and liabilities, and
- hedging instruments.

IAS 39 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, a bank may choose to disclose separately the change in fair value of those derivatives that IAS 39 classifies as held for trading but that the bank classifies as part of risk management activities outside the trading portfolio.

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Paragraph 170**Question 170-2****Presentation of interest income**

For an investment in a debt security held for trading, must interest income on a historical cost basis be disclosed separately from the net change in fair value?

Yes. IAS 39.170(c) requires that interest income on a historical cost basis be disclosed. That disclosure may, but need not, be on the face of the income statement. Alternatively, the income statement may report a single amount, with interest income disclosed in the notes.

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Effective date and transition

Paragraph 172

Question 172-1

Transition rules: available-for-sale financial assets previously carried at cost

If available-for-sale (AFS) financial assets previously had been carried at cost, IAS 39.172(d) requires that on initial application of IAS 39 the adjustment to fair value should be an adjustment of retained earnings. If an enterprise has made the accounting policy choice under IAS 39.103(b)(ii) of reporting fair value changes of AFS assets in equity, is the amount of the adjustment of retained earnings on initial application of IAS 39 reported in net profit or loss at the time the AFS asset is sold?

Yes. When the AFS financial asset eventually is sold, the cumulative gain or loss on that asset that has been recognised directly in equity, including the amount of the adjustment of retained earnings on initial application of IAS 39, is included in net profit or loss for the period.

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Paragraph 172

Question 172-2

Transition rules: cash flow hedges

IAS 39.172(f) indicates that if an enterprise had deferred gains and losses on cash flow hedges prior to initial application of IAS 39, those deferred gains and losses should be reclassified as a separate component of equity to the extent the transactions meet the hedging criteria in IAS 39.142. IAS 39.142(c) requires that, for cash flow hedges, a forecasted transaction that is the subject of the hedge must be “highly probable”. If a forecasted transaction does not, and did not at the inception of the hedge, meet the “highly probable” criterion of IAS 39.142(c), does IAS 39 require, therefore, that any net cumulative gains or losses be taken to net profit or loss on initial application?

It depends. If, on initial application of IAS 39, the forecasted transaction is not “highly probable”, but is at least expected to occur, the entire deferred gain or loss on initial application of IAS 39 is reported in equity. IAS 39.172(f) applies if the hedge qualifies as a cash flow hedge under IAS 39.142. If the hedge does not qualify as a cash flow hedge under IAS 39.142, then IAS 39.172(b) applies. IAS 39.172(b) indicates that if the hedging instrument is still held, hedge accounting is no longer appropriate starting with the beginning of the financial year in which IAS 39 is applied. IAS 39.172(b) then refers to IAS 39.163, which explains how to discontinue hedge accounting for cash flow hedges. It follows from IAS 39.163 that any net cumulative gain or loss that has been reclassified to equity on initial application of IAS 39 should remain in equity until the forecasted transaction occurs unless the forecasted transaction is no longer expected to occur, in which case any related net cumulative gain or loss that had been reported directly in equity should be reported in net profit or loss for the period.

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Paragraph 172

Question 172-3

Transition rules: previous revaluation under IAS 25

Prior to IAS 39, an enterprise measured certain investments at fair value under IAS 25 and reported the revaluation gains directly in equity. How is the pre-IAS 39 gain treated at the beginning of the financial year in which IAS 39 is initially adopted?

The answer depends on two factors. First, are the investments classified as available-for-sale (AFS) or as trading under IAS 39 and, second, if the investments are classified as AFS, has the enterprise adopted the policy of reporting changes in fair value in net profit or loss or directly in equity until the investment is sold, collected, or otherwise disposed of.

The pre-IAS 39 revaluation gain that had been reported in equity is reclassified into retained earnings on initial adoption of IAS 39 if either (a) the investment is classified as trading or (b) the investment is classified as AFS and the enterprise has adopted the policy of reporting changes in fair value in net profit or loss. The pre-IAS 39 revaluation gain that had been reported in equity should continue to be reported as a separate component of equity if the investment is classified as AFS and the enterprise has adopted the policy of reporting changes in fair value directly in equity until the investment is sold, collected, or otherwise disposed of.

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Paragraph 172

Question 172-4

Transition rules: prior derecognition

IAS 39.172(h) states:

If a securitisation, transfer, or other derecognition transaction was entered into prior to the beginning of the financial year in which this Standard is initially applied, the accounting for that transaction should not be retrospectively changed to conform to the requirements of this Standard.

