

**International Accounting Standard IAS 39**

# Financial Instruments: Recognition and Measurement

**January 2012**

*(incorporating amendments from IFRSs issued up to 31 December 2011, including those with an effective date after 1 January 2012)*

## **BASIS FOR CONCLUSIONS**

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IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT**

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**DISSENTING OPINION**

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

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

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

*In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 Financial Instruments. Accordingly, the following were deleted: paragraphs BC13 and BC14, the heading above paragraph BC25 and paragraphs BC25–BC29, paragraph BC70, the heading above paragraph BC104A and paragraphs BC104A–BC104E, the headings above paragraphs BC125, BC127 and BC129 and paragraphs BC125–BC130, the heading above paragraph BC221 and that paragraph and the heading above paragraph BC222 and that paragraph.*

*In October 2010 the Board relocated to IFRS 9 the requirements of IAS 39 relating to classification and measurement of financial liabilities and derecognition of financial assets and financial liabilities. The Board did not reconsider most of those requirements. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC37–BC79A and BC85–BC104.*

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

## Background

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

## IAS 39 BC

- BC9 In July 2001 the Board announced that it would undertake a project to improve the existing requirements on the accounting for financial instruments in IAS 32 and IAS 39. The improvements deal with practice issues identified by audit firms, national standard-setters, regulators and others, and issues identified in the IAS 39 implementation guidance process or by IASB staff.
- BC10 In June 2002 the Board published an Exposure Draft of proposed amendments to IAS 32 and IAS 39 for a 116-day comment period. More than 170 comment letters were received.
- BC11 Subsequently, the Board took steps to enable constituents to inform it better about the main issues arising out of the comment process, and to enable the Board to explain its views of the issues and its tentative conclusions. These consultations included:
- (a) discussions with the Standards Advisory Council on the main issues raised in the comment process.
  - (b) nine round-table discussions with constituents during March 2003 conducted in Brussels and London. Over 100 organisations and individuals took part in those discussions.
  - (c) discussions with the Board's liaison standard-setters of the issues raised in the round-table discussions.
  - (d) meetings between members of the Board and its staff and various groups of constituents to explore further issues raised in comment letters and at the round-table discussions.
- BC11A Some of the comment letters on the June 2002 Exposure Draft and participants in the round-tables raised a significant issue for which the June 2003 Exposure Draft had not proposed any changes. This was hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as 'macro hedging') and the related question of the treatment in hedge accounting of deposits with a demand feature (sometimes referred to as 'demand deposits' or 'demandable liabilities'). In particular, some were concerned that it was very difficult to achieve fair value hedge accounting for a macro hedge in accordance with previous versions of IAS 39.
- BC11B In the light of these concerns, the Board decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. This resulted in a further Exposure Draft of Proposed Amendments to IAS 39 that was published in August 2003 and on which more than 120 comment letters were received. The amendments proposed in the Exposure Draft were finalised in March 2004.
- BC11C [Deleted]
- BC11D In September 2007, following a request from the International Financial Reporting Interpretations Committee (IFRIC), the Board published *Exposures Qualifying for Hedge Accounting*, an exposure draft of proposed amendments to IAS 39. The Board's objective was to clarify its requirements on exposures qualifying for hedge accounting and to provide additional guidance by specifying eligible risks and portions of cash flows. The Board received 75 responses to the exposure draft. Many respondents raised concerns about the rule-based approach proposed in the exposure draft. Their responses indicated that there was little

diversity in practice regarding the designation of hedged items. However, the responses demonstrated that diversity in practice existed, or was likely to occur, in the two situations set out in paragraph BC172C. After considering the responses, the Board decided to focus on those two situations. Rather than specifying eligible risks and portions as proposed in the exposure draft, the Board decided to address those situations by adding application guidance to illustrate how the principles underlying hedge accounting should be applied. The Board subsequently issued *Eligible Hedged Items* (Amendment to IAS 39) in July 2008. The rationale for the amendment is set out in paragraphs BC172B–BC172J.

BC11E– [Deleted]  
BC11F

BC12 The Board did not reconsider the fundamental approach to accounting for financial instruments contained in IAS 39.<sup>2</sup> Some of the complexity in existing requirements is inevitable in a mixed measurement model based in part on management's intentions for holding financial instruments and given the complexity of finance concepts and fair value estimation issues. The amendments reduce some of the complexity by clarifying the Standard, eliminating internal inconsistencies and incorporating additional guidance into the Standard.

BC13– [Deleted]  
BC14

## Scope

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### Loan commitments<sup>3</sup>

BC15 Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. In the IAS 39 implementation guidance process, the question was raised whether a bank's loan commitments are derivatives accounted for at fair value under IAS 39. This question arises because a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. In effect, it is a written option for the potential borrower to obtain a loan at a specified rate.

BC16 To simplify the accounting for holders and issuers of loan commitments, the Board decided to exclude particular loan commitments from the scope of IAS 39. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement

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2 In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39. In 2011 the Board's project on fair value measurement resulted in the relocation of the requirements for measuring fair value to IFRS 13.

3 In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

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of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).<sup>4</sup>

- BC17 However, the Board decided that an entity should be permitted to measure a loan commitment at fair value with changes in fair value recognised in profit or loss on the basis of designation at inception of the loan commitment as a financial liability through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis.
- BC18 The Board further decided that a loan commitment should be excluded from the scope of IAS 39 only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is difficult to justify its exclusion from the requirement in IAS 39 to measure at fair value similar instruments that meet the definition of a derivative.
- BC19 Some comments received on the Exposure Draft disagreed with the Board's proposal that an entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IAS 39 to all of its loan commitments. The Board considered this concern and agreed that the words in the Exposure Draft did not reflect the Board's intention. Thus, the Board clarified that if an entity has a past practice of selling the assets resulting from its loan commitments shortly after origination, it applies IAS 39 only to its loan commitments in the same class.
- BC20 Finally, the Board decided that commitments to provide a loan at a below-market interest rate should be initially measured at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. It noted that without such a requirement, liabilities that result from such commitments might not be recognised in the balance sheet, because in many cases no cash consideration is received.
- BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on loan commitments from the scope section of the Standard to the section on subsequent measurement. The purpose of this change was to rationalise the presentation of this material without making substantive changes.

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<sup>4</sup> IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of loans and receivables.



## Financial guarantee contracts<sup>5</sup>

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

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<sup>5</sup> In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

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- BC23 Some respondents to the Exposure Draft of July 2004 argued that there were important economic differences between credit insurance contracts and other forms of contract that met the proposed definition of a financial guarantee contract. However, both in developing the Exposure Draft and in subsequently discussing the comments received, the Board was unable to identify differences that would justify differences in accounting treatment.
- BC23A Some respondents to the Exposure Draft of July 2004 noted that some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not address until phase II of its project on insurance contracts. They argued that the Exposure Draft did not give enough guidance to enable them to account for these features. The Board concluded it could not address such features in the short term. The Board noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the Board was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the Board decided the following:
- (a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.
  - (b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39.
- BC23B The Board does not regard criteria such as those described in paragraph BC23A(a) as suitable for the long term, because they can lead to different accounting for contracts that have similar economic effects. However, the Board could not find a more compelling approach to resolve its concerns for the short term. Moreover, although the criteria described in paragraph BC23A(a) may appear imprecise, the Board believes that the criteria would provide a clear answer in the vast majority of cases. Paragraph AG4A gives guidance on the application of those criteria.
- BC23C The Board considered convergence with US GAAP. In US GAAP, the requirements for financial guarantee contracts (other than those covered by US standards specific to the insurance sector) are in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The recognition and measurement requirements of FIN 45 do not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. Some respondents to the Exposure Draft of July 2004 asked the Board to provide a similar exemption. They argued that the requirement to recognise these financial guarantee contracts in separate or individual financial statements would cause costs disproportionate to the likely benefits, given that intragroup transactions are eliminated on consolidation. However, to avoid the omission of material liabilities from separate or individual financial statements, the Board did not create such an exemption.

