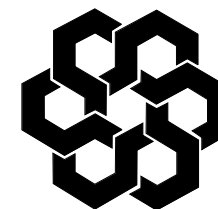


IAS 39 Implementation Guidance Questions and Answers

Prepared by the IASC Staff

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



**International
Accounting Standards
Committee** ®

The IAS 39 Implementation Guidance was prepared by the IASC Staff and was approved for issuance by the IAS 39 Implementation Guidance Committee (IGC), which was established by the Board of the International Accounting Standards Committee (IASC) for the purpose of reviewing and approving implementation guidance on IAS 39. The implementation guidance has not been considered by the IASC Board and does not necessarily represent the views of the Board.

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International Accounting Standards Committee, 166 Fleet Street, London EC4A 2DY, United Kingdom. Telephone: +44 (020) 7353-0565, Fax: +44 (020) 7353-0562, E-mail: iasc@iasc.org.uk Internet: <http://www.iasc.org.uk>

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 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 is 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. The IGC has ten members (all experts in financial instruments with backgrounds as accounting standard-setters, auditors, bankers, and preparers, from eight countries) and observers from the Basel Committee, IOSCO, and the European Commission.

IGC Procedures

The Q&A in this document were drafted by the IASC Staff. The questions are based largely on inquiries received by IASC or by national standard-setters. The draft Q&A were discussed and revised by the IGC, and were approved to be posted on the IASC Web Site 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 at 15 September 2000. It includes final versions of the draft Q&A issued for public comment on 8 May 2000, 12 June 2000, and 14 July 2000.

Status of Q&A

The guidance in this document represents the consensus view of the IGC on the appropriate interpretation and practical application of IAS 39 in a range of circumstances. 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 Q&A in this document do not have the status of such a Standard or Interpretation. Standards and Interpretations are approved by the IASC Board only after extensive due process and deliberation.

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

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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****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 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

<i>Type of contract</i>	<i>Main pricing-settlement variable (Underlying variable)</i>
Purchased or Written Commodity Option (call or put)	Commodity prices
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 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 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 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 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 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 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 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 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 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 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 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 of the note divided by 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 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 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 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 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 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 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 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 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 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 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 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 134-2****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 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 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 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 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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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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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 kronor 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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