If a prior year derecognition transaction would not now meet the IAS 39 derecognition criteria, does IAS 39.172(h) require that the transaction be “un-derecognised” as of the beginning of the financial year in which IAS 39 is initially applied (even though the accounting should not be retrospectively changed)?

No. IAS 39.172(h) does not undo the prior derecognition accounting. However, any further transfers of financial assets as part of the same securitisation scheme (for example, to maintain a specified balance of mortgage or credit card receivables) after IAS 39 is initially applied would have to meet the derecognition criteria of IAS 39.

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Paragraph 172

Question 172-5

Transition rules: retrospective application of hedging criteria by first-time adopters

An enterprise applies IAS for the first time as its primary basis of accounting in its year ended 31 December 2001. SIC-8, First-Time Application of IASs as the Primary Basis of Accounting, states:

In the period when IASs are applied in full for the first time as the primary accounting basis, the financial statements of an enterprise should be prepared and presented as if the financial statements had always been prepared in accordance with the Standards and Interpretations effective for the period of first-time application ... except when (a) individual Standards or Interpretations require or permit a different transitional treatment.

IAS 39.172(b) states that retrospective application of the hedge accounting criteria in IAS 39 is not permitted. In its IAS financial statements for years prior to 2001, is this enterprise permitted to retrospectively designate hedges using criteria other than those in IAS 39?

No. IAS 39.172(a) prohibits retrospective application of hedge accounting policies. Therefore, it is inappropriate for a first time adopter of IAS to retrospectively designate or undesignate hedges using criteria other than those in IAS 39. If a previously designated hedge meets the conditions for an effective hedge in IAS 39.142, IAS 39.172(b) permits continued designation of the hedging relationship for hedge accounting purposes.

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Paragraph 172

Question 172-6

Transition rules: fair value hedges

If a previously designated fair value hedge does not meet the conditions for an effective hedge under IAS 39 and the hedging instrument is still held, hedge accounting should be discontinued from the beginning of the financial year in which the Standard is initially applied (IAS 39.172(b)). What is the treatment of previous fair value adjustments to the carrying amount of the hedged item on initial application of IAS 39?

If an enterprise had designated a hedge against a fair value exposure prior to adopting IAS 39, the treatment of previous adjustments to the carrying amount of the hedged item depends on whether the hedged item is a debt or equity instrument and, if it is a debt instrument, whether it is carried at fair value or at amortised cost under IAS 39.

If the hedged item is an interest bearing financial instrument carried at amortised cost under IAS 39, such as a fixed rate debt security that is classified as a held-to-maturity investment, on adoption of IAS 39 any previous adjustment to the carrying amount should be amortised to net profit or loss (IAS 39.157). The adjustment should be fully amortised by maturity of the debt instrument. If the hedged item is an interest bearing financial instrument carried at fair value under IAS 39, no transition adjustment is necessary unless the carrying amount was only partially adjusted to fair value in which case the adjustment to full fair value is recognised in equity in accordance with IAS 39.172(d) on initial application of IAS 39.

If the hedged item is an equity security, no transition adjustment is required if the equity security was already carried at fair value in previous financial statements since equity securities continue to be measured at fair value under IAS 39. If the enterprise did not carry the equity security at fair value, the enterprise should make a transition adjustment to fair value and recognise the adjustment in equity in accordance with paragraph 172(d) on initial application of IAS 39.

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Paragraph 172**Question 172-7****Transition rules: held-to-maturity financial assets**

If an enterprise has sold or transferred “held-to-maturity” financial assets in the two financial years before IAS 39 is first applied, does the reference in IAS 39.172(d) to IAS 39.66-102, including IAS 39.83, prevent any financial assets being classified as held to maturity on transition?

No. IAS 39 is applied prospectively. For financial years prior to the initial application of IAS 39, IAS 25 is applied to the accounting for debt investments. Since IAS 25 does not contain any classification category for held-to-maturity investments, an enterprise would not have classified any investments as held to maturity for the purposes of preparing financial statements in accordance with International Accounting Standards. Therefore, IAS 39.83 is not applied on transition.

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Paragraph 172**Question 172-8****Transition rules: hedge documentation on first day of initial application**

During the financial year that IAS 39 is first applied, may an enterprise retroactively designate and document hedges “as of” the beginning of that financial year?