- BC23D The Board issued the amendments for financial guarantee contracts in August 2005. After those amendments, the recognition and measurement requirements for financial guarantee contracts within the scope of IAS 39 are consistent with FIN 45 in some areas, but differ in others:
- (a) Like FIN 45, IAS 39 requires initial recognition at fair value.
  - (b) IAS 39 requires systematic amortisation, in accordance with IAS 18, of the liability recognised initially. This is compatible with FIN 45, though FIN 45 contains less prescriptive requirements on subsequent measurement. Both IAS 39 and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).
  - (c) Like FIN 45, IAS 39 permits a different treatment for financial guarantee contracts issued by insurers.
  - (d) Unlike FIN 45, IAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control. However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities.
- BC23E Some respondents to the Exposure Draft of July 2004 asked for guidance on the treatment of financial guarantee contracts by the holder. However, this was beyond the limited scope of the project.

### **Contracts to buy or sell a non-financial item<sup>6</sup>**

- BC24 Before the amendments, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The Board concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative when it (i) can be settled net or by exchanging financial instruments and (ii) is not held for the purpose of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale). In addition, the Board concluded that the notion of when a contract can be settled net should include contracts:
- (a) where the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments;
  - (b) for which the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
  - (c) in which the non-financial item that is the subject of the contract is readily convertible to cash.

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<sup>6</sup> In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

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

### **Business combination forward contracts**

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

application. The Board also rejected applying the amendment prospectively only to new contracts entered into after the effective date because that would create a lack of comparability between contracts outstanding as of the effective date and contracts entered into after the effective date. Therefore, the Board concluded that the amendment to paragraph 2(g) should be applied prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010.

BC25– [Deleted]  
BC29

### **Effective interest rate (paragraphs 9 and AG5–AG8)**

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

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

### **Accounting for a change in estimates**

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

BC37– [Deleted]

BC104E

### **Impairment and uncollectibility of financial assets**

BC105– [Deleted]

BC107

#### *Incurred versus expected losses*

- BC108 Some respondents to the Exposure Draft were confused about whether the Exposure Draft reflected an 'incurred loss' model or an 'expected loss' model. Others expressed concern about the extent to which 'future losses' could be recognised as impairment losses. They suggested that losses should be recognised only when they are incurred (ie a deterioration in the credit quality of an asset or a group of assets after their initial recognition). Other respondents favoured the use of an expected loss approach. They suggested that expected future losses should be considered in the determination of the impairment loss for a group of assets even if the credit quality of a group of assets has not deteriorated from original expectations.

- BC109 In considering these comments, the Board decided that impairment losses should be recognised only if they have been incurred. The Board reasoned that it was inconsistent with an amortised cost model to recognise impairment on the basis of expected future transactions and events. The Board also decided that guidance should be provided about what ‘incurred’ means when assessing whether impairment exists in a group of financial assets. The Board was concerned that, in the absence of such guidance, there could be a range of interpretations about when a loss is incurred or what events cause a loss to be incurred in a group of assets.
- BC110 Therefore, the Board included guidance in IAS 39 that specifies that for a loss to be incurred, an event that provides objective evidence of impairment must have occurred after the initial recognition of the financial asset, and IAS 39 now identifies types of such events. Possible or expected future trends that may lead to a loss in the future (eg an expectation that unemployment will rise or a recession will occur) do not provide objective evidence of impairment. In addition, the loss event must have a reliably measurable effect on the present value of estimated future cash flows and be supported by current observable data.

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

- BC111 It was not clear in the original IAS 39 whether loans and receivables<sup>7</sup> and some other financial assets, when reviewed for impairment and determined not to be impaired, could or should subsequently be included in the assessment of impairment for a group of financial assets with similar characteristics.
- BC112 The Exposure Draft proposed that a loan asset or other financial asset that is measured at amortised cost and has been individually assessed for impairment and found not to be impaired should be included in a collective assessment of impairment. The Exposure Draft also included proposed guidance about how to evaluate impairment inherent in a group of financial assets.
- BC113 The comment letters received on the Exposure Draft indicated considerable support for the proposal to include in a collective evaluation of impairment an individually assessed financial asset that is found not to be impaired.
- BC114 The Board noted the following arguments in favour of an additional portfolio assessment for individually assessed assets that are found not to be impaired.
- (a) Impairment that cannot be identified with an individual loan may be identifiable on a portfolio basis. The *Framework*<sup>8</sup> states that for a large population of receivables, some degree of non-payment is normally regarded as probable. In that case, an expense representing the expected reduction in economic benefits is recognised (*Framework*, paragraph 85).<sup>9</sup> For example, a lender may have some concerns about identified loans with

<sup>7</sup> IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of loans and receivables.

<sup>8</sup> References to the *Framework* are to IASC’s *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

<sup>9</sup> now paragraph 4.40 of the *Conceptual Framework*

similar characteristics, but not have sufficient evidence to conclude that an impairment loss has occurred on any of those loans on the basis of an individual assessment. Experience may indicate that some of those loans are impaired even though an individual assessment may not reveal this. The amount of loss in a large population of items can be estimated on the basis of experience and other factors by weighing all possible outcomes by their associated probabilities.

- (b) Some time may elapse between an event that affects the ability of a borrower to repay a loan and actual default of the borrower. For example, if the market forward price for wheat decreases by 10 per cent, experience may indicate that the estimated payments from borrowers that are wheat farmers will decrease by 1 per cent over a one-year period. When the forward price decreases, there may be no objective evidence that any individual wheat farmer will default on an individually significant loan. On a portfolio basis, however, the decrease in the forward price may provide objective evidence that the estimated future cash flows on loans to wheat farmers have decreased by 1 per cent over a one-year period.
- (c) Under IAS 39, impairment of loans is measured on the basis of the present value of estimated future cash flows. Estimations of future cash flows may change because of economic factors affecting a group of loans, such as country and industry factors, even if there is no objective evidence of impairment of an individual loan. For example, if unemployment increases by 10 per cent in a quarter in a particular region, the estimated future cash flows from loans to borrowers in that region for the next quarters may have decreased even though no objective evidence of impairment exists that is based on an individual assessment of loans to borrowers in that region. In that case, objective evidence of impairment exists for the group of financial assets, even though it does not exist for an individual asset. A requirement for objective evidence to exist to recognise and measure impairment in individually significant loans might result in delayed recognition of loan impairment that has already occurred.
- (d) Accepted accounting practice in some countries is to establish a provision to cover impairment losses that, although not specifically identified to individual assets, are known from experience to exist in a loan portfolio as of the balance sheet date.
- (e) If assets that are individually not significant are collectively assessed for impairment and assets that are individually significant are not, assets will not be measured on a consistent basis because impairment losses are more difficult to identify asset by asset.
- (f) What is an individually significant loan that is assessed on its own will differ from one entity to another. Thus, identical exposures will be evaluated on different bases (individually or collectively), depending on their significance to the entity holding them. If a collective evaluation were not to be required, an entity that wishes to minimise its recognised impairment losses could elect to assess all loans individually. Requiring a collective assessment of impairment for all exposures judged not to be impaired individually enhances consistency between entities rather than reduces it.