No. The designation and documentation of a hedge relationship must be completed on or before the first day of the financial year that IAS 39 is first applied if the hedge relationship is to qualify for hedge accounting from that date. Hedge accounting can only be applied prospectively from the date that the hedge relationship is fully designated and documented.

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Paragraph 172**Question 172-9****Transition rules: internal hedging derivatives**

If an enterprise used hedge accounting for an internal derivative contract prior to adopting IAS 39, can it continue to apply hedge accounting for that internal transaction following the adoption of IAS 39?

No. There is no transition provision or other provision in IAS 39 that permits an enterprise to continue applying hedge accounting policies that are not permitted by IAS 39. Therefore, IAS 39.134 is applied prospectively in accordance with IAS 39.172(b). IAS 39.134 states that only derivatives that involve a party external to the enterprise can be designated as hedging instruments. Questions 134-1, 134-1-a, and 134-1-b discuss circumstances under which hedge accounting may be achieved when an enterprise uses internal derivative transactions for risk management purposes.

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Interaction between IAS 39 and other IAS

IAS 39 and IAS 7**Question Other-1****Hedge accounting: cash flow statements**

How should cash flows arising from hedging instruments be classified in cash flow statements?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities based on the classification of the cash flows arising from the hedged item. While the terminology in IAS 7.16 has not been updated to reflect IAS 39, the classification of cash flows arising from hedging instruments in the cash flow statement should be consistent with the classification of these instruments as hedging instruments under IAS 39.

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IAS 39 and IAS 21.19**Question Other-2****Hedge of a net investment in a foreign entity: whether IAS 39 applies**

In applying IAS 21.19, is it permitted to designate a non-derivative liability as a hedge of a net investment in a foreign entity when the hedge relationship would not qualify for hedge accounting under IAS 39?

No. IAS 21.19 should be read in conjunction with IAS 39, in particular IAS 39.142. The same requirements on designation and effectiveness apply to hedges of a net investment in a foreign entity as to other hedging relationships under IAS 39. Therefore, enterprises that in the past have used hedge accounting for hedges of net investments in foreign entities in accordance with IAS 21 will need to determine whether their existing hedges qualify for hedge accounting under IAS 39. If not, hedge accounting is discontinued in accordance with the transition rules in IAS 39.172.

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IAS 39 and IAS 21.30**Question Other-3**

Exchange differences arising on translation of foreign entities: equity or income?

IAS 21.30 states that all exchange differences resulting from translating the financial statements of a foreign entity (a foreign operation whose activities are not integral to those of the reporting enterprise) should be classified as equity until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets held for trading and financial assets that are available for sale.

IAS 39.103 requires that changes in fair value of financial assets held for trading be reported in net profit or loss and allows an enterprise to adopt a policy of reporting changes in fair value of available for sale investments either in equity or in net profit or loss.

If the foreign entity is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are IAS 39.103 and IAS 21.30 applied?

IAS 39 did not amend IAS 21 and therefore did not change the application of the net investment method of accounting for foreign entities under IAS 21. Therefore, IAS 39 applies in the accounting for financial instruments in the financial statements of a foreign entity and IAS 21.30 continues to apply in translating the financial statements of a foreign entity for incorporation in the financial statements of the reporting enterprise.

To illustrate: Company A is domiciled in Country X. A has a foreign subsidiary (B) in Country Y, which is classified as a foreign entity under IAS 21. B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under IAS 39.

In B's financial statements for year 20x0, the fair value and carrying amount of the debt instrument is 100 in the local currency of Country Y. In Company A's consolidated financial statements, the asset is translated into the currency of Country X at the spot exchange rate applicable at the balance sheet date (2.00). Thus, the carrying amount is 200 (=100 x 2.00) in the reporting currency of Country A.

At the end of year 20x1, the fair value of the debt instrument has increased to 110 in the local currency of Country Y. B reports the trading asset at 110 in its balance sheet and recognises a fair value gain of 10 in its income statement. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from 200 to 330 (=110 x 3.00) in the currency of Country X. Therefore, Company A reports the trading asset at 330 in its consolidated financial statements.

Since B is classified as a foreign entity, Company A translates the income statement of B "at the exchange rates at the dates of the transactions". Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ($[3.00 + 2.00] / 2 = 2.50$). Therefore, while the fair value of the trading asset has increased by 130 (= 330 - 200), Company A recognises only 25 (10×2.5) of this increase in consolidated net profit or loss to comply with IAS 21.30(b). The resulting exchange difference, that is, the remaining increase in the fair value of the debt instrument ($130 - 25 = 105$), is classified as equity until the disposal of the net investment in the foreign entity in accordance with IAS 21.30(c).