BC115 Arguments against an additional portfolio assessment for individually assessed loans that are found not to be impaired are as follows.

- (a) It appears illogical to make an impairment provision on a group of loans that have been assessed for impairment on an individual basis and have been found not to be impaired.
- (b) The measurement of impairment should not depend on whether a lender has only one loan or a group of similar loans. If the measurement of impairment is affected by whether the lender has groups of similar loans, identical loans may be measured differently by different lenders. To ensure consistent measurement of identical loans, impairment in individually significant financial assets should be recognised and measured asset by asset.
- (c) The *Framework* specifies that financial statements are prepared on the accrual basis of accounting, according to which the effects of transactions and events are recognised when they occur and are recognised in the financial statements in the periods to which they relate. Financial statements should reflect the outcome of events that took place before the balance sheet date and should not reflect events that have not yet occurred. If an impairment loss cannot be attributed to a specifically identified financial asset or a group of financial assets that are not individually significant, it is questionable whether an event has occurred that justifies the recognition of impairment. Even though the risk of loss may have increased, a loss has not yet materialised.
- (d) The *Framework*, paragraph 94,<sup>10</sup> requires an expense to be recognised only if it can be measured reliably. The process of estimating impairment in a group of loans that have been individually assessed for impairment but found not to be impaired may involve a significant degree of subjectivity. There may be a wide range of reasonable estimates of impairment. In practice, the establishment of general loan loss provisions is sometimes viewed as more of an art than a science. This portfolio approach should be applied only if it is necessary on practical grounds and not to override an assessment made on an individual loan, which must provide a better determination of whether an allowance is necessary.
- (e) IAS 39 requires impairment to be measured on a present value basis using the original effective interest rate. Mechanically, it may not be obvious how to do this for a group of loans with similar characteristics that have different effective interest rates. In addition, measurement of impairment in a group of loans based on the present value of estimated cash flows discounted using the original effective interest rate may result in double-counting of losses that were expected on a portfolio basis when the loans were originated because the lender included compensation for those losses in the contractual interest rate charged. As a result, a portfolio assessment of impairment may result in the recognition of a loss almost as soon as a loan is issued. (This question arises also in measuring impairment on a portfolio basis for loans that are not individually assessed for impairment under IAS 39.)

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<sup>10</sup> now paragraph 4.49 of the *Conceptual Framework*

- BC116 The Board was persuaded by the arguments in favour of a portfolio assessment for individually assessed assets that are found not to be impaired and decided to confirm that a loan or other financial asset measured at amortised cost that is individually assessed for impairment and found not to be impaired should be included in a group of similar financial assets that are assessed for impairment on a portfolio basis. This is to reflect that, in the light of the law of large numbers, impairment may be evident in a group of assets, but not yet meet the threshold for recognition when any individual asset in that group is assessed. The Board also confirmed that it is important to provide guidance about how to assess impairment on a portfolio basis to introduce discipline into a portfolio assessment. Such guidance promotes consistency in practice and comparability of information across entities. It should also mitigate concerns that collective assessments of impairment should not be used to conceal changes in asset values or as a cushion for potential future losses.
- BC117 Some respondents expressed concerns about some of the detailed guidance proposed in the Exposure Draft, such as the guidance about adjusting the discount rate for expected losses. Many entities indicated that they do not have the data and systems necessary to implement the proposed approach. The Board decided to eliminate some of the detailed application guidance (eg whether to make an adjustment of the discount rate for originally expected losses and an illustration of the application of the guidance).

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

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

that have been incurred on a group basis as of the balance sheet date, but cannot yet be identified with individual assets. As soon as information is available to identify losses on individually impaired assets, those assets are removed from the group that is collectively assessed for impairment.

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

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

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

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

## IAS 39 BC

- (d) Changes in estimates of future cash flows should be directionally consistent with changes in underlying observable data.
- (e) Estimation methods should be adjusted to reduce differences between estimates of future cash flows and actual cash flows.

BC125- [Deleted]

BC130

## Hedging

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

### **Consideration of the shortcut method in SFAS 133**

BC132 SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* issued by the FASB allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method').

BC133 The original IAS 39 and the Exposure Draft precluded the use of the shortcut method. Many comments received on the Exposure Draft argued that IAS 39 should permit use of the shortcut method. The Board considered the issue in developing the Exposure Draft, and discussed it in the round-table discussions that were held in the process of finalising IAS 39.

BC134 The Board noted that, if the shortcut method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the shortcut method.

BC135 Additionally, IAS 39 permits the hedging of portions of financial assets and financial liabilities in cases when US GAAP does not. The Board noted that under IAS 39 an entity may hedge a portion of a financial instrument (eg interest rate risk or credit risk), and that if the critical terms of the hedging instrument and the hedged item are the same, the entity would, in many cases, recognise no ineffectiveness.

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

BC135A IAS 39 permits a hedged item to be designated as a portion of the cash flows or fair value of a financial asset or financial liability. In finalising the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, the Board received comments that demonstrated that the meaning of a 'portion' was

unclear in this context. Accordingly, the Board decided to amend IAS 39 to provide further guidance on what may be designated as a hedged portion, including confirmation that it is not possible to designate a portion that is greater than the total cash flows of the asset or liability.

### **Expected effectiveness (paragraphs AG105–AG113)**

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

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

- BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non-financial item other than foreign currency risk.
- BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.
- BC139 The Board confirmed that non-financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the market. In this context, the Board decided to clarify that a hedge ratio of other than one-to-one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

### **Loan servicing rights**

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

servicing rights at fair value through profit or loss would create a further exception, because this treatment is optional (except for items that are held for trading). The Board therefore decided not to amend the scope of IAS 39 for loan servicing rights.

### **Whether to permit hedge accounting using cash instruments**

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

longer qualifies as a hedging instrument and selectively avoid recognising the changes in fair value of the non-derivative instrument in equity (for a cash flow hedge) or profit or loss (for a fair value hedge).

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

### **Whether to treat hedges of forecast transactions as fair value hedges**

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

### **Hedges of firm commitments (paragraphs 93 and 94)**

- BC149 The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. In other words, hedging gains and losses, to the extent that the hedge is effective, were initially recognised in equity and were subsequently 'recycled' to profit or loss in the same period(s) that the hedged firm commitment affected profit or loss (although, when basis adjustment was used, they adjusted the initial carrying amount of an asset or liability recognised in the meantime). Some believe this is appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised. Moreover, some believe it is conceptually incorrect to recognise the hedged fair value exposure of a firm commitment as an asset or liability merely because it has been hedged.
- BC150 The Board considered whether hedges of firm commitments should be treated as cash flow hedges or fair value hedges. The Board concluded that hedges of firm commitments should be accounted for as fair value hedges.



- BC151 The Board noted that, in concept, a hedge of a firm commitment is a fair value hedge. This is because the fair value of the item being hedged (the firm commitment) changes with changes in the hedged risk.
- BC152 The Board was not persuaded by the argument that it is conceptually incorrect to recognise an asset or liability for a firm commitment merely because it has been hedged. It noted that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised. For example, assume an entity hedges a fixed rate loan asset with a pay-fixed, receive-variable interest rate swap. If there is a loss on the swap, applying fair value hedge accounting requires the offsetting gain on the loan to be recognised, ie the carrying amount of the loan is increased. Thus, applying hedge accounting has the effect of recognising a part of an asset (the increase in the loan's value attributable to interest rate movements) that would otherwise not have been recognised. The only difference in the case of a firm commitment is that, without hedge accounting, none of the commitment is recognised, ie the carrying amount is zero. However, this difference merely reflects that the historical cost of a firm commitment is usually zero. It is not a fundamental difference in concept.
- BC153 Furthermore, the Board's decision converges with SFAS 133, and thus eliminates practical problems and eases implementation for entities that report under both standards.
- BC154 However, the Board clarified that a hedge of the foreign currency risk of a firm commitment may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly a foreign currency cash flow hedge of a forecast transaction need not be re-designated as a fair value hedge when the forecast transaction becomes a firm commitment.

### **Basis adjustments (paragraphs 97–99)**

- BC155 The question of basis adjustment arises when an entity hedges the future purchase of an asset or the future issue of a liability. One example is that of a US entity that expects to make a future purchase of a German machine that it will pay for in euro. The entity enters into a derivative to hedge against possible future changes in the US dollar/euro exchange rate. Such a hedge is classified as a cash flow hedge under IAS 39, with the effect that gains and losses on the hedging instrument (to the extent that the hedge is effective) are initially recognised in equity.<sup>11</sup> The question the Board considered is what the accounting should be once the future transaction takes place. In its deliberations on this issue, the Board discussed the following approaches:
- (a) to remove the hedging gain or loss from equity and recognise it as part of the initial carrying amount of the asset or liability (in the example above, the machine). In future periods, the hedging gain or loss is automatically recognised in profit or loss by being included in amounts such as depreciation expense (for a fixed asset), interest income or expense (for a financial asset or financial liability), or cost of sales (for inventories). This treatment is commonly referred to as 'basis adjustment'.

<sup>11</sup> As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

- (b) to leave the hedging gain or loss in equity. In future periods, the gain or loss on the hedging instrument is 'recycled' to profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. This recycling requires a separate adjustment and is not automatic.

- BC156 It should be noted that both approaches have the same effect on profit or loss and net assets for all periods affected, so long as the hedge is accounted for as a cash flow hedge. The difference relates to balance sheet presentation and, possibly, the line item in the income statement.
- BC157 In the Exposure Draft, the Board proposed that the 'basis adjustment' approach for forecast transactions (approach (a)) should be eliminated and replaced by approach (b) above. It further noted that eliminating the basis adjustment approach would enable IAS 39 to converge with SFAS 133.
- BC158 Many of the comments received from constituents disagreed with the proposal in the Exposure Draft. Those responses argued that it would unnecessarily complicate the accounting to leave the hedging gain or loss in equity when the hedged forecast transaction occurs. They particularly noted that tracking the effects of cash flow hedges after the asset or liability is acquired would be complicated and would require systems changes. They also pointed out that treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment results in the recognition of an asset or liability. For example, for a perfectly effective hedge of the foreign currency risk of a firm commitment to buy a machine, the effect is to recognise the machine initially at its foreign currency price translated at the forward rate in effect at the inception of the hedge rather than the spot rate. Therefore, they questioned whether it is consistent to treat a hedge of a firm commitment as a fair value hedge while precluding basis adjustments for hedges of forecast transactions.
- BC159 Others believe that a basis adjustment is difficult to justify in principle for forecast transactions, and also argue that such basis adjustments impair comparability of financial information. In other words, two identical assets that are purchased at the same time and in the same way, except for the fact that one was hedged, should not be recognised at different amounts.
- BC160 The Board concluded that IAS 39 should distinguish between hedges of forecast transactions that will result in the recognition of a *financial* asset or a *financial* liability and those that will result in the recognition of a *non-financial* asset or a *non-financial* liability.

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

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

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

An entity applies the guidance in the answer to Question F.6.2 of the guidance on implementing IAS 39. On 1 January 20X0 the entity designates forecast cash flows for the risk of variability arising from changes in interest rates. Those forecast cash flows arise from the repricing of existing financial instruments and are scheduled for 1 April 20X0. The entity is exposed to variability in cash flows for the three-month period beginning on 1 April 20X0 attributable to changes in interest rate risk that occur from 1 January 20X0 to 31 March 20X0. The occurrence of the forecast cash flows is deemed to be highly probable and all the other relevant hedge accounting criteria are met.

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

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

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

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

**Hedging using internal contracts**

- BC165 IAS 39 does not preclude entities from using internal contracts as a risk management tool, or as a tracking device in applying hedge accounting for external contracts that hedge external positions. Furthermore, IAS 39 permits hedge accounting to be applied to transactions between entities in the same group in the *separate reporting* of those entities. However, IAS 39 does not permit hedge accounting for transactions between entities in the same group in consolidated financial statements. The reason is the fundamental requirement of consolidation that the accounting effects of internal contracts should be eliminated in consolidated financial statements, including any internally generated gains or losses. Designating internal contracts as hedging instruments could result in non-elimination of internal gains and losses and have other accounting effects. The Exposure Draft did not propose any change in this area.
- BC166 To illustrate, assume the banking book division of Bank A enters into an internal interest rate swap with the trading book division of the same bank. The purpose is to hedge the net interest rate risk exposure in the banking book of a group of similar fixed rate loan assets funded by floating rate liabilities. Under the swap,

the banking book pays fixed interest payments to the trading book and receives variable interest rate payments in return. The bank wants to designate the internal interest rate swap in the banking book as a hedging instrument in its consolidated financial statements.

- BC167 If the internal swap in the banking book is designated as a hedging instrument in a cash flow hedge of the liabilities, and the internal swap in the trading book is classified as held for trading, internal gains and losses on that internal swap would not be eliminated. This is because the gains and losses on the internal swap in the banking book would be recognised in equity<sup>12</sup> to the extent the hedge is effective and the gains and losses on the internal swap in the trading book would be recognised in profit or loss.
- BC168 If the internal swap in the banking book is designated as a hedging instrument in a fair value hedge of the loan assets and the internal swap in the trading book is classified as held for trading, the changes in the fair value of the internal swap would offset both in total net assets in the balance sheet and profit or loss. However, without elimination of the internal swap, there would be an adjustment to the carrying amount of the hedged loan asset in the banking book to reflect the change in the fair value attributable to the risk hedged by the internal contract. Moreover, to reflect the effect of the internal swap the bank would in effect recognise the fixed rate loan at a floating interest rate and recognise an offsetting trading gain or loss in the income statement. Hence the internal swap would have accounting effects.
- BC169 Some respondents to the Exposure Draft and some participants in the round-tables objected to not being able to obtain hedge accounting in the consolidated financial statements for internal contracts between subsidiaries or between a subsidiary and the parent (as illustrated above). Among other things, they emphasised that the use of internal contracts is a key risk management tool and that the accounting should reflect the way in which risk is managed. Some suggested that IAS 39 should be changed to make it consistent with US GAAP, which allows the designation of internal derivative contracts as hedging instruments in cash flow hedges of forecast foreign currency transactions in specified, limited circumstances.
- BC170 In considering these comments, the Board noted that the following principles apply to consolidated financial statements:
- (a) financial statements provide financial information about an entity or group as a whole (as that of a single entity). Financial statements do not provide financial information about an entity as if it were two separate entities.
  - (b) a fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts as hedging instruments would require a change to the consolidation principles.