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IAS 39 and IAS 21.11

Question Other-4

Fair value hedge of asset measured at cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does IAS 39 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in IAS 39.142 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

To illustrate: A shipping company in Denmark has a US subsidiary that is integral to the operations of the company. The shipping company uses the IAS 16 benchmark treatment of measuring its ships at historical cost less depreciation in the consolidated financial statements. In accordance with IAS 21.11(b), the ships are reported in Danish kroner using the historical exchange rate. To fully or partly hedge the potential currency risk on the ships at disposal in dollars, the shipping company normally finances its purchases of ships with loans denominated in dollars.

In this case, a dollar borrowing (or a portion of it) may be designated as a cash flow hedge of the anticipated sale of the ship financed by the borrowing provided the sale is highly probable, for instance, because it is expected to occur in the immediate future, and the amount of the sales proceeds designated as being hedged is equal to the amount of the foreign currency borrowing designated as the hedging instrument. The gains and losses on the currency borrowing that are determined to constitute an effective hedge of the anticipated sale are recognised directly in equity through the statement of changes in equity in accordance with IAS 39.158(a).

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IAS 39 and IAS 21

Question Other-5

Interaction between IAS 39 and IAS 21

IAS 39 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in net profit or loss. IAS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in net profit or loss. Since the provisions in IAS 21 and IAS 39 partly overlap each other, for instance, for the purposes of determining gains and losses that should be reported in net profit or loss or in equity, the order in which IAS 21 and IAS 39 are applied can affect the measurement of assets and liabilities and net income. In what order are IAS 21 and IAS 39 applied?

Balance sheet

Generally, the measurement of a financial asset or financial liability at fair value, cost, or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IAS 39. Then, the foreign currency amount is reported in the reporting currency using the closing rate or a historical rate in accordance with IAS 21 (IAS 39.78 and IAS 39.94). For instance, if a monetary financial asset (such as a debt instrument) is carried at amortised cost under IAS 39, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is reported using the closing rate in the enterprise's financial statements (IAS 21.11). That applies regardless of whether a monetary item is measured at cost, amortised cost or fair value in the foreign currency (IAS 21.12). A non-monetary financial asset (such as an investment in an equity security) is translated using the closing rate if it is carried at fair value in the foreign currency (IAS 21.11(c)) and at a historical rate if it is not carried at fair value under IAS 39 because its fair value cannot be reliably measured (IAS 21.11(b) and IAS 39.69).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IAS 39, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been reported using a historical rate under IAS 21 (IAS 39.153), that is, the foreign currency amount is reported using the closing rate. This exception applies to non-monetary

items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IAS 21.11(b)).

Income statement

The reporting of a change in the carrying amount of a financial asset or financial liability in net profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for instance, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign entity. The issue of reporting changes in the carrying amount of a financial asset or financial liability held by a foreign entity is addressed in a separate Q&A (see Question Other-3).

Any exchange difference arising on reporting a *monetary item* at a rate different from that at which it was initially recorded during the period, or reported in previous financial statements, is reported in net profit or loss or in equity in accordance with IAS 21 (IAS 39.78, IAS 39.94, IAS 21.15, and IAS 21.17), unless the monetary item is designated as a cash flow hedge of an unrecognised firm commitment or forecasted transaction in foreign currency in which case the rules about reporting of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.158). Differences arising from reporting a monetary item at a foreign currency amount different from that at which it was previously reported are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the balance sheet measurement of a monetary item are reported in net profit or loss or in equity in accordance with IAS 39. For instance, if an enterprise reports gains and losses on available-for-sale monetary financial assets in equity (IAS 39.103(b)), the enterprise nevertheless reports the changes in the carrying amount relating to changes in foreign exchange rates in net profit or loss (IAS 21.11(a)).

Any changes in the carrying amount of a *non-monetary item* are reported in net profit or loss or in equity in accordance with IAS 39 (IAS 39.78 and IAS 39.94). For instance, if an enterprise reports gains and losses on available-for-sale financial assets in equity (IAS 39.103(b)), the enterprise reports the entire change in the carrying amount, including the effect of changes in foreign

currency rates, in equity. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or forecasted transaction in foreign currency, the rules about reporting of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.158).