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<sup>12</sup> As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

## IAS 39 BC

- (c) it is conceptually wrong to permit an entity to recognise internally generated gains and losses or make other accounting adjustments because of internal transactions. No external event has occurred.
- (d) an ability to recognise internally generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control the associated risks. It is not the purpose of accounting standards to prescribe how entities should manage and control risks.
- (e) permitting the designation of internal contracts as hedging instruments violates the following requirements in IAS 39:
  - (i) the prohibition against designating as a hedging instrument a non-derivative financial asset or non-derivative financial liability for other than foreign currency risk. To illustrate, if an entity has two offsetting internal contracts and one is the designated hedging instrument in a fair value hedge of a non-derivative asset and the other is the designated hedging instrument in a fair value hedge of a non-derivative liability, from the entity's perspective the effect is to designate a hedging relationship between the asset and the liability (ie a non-derivative asset or non-derivative liability is used as the hedging instrument).
  - (ii) the prohibition on designating a net position of assets and liabilities as the hedged item. To illustrate, an entity has two internal contracts. One is designated in a fair value hedge of an asset and the other in a fair value hedge of a liability. The two internal contracts do not fully offset, so the entity lays off the net risk exposure by entering into a net external derivative. In that case, the effect from the entity's perspective is to designate a hedging relationship between the net external derivative and a net position of an asset and a liability.
  - (iii) the option to fair value assets and liabilities does not extend to portions of assets and liabilities.
- (f) the Board is considering separately whether to make an amendment to IAS 39 to facilitate fair value hedge accounting for portfolio hedges of interest rate risk. The Board believes that that is a better way to address the concerns raised about symmetry with risk management systems than permitting the designation of internal contracts as hedging instruments.
- (g) the Board decided to permit an option to measure any financial asset or financial liability at fair value with changes in fair value recognised in profit or loss. This enables an entity to measure matching asset/liability positions at fair value without a need for hedge accounting.

BC171 The Board reaffirmed that it is a fundamental principle of consolidation that any accounting effect of internal contracts is eliminated on consolidation. The Board decided that no exception to this principle should be made in IAS 39. Consistently with this decision, the Board also decided not to explore an

amendment to permit internal derivative contracts to be designated as hedging instruments in hedges of some forecast foreign currency transactions, as is permitted by SFAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities*.

- BC172 The Board also decided to clarify that IAS 39 does not preclude hedge accounting for transactions between entities in the same group in individual or separate financial statements of those entities because they are not internal to the entity (ie the individual entity).
- BC172A Previously, paragraphs 73 and 80 referred to the need for hedging instruments to involve a party external to the reporting entity. In doing so, they used a segment as an example of a reporting entity. However, IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non-IFRS basis. Therefore, the two IFRSs appeared to conflict. In *Improvements to IFRSs* issued in May 2008 and April 2009, the Board removed from paragraphs 73 and 80 references to the designation of hedging instruments at the segment level.

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

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

#### **Designation of a one-sided risk in a hedged item**

- BC172D The IFRIC received requests for guidance on whether an entity can designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option, including changes in the time value, are regarded as effective and would be recognised in other comprehensive income. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.
- BC172E After considering the responses to the exposure draft, the Board confirmed that the designation set out in paragraph BC172D is not permitted.
- BC172F The Board reached that decision by considering the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase (a one-sided risk). The Board noted that the forecast transaction contained no separately identifiable risk that affects profit or loss that is equivalent to the time value of a purchased option hedging instrument (with the same principal terms

as the designated risk). The Board concluded that the intrinsic value of a purchased option, but not its time value, reflects a one-sided risk in a hedged item. The Board then considered a purchased option designated in its entirety as the hedging instrument. The Board noted that hedge accounting is based on a principle of offsetting changes in fair value or cash flows between the hedging instrument and the hedged item. Because a designated one-sided risk does not contain the time value of a purchased option hedging instrument, the Board noted that there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. Therefore, the Board concluded that a purchased option designated in its entirety as the hedging instrument of a one-sided risk will not be perfectly effective.

### **Designation of inflation in particular situations**

- BC172G The IFRIC received a request for guidance on whether, for a hedge of a fixed rate financial instrument, an entity can designate inflation as the hedged item. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.
- BC172H After considering the responses to the exposure draft, the Board acknowledged that expectations of future inflation rates can be viewed as an economic component of nominal interest. However, the Board also noted that hedge accounting is an exception to normal accounting principles for the hedged item (fair value hedges) or hedging instrument (cash flow hedges). To ensure a disciplined use of hedge accounting the Board noted that restrictions regarding eligible hedged items are necessary, especially if something other than the entire fair value or cash flow variability of a hedged item is designated.
- BC172I The Board noted that paragraph 81 permits an entity to designate as the hedged item something other than the entire fair value change or cash flow variability of a financial instrument. For example, an entity may designate some (but not all) risks of a financial instrument, or some (but not all) cash flows of a financial instrument (a 'portion').
- BC172J The Board noted that, to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the fair value or cash flows of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. The Board noted that these principles were important in order for the effectiveness requirements set out in paragraph 88 to be applied in a meaningful way. The Board also noted that deciding whether designated risks and portions are separately identifiable and reliably measurable requires judgement. However, the Board confirmed that unless the inflation portion is a contractually specified portion of cash flows and other cash flows of the financial instrument are not affected by the inflation portion, inflation is not separately identifiable and reliably measurable and is not eligible for designation as a hedged risk or portion of a financial instrument.



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

### Background

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

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

### Scope

- BC175 The Board decided to limit any amendments to IAS 39 to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:
- (a) implementation guidance on IAS 39<sup>13</sup> explains how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.
  - (b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in paragraph BC176 do not arise in combination for such other hedging arrangements.

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

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

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<sup>13</sup> see Q&A F.6.1 and F.6.2

- (a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual repricing date. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness tests.<sup>14</sup> Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement<sup>15</sup> that a group of hedged assets or liabilities must be 'similar' and the related requirement<sup>16</sup> that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.
- (b) IAS 39<sup>17</sup> prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets or a group of similar assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.
- (c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk.<sup>18</sup> Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life.<sup>19</sup> This, too, gives rise to significant systems needs.

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

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<sup>14</sup> see IAS 39, paragraph AG105

<sup>15</sup> see IAS 39, paragraph 78

<sup>16</sup> see IAS 39, paragraph 83

<sup>17</sup> see IAS 39, paragraph AG101

<sup>18</sup> see IAS 39, paragraph 89(b)

<sup>19</sup> see IAS 39, paragraph 92

- (a) derivatives should be measured at fair value;
- (b) hedge ineffectiveness should be identified and recognised in profit or loss;<sup>20</sup> and
- (c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet.

### Prepayment risk

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

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<sup>20</sup> Subject to the same materiality considerations that apply in this context as throughout IFRSs.

BC181 The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged.

#### **Designation of the hedged item and liabilities with a demand feature**

BC182 The Board considered two main ways to overcome the issue noted in paragraph BC176(b). These were:

- (a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a repricing time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.
- (b) to designate the hedged item as a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.

BC183 Some of those who commented on the Exposure Draft favoured designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset-liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.

BC184 In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

BC185 The Board noted that under the first approach in paragraph BC182 (designating an overall net position), an issue arises if the entity has liabilities that are repayable on demand or after a notice period (referred to below as 'demandable liabilities'). This includes items such as demand deposits and some types of time deposits. The Board was informed that, when managing interest rate risk, many entities that have demandable liabilities include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of demandable liabilities in the portfolio to be due because of net withdrawals from the accounts

in the portfolio. This expected repayment date is typically a period covering several years into the future (eg 0–10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include demandable liabilities in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

- (a) it is consistent with how demandable liabilities are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. The interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.
- (b) it is consistent with the treatment of prepayable assets to include demandable liabilities in a portfolio hedge based on expected repayment dates.
- (c) as with prepayable assets, expected maturities for demandable liabilities are based on the historical behaviour of customers.
- (d) applying the fair value hedge accounting framework to a portfolio that includes demandable liabilities would not entail an immediate gain on origination of such liabilities because all assets and liabilities enter the hedged portfolio at their carrying amounts. Furthermore, IAS 39 requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (ie the amount deposited).<sup>21</sup>
- (e) historical analysis shows that a base level of a portfolio of demandable liabilities, such as chequing accounts, is very stable. Whilst a portion of the demandable liabilities varies with interest rates, the remaining portion—the base level—does not. Hence, entities regard this base level as a long-term fixed rate item and include it as such in the scheduling that is used for risk management purposes.
- (f) the distinction between ‘old’ and ‘new’ money makes little sense at a portfolio level. The portfolio behaves like a long-term item even if individual liabilities do not.

BC186 The Board noted that this issue is related to that of how to measure the fair value of a demandable liability. In particular, it interrelates with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.<sup>21</sup> This requirement applies to all liabilities with a demand feature, not only to those included in a portfolio hedge.

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<sup>21</sup> In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

BC187 The Board also noted that:

- (a) although entities, when managing risk, may schedule demandable liabilities based on the expected repayment date of the total balance of a portfolio of accounts, the deposit liabilities included in that balance are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Put another way, the balance of the portfolio is relatively stable only because withdrawals on some accounts (which usually occur relatively quickly) are offset by new deposits into others. Thus, the liability being hedged is actually the forecast replacement of existing deposits by the receipt of new deposits. IAS 39 does not permit a hedge of such a forecast transaction to qualify for fair value hedge accounting. Rather, fair value hedge accounting can be applied only to the liability (or asset) or firm commitment that exists today.
- (b) a portfolio of demandable liabilities is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit demandable liabilities to be included in a fair value hedge on the basis of a stable base level created by expected replacements, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.
- (c) a portfolio of similar core deposits is not different from an individual deposit, other than that, in the light of the ‘law of large numbers’, the behaviour of the portfolio is more predictable. There are no diversification effects from aggregating many similar items.
- (d) it would be inconsistent with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, to schedule such liabilities for hedging purposes using a different date. For example, consider a deposit of CU100 that can be withdrawn on demand without penalty. IAS 39 states that the fair value of such a deposit is CU100. That fair value is unaffected by interest rates and does not change when interest rates move. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk—there is no fair value exposure to hedge.

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

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

BC189 As a result, the Board decided:

- (a) to confirm the requirement in IAS 39 that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid',<sup>22</sup> and

<sup>22</sup> In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

- (b) consequently, that a demandable liability cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

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

- BC190 The Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a portion *of the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular repricing time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes to hedge its net exposure of CU20. Also assume that all of the liabilities are demandable liabilities and the time period is later than that containing the earliest date on which the items can be repaid. If the hedged item is designated as CU20 of *assets*, then the demandable *liabilities* are not included in the hedged item, but rather are used only to determine how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demandable liabilities can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item, because the net position comprises CU100 of assets and CU80 of demandable liabilities, whether the demandable liabilities can be designated as a hedged item in a fair value hedge becomes critical.
- BC191 Given the above points, the Board decided that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the demandable liabilities issue. It also noted that this approach is consistent with IAS 39,<sup>23</sup> whereas designating an overall net position is not. IAS 39<sup>24</sup> prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating an amount of assets (or liabilities) equal to the net position.
- BC192 However, the Board also recognised that this method of designation would not fully resolve the demandable liabilities issue. In particular, the issue is still relevant if, in a particular repricing time period, the entity has so many demandable liabilities whose earliest repayment date is before that time period that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including the demandable liabilities) exceed its fixed rate assets in this repricing time period. In this case, the entity is in a net liability position. Thus, it needs to designate an amount of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than those that can be demanded before that time period, this implies designating the demandable liabilities as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting. (If the liabilities are non-interest bearing, they cannot be designated as the

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<sup>23</sup> see IAS 39, paragraph 84

<sup>24</sup> see IAS 39, paragraph AG101



hedged item in a cash flow hedge because their cash flows do not vary with changes in interest rates, ie there is no cash flow exposure to interest rates.<sup>25</sup> However, the hedging relationship may qualify for cash flow hedge accounting if designated as a hedge of associated assets.)

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

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

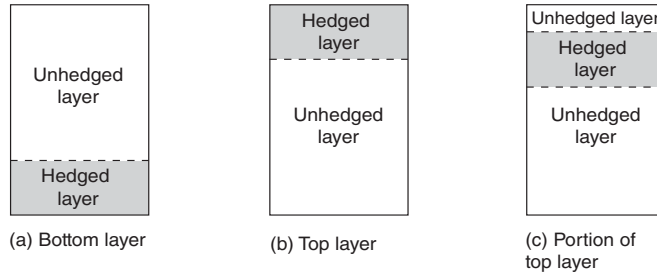
#### *Layer approach*

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

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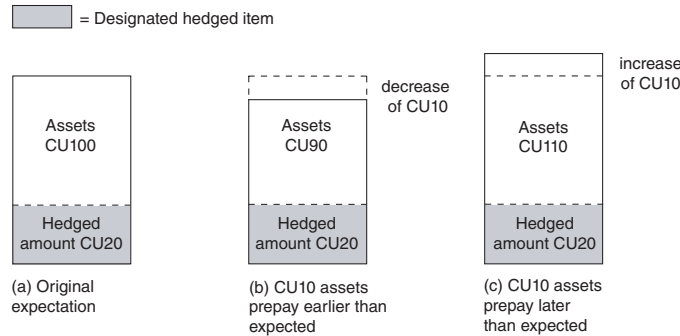
<sup>25</sup> see Guidance on Implementing IAS 39, Question and Answer F.6.3.

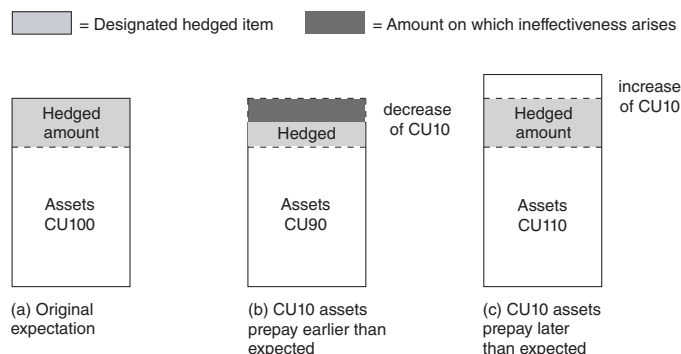
**Figure 1: Illustrating the designation of an amount of assets as a layer**



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

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

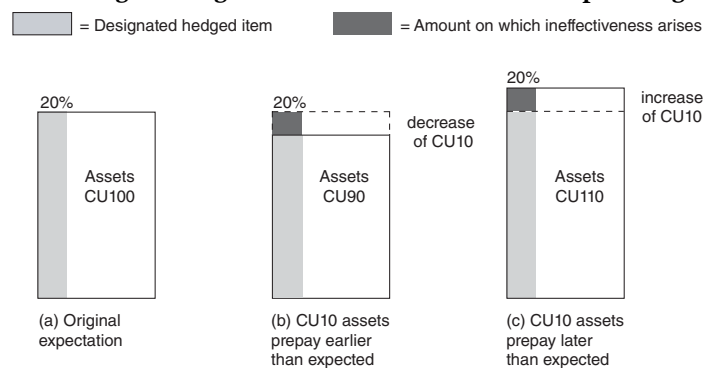


**Figure 3: Illustrating the effect on changes in prepayments in a top layer approach**

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

#### Percentage approach

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

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

*Arguments for and against the layer approach*

BC200 The arguments for the layer approach are as follows:

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

BC201 The arguments against the layer approach are as follows:

- (a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.
- (b) The fact that no ineffectiveness is recognised if the amount in a repricing time period is re-estimated upwards (with the effect that the entity becomes underhedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both when the entity becomes overhedged (ie the derivative exceeds the hedged item) and when it becomes underhedged (ie the derivative is smaller than the hedged item).
- (c) As noted in paragraph BC200(e), a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. When interest rates change, the fair value of both of these components changes.