In cases where some portion of the change in carrying amount is reported in equity and some portion is reported in net profit or loss, for instance, if the fair value of a bond has increased in foreign currency and decreased in the reporting currency, an enterprise cannot offset those two components for the purposes of determining gains or losses that should be recognised in net profit or loss or in equity.

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IAS 39 and IAS 21

Question Other-6

Available-for-sale financial assets: separation of currency component

As discussed in Question Other-5, if an enterprise reports gains and losses on available-for-sale monetary financial assets in equity under IAS 39.103(b), the enterprise nevertheless reports the changes in the carrying amount relating to changes in foreign exchange rates in net profit or loss in accordance with IAS 21.11(a) and IAS 21.15. How is the cumulative gain or loss that is reported in equity determined?

It is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the measurement currency of the reporting enterprise. For purposes of applying IAS 21.15 the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate, on 31 December 2001 Enterprise A acquires a bond denominated in a foreign currency (FC) for its fair value of FC 1,000. The bond is the same as the one in Question 73-1, that is, it has five years remaining to maturity and a principal amount of FC 1,250, carries fixed interest of 4.7 percent that is paid annually ($1,250 \times 4.7\% = 59$ per year), and has an effective interest rate of 10 percent. Enterprise A classifies the bond as available for sale. It has a policy of reporting gains and losses on available-for-sale financial assets in equity. The exchange rate is FC 1 to 1.5 measurement currency units (MC) and the carrying amount of the bond is MC 1,500 ($= 1,000 \times 1.5$).

	Debit	Credit
Bond	1,500	
Cash		1,500

On 31 December 2002, the foreign currency has appreciated and the exchange rate is FC 1 to MC 2. The fair value of the bond is FC 1,060 and thus the carrying amount is MC 2,120 ($= 1,060 \times 2$). The amortised cost is FC 1,041 ($= MC 2,082$). In this case, the cumulative gain or loss to be included directly in equity is the difference between the fair value and the amortised cost on 31 December 2002, that is, MC 38 ($= 2,120 - 2,082$).

Interest received on the bond on 31 December 2002 is FC 59 ($= MC 118$). Interest income determined in accordance with the effective interest method is FC 100 ($= 1,000 \times 10\%$). The average exchange rate during the year is FC 1 to MC 1.75. For purposes of this illustrative example, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (IAS 21.10). Thus, reported interest income is MC 175 ($= 100 \times 1.75$) including accretion of the initial discount of MC 72 ($= [100 - 59] \times 1.75$). Accordingly, the exchange difference on the bond that is reported in net profit or loss is MC 510 ($= 2,082 - 1,500 - 72$). Also, there is an exchange gain on the interest receivable for the year of MC 15 ($= 59 \times [2.00 - 1.75]$).

	Debit	Credit
Bond	620	
Cash	118	
Interest income		175
Exchange gain		525
Fair value change in equity		38

On 31 December 2003, the foreign currency has appreciated further and the exchange rate is FC 1 to MC 2.50. The fair value of the bond is FC 1,070 and thus the carrying amount is MC 2,675 ($= 1,070 \times 2.50$). The amortised cost is FC 1,086 ($= MC 2,715$). The cumulative gain or loss to be included directly in equity is the difference between the fair value and the amortised cost on 31 December 2003, that is, negative MC 40 ($= 2,675 - 2,715$). Thus, there is a debit to equity equal to the change in the difference during 2003 of MC 78 ($= MC 40 + MC 38$).

Interest received on the bond on 31 December 2003 is FC 59 ($= MC 148$). Interest income determined in accordance with the effective interest method is FC 104 ($= 1,041 \times 10\%$). The average exchange rate during the year is FC 1 to MC 2.25. For purposes of this illustrative example, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (IAS 21.10). Thus, reported interest income is MC 234 ($= 104 \times 2.25$) including accretion of the initial discount of MC 101 ($= [104 - 59] \times 2.25$). Accordingly, the exchange difference on the bond that is reported in net profit or loss is MC 532 ($= 2,715 - 2,082 - 101$). Also, there is an exchange gain on the interest receivable for the year of MC 15 ($= 59 \times [2.50 - 2.25]$).

	Debit	Credit
Bond	555	
Cash	148	
Fair value change in equity	78	
Interest income		234
Exchange gain		547

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