- (d) The objective of applying fair value hedge accounting to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain results that closely approximate those that would have been obtained if individual assets or liabilities had been designated as the hedged item. If individual prepayable assets had been designated as the hedged item, the change in both the components noted in (c) above (to the extent they are attributable to the hedged risk) would be recognised in profit or loss, both when interest rates increase and when they decrease. Accordingly, the change in the fair value of the hedged asset would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that in the simplified approach of designating the hedged item as an amount, ineffectiveness should similarly arise.
- (e) All prepayable assets in a repricing time period, and not just a layer of them, contain a prepayment option whose fair value changes with changes in interest rates. Accordingly, when interest rates change, the fair value of the hedged assets (which include a prepayment option whose fair value has changed) will change by an amount different from that of the hedging derivative (which typically does not contain a prepayment option), and ineffectiveness will arise. This effect occurs regardless of whether interest rates increase or decrease—ie regardless of whether re-estimates of prepayments result in the amount in a time period being more or less.
- (f) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item. Often the biggest single cause of changes in prepayment rates is changes in interest rates. This close relationship is the reason why IAS 39 prohibits a held-to-maturity asset<sup>26</sup> from being a hedged item with respect to either interest rate risk or prepayment risk. Furthermore, most entities do not separate the two components for risk management purposes. Rather, they incorporate the prepayment option by scheduling amounts based on expected maturities. When entities choose to use risk management practices—based on not separating prepayment and interest rate risk—as the basis for designation for hedge accounting purposes, it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item.
- (g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be different from the effect on the fair value of a portfolio of otherwise identical but non-prepayable items. However, using a layer approach, this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

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

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

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

BC203 The Board also considered comments on the Exposure Draft that:

- (a) some entities hedge prepayment risk and interest rate risk separately, by hedging to the expected prepayment date using interest rate swaps, and hedging possible variations in these expected prepayment dates using swaptions.
- (b) the embedded derivatives provisions of IAS 39 require some prepayable assets to be separated into a prepayment option and a non-prepayable host contract (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for trading). This seems to conflict with the view in the Exposure Draft that the two risks are too difficult to separate for the purposes of a portfolio hedge.<sup>27</sup>

BC204 In considering these arguments, the Board noted that the percentage approach described in paragraph AG126(b) is a proxy for measuring the change in the fair value of the *entire* asset (or liability)—including any embedded prepayment option—that is attributable to changes in interest rates. The Board had developed this proxy in the Exposure Draft because it had been informed that most entities (a) do not separate interest rate risk and prepayment risk for risk management purposes and hence (b) were unable to value the change in the value of the entire asset (including any embedded prepayment option) that is attributable to changes in the hedged interest rates. However, the comments described in paragraph BC203 indicated that in some cases, entities may be able to measure this change in value directly. The Board noted that such a direct method of measurement is conceptually preferable to the proxy described in paragraph AG126(b) and, accordingly, decided to recognise it explicitly. Thus, for example, if an entity that hedges prepayable assets using a combination of interest rate swaps and swaptions is able to measure directly the change in fair value of the entire asset, it could measure effectiveness by comparing the change in the value of the swaps and swaptions with the change in the fair value of the entire asset (including the change in the value of the prepayment option embedded in them) that is attributable to changes in the hedged interest rate. However, the Board also decided to permit the proxy proposed in the Exposure Draft for those entities that are unable to measure directly the change in the fair value of the entire asset.

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<sup>27</sup> In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

*Consideration of systems requirements*

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

**The carrying amount of the hedged item**

- BC207 The last issue noted in paragraph BC176 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands of—individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a decrease in the fair value of a financial asset (financial liability) being recognised as a financial liability (financial asset). Furthermore, for some repricing time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such repricing time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.
- BC208 Accordingly, the Board decided that two line items should be presented, as follows:
- (a) for those repricing time periods for which the hedged item is an asset, the change in its fair value is presented in a single separate line item within assets; and

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

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

### **Derecognition of amounts included in the separate line items**

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

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

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

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



*Amortisation*

- BC212 The Board also noted that if the designated hedged amount for a repricing time period is reduced, IAS 39<sup>28</sup> requires that the separate balance sheet line item described in paragraph 89A relating to that reduction is amortised on the basis of a recalculated effective interest rate. The Board noted that for a portfolio hedge of interest rate risk, amortisation based on a recalculated effective interest rate could be complex to determine and could demand significant additional systems requirements. Consequently, the Board decided that in the case of a portfolio hedge of interest rate risk (and only in such a hedge), the line item balance may be amortised using a straight-line method when a method based on a recalculated effective interest rate is not practicable.

**The hedging instrument**

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

**Hedge effectiveness for a portfolio hedge of interest rate risk**

- BC216 Some respondents to the Exposure Draft questioned whether IAS 39's effectiveness tests<sup>29</sup> should apply to a portfolio hedge of interest rate risk. The Board noted that its objective in amending IAS 39 for a portfolio hedge of interest rate risk is to permit fair value hedge accounting to be used more easily, whilst continuing to meet the principles of hedge accounting. One of these principles is that the hedge is highly effective. Thus, the Board concluded that the effectiveness requirements in IAS 39 apply equally to a portfolio hedge of interest rate risk.
- BC217 Some respondents to the Exposure Draft sought guidance on how the effectiveness tests are to be applied to a portfolio hedge. In particular, they asked how the prospective effectiveness test is to be applied when an entity periodically 'rebalances' a hedge (ie adjusts the amount of the hedging instrument to reflect

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28 see paragraph 92

29 see paragraph AG105

changes in the hedged item). The Board decided that if the entity's risk management strategy is to change the amount of the hedging instrument periodically to reflect changes in the hedged position, that strategy affects the determination of the term of the hedge. Thus, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. The Board noted that this decision does not conflict with the requirement in paragraph 75 that 'a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding'. This is because the entire hedging instrument is designated (and not only some of its cash flows, for example, those to the time when the hedge is next adjusted). However, expected effectiveness is assessed by considering the change in the fair value of the entire hedging instrument only for the period until it is next adjusted.

- BC218 A third issue raised in the comment letters was whether, for a portfolio hedge, the retrospective effectiveness test should be assessed for all time buckets in aggregate or individually for each time bucket. The Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.

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

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

- BC221– [Deleted]  
BC222

## Dissenting opinions

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

- DO1 Messrs Cope, Leisenring and McGregor dissent from the issue of this Standard.
- DO2 Mr Leisenring dissents because he disagrees with the conclusions concerning derecognition, impairment of certain assets and the adoption of basis adjustment hedge accounting in certain circumstances.
- DO3 The Standard requires in paragraphs 30 and 31 that to the extent of an entity's continuing involvement in an asset, a liability should be recognised for the consideration received. Mr Leisenring believes that the result of that accounting is to recognise assets that fail to meet the definition of assets and to record liabilities that fail to meet the definition of liabilities. Furthermore, the Standard fails to recognise forward contracts, puts or call options and guarantees that are created, but instead records a fictitious 'borrowing' as a result of rights and obligations created by those contracts. There are other consequences of the continuing involvement approach that has been adopted. For transferors, it results in very different accounting by two entities when they have identical contractual rights and obligations only because one entity once owned the transferred financial asset. Furthermore, the 'borrowing' that is recognised is not accounted for like other loans, so no interest expense may be recorded. Indeed, implementing the proposed approach requires the specific override of measurement and presentation standards applicable to other similar financial instruments that do not arise from derecognition transactions. For example, derivatives created by derecognition transactions are not accounted for at fair value. For transferees, the approach also requires the override of the recognition and measurement requirements applicable to other similar financial instruments. If an instrument is acquired in a transfer transaction that fails the derecognition criteria, the transferee recognises and measures it differently from an instrument that is acquired from the same counterparty separately.
- DO4 Mr Leisenring also disagrees with the requirement in paragraph 64 to include an asset that has been individually judged not to be impaired in a portfolio of similar assets for an additional portfolio assessment of impairment. Once an asset is judged not to be impaired, it is irrelevant whether the entity owns one or more similar assets as those assets have no implications for whether the asset that was individually considered for impairment is or is not impaired. The result of this accounting is that two entities could each own 50 per cent of a single loan. Both entities could conclude the loan is not impaired. However, if one of the two entities happens to have other loans that are similar, it would be allowed to recognise an impairment with respect to the loan where the other entity is not. Accounting for identical exposures differently is unacceptable. Mr Leisenring believes that the arguments in paragraph BC115 are compelling.
- DO5 Mr Leisenring also dissents from paragraph 98 which allows but does not require basis adjustment for hedges of forecast transactions that result in the recognition of non-financial assets or liabilities. This accounting results in always adjusting the recorded asset or liability at the date of initial recognition away from its fair value. It also records an asset, if the basis adjustment

alternative is selected, at an amount other than its cost as defined in IAS 16 *Property, Plant and Equipment* and further described in paragraph 16 of that Standard. If a derivative were to be considered a part of the cost of acquiring an asset, hedge accounting in these circumstances should not be elective to be consistent with IAS 16. Mr Leisenring also objects to creating this alternative as a result of an improvement project that ostensibly had as an objective the reduction of alternatives. The non-comparability that results from this alternative is both undesirable and unnecessary.

- DO6 Mr Leisenring also dissents from the application guidance in paragraph AG71 and in particular the conclusion contained in paragraph BC98. He does not believe that an entity that originates a contract in one market should measure the fair value of the contract by reference to a different market in which the transaction did not take place. If prices change in the transacting market, that price change should be recognised when subsequently measuring the fair value of the contract. However, there are many implications of switching between markets when measuring fair value that the Board has not yet addressed. Mr Leisenring believes a gain or loss should not be recognised based on the fact a transaction could occur in a different market.
- DO7 Mr Cope dissents from paragraph 64 and agrees with Mr Leisenring's analysis and conclusions on loan impairment as set out above in paragraph DO4. He finds it counter-intuitive that a loan that has been determined not to be impaired following careful analysis should be subsequently accounted for as if it were impaired when included in a portfolio.
- DO8 Mr Cope also dissents from paragraph 98, and, in particular, the Board's decision to allow a free choice over whether basis adjustment is used when accounting for hedges of forecast transactions that result in the recognition of non-financial assets or non-financial liabilities. In his view, of the three courses of action open to the Board—retaining IAS 39's requirement to use basis adjustment, prohibiting basis adjustment as proposed in the June 2002 Exposure Draft, or providing a choice—the Board has selected the worst course. Mr Cope believes that the best approach would have been to prohibit basis adjustment, as proposed in the Exposure Draft, because, in his opinion, basis adjustments result in the recognition of assets and liabilities at inappropriate amounts.
- DO9 Mr Cope believes that increasing the number of choices in international standards is bad policy. The Board's decision potentially creates major differences between entities choosing one option and those choosing the other. This lack of comparability will adversely affect users' ability to make sound economic decisions.
- DO10 In addition, Mr Cope notes that entities that are US registrants may choose not to adopt basis adjustment in order to avoid a large reconciling difference to US GAAP. Mr Cope believes that increasing differences between IFRS-compliant entities that are US registrants and those that are not is undesirable.
- DO11 Mr McGregor dissents from paragraph 98 and agrees with Mr Cope's and Mr Leisenring's analyses and conclusions as set out above in paragraphs DO5 and DO8–DO10.
- DO12 Mr McGregor also dissents from this Standard because he disagrees with the conclusions about impairment of certain assets.

- DO13 Mr McGregor disagrees with paragraphs 67 and 69, which deal with the impairment of equity investments classified as available for sale. These paragraphs require impairment losses on such assets to be recognised in profit or loss when there is objective evidence that the asset is impaired. Previously recognised impairment losses are not to be reversed through profit and loss when the assets' fair value increases. Mr McGregor notes that the Board's reasoning for prohibiting reversals through profit or loss of previously impaired available-for-sale equity investments, set out in paragraph BC130 of the Basis for Conclusions, is that it '... could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value'. He agrees with this reasoning but believes that it applies equally to the recognition of impairment losses in the first place. Mr McGregor believes that the significant subjectivity involved in assessing whether a reduction in fair value represents an impairment (and thus should be recognised in profit or loss) or another decrease in value (and should be recognised directly in equity) will at best lead to a lack of comparability within an entity over time and between entities, and at worst provide an opportunity for entities to manage reported profit or loss.
- DO14 Mr McGregor believes that all changes in the fair value of assets classified as available for sale should be recognised in profit or loss. However, such a major change to the Standard would need to be subject to the Board's full due process. At this time, to overcome the concerns expressed in paragraph DO13, he believes that for equity investments classified as available for sale, the Standard should require all changes in fair value below cost to be recognised in profit or loss as impairments and reversals of impairments and all changes in value above cost to be recognised in equity. This approach treats all changes in value the same way, no matter what their cause. The problem of how to distinguish an impairment loss from another decline in value (and of deciding whether there is an impairment in the first place) is eliminated because there is no longer any subjectivity involved. In addition, the approach is consistent with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.
- DO15 Mr McGregor disagrees with paragraph 106 of the Standard and with the consequential amendments to paragraph 27<sup>30</sup> of IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Paragraph 106 requires entities to apply the derecognition provisions prospectively to financial assets. Paragraph 27 of IFRS 1 requires first-time adopters to apply the derecognition provisions of IAS 39 (as revised in 2003) prospectively to non-derivative financial assets and financial liabilities. Mr McGregor believes that existing IAS 39 applicers should apply the derecognition provisions retrospectively to financial assets, and that first-time adopters should apply the derecognition provisions of IAS 39 retrospectively to all financial assets and financial liabilities. He is concerned that financial assets may have been derecognised under the original IAS 39 by entities that were subject to it, which might not have been derecognised under the revised IAS 39. He is also concerned that non-derivative financial assets and financial liabilities may have been derecognised by first-time adopters under previous GAAP that would not have been derecognised under the revised IAS 39. These amounts may be significant in many cases. Not requiring recognition of such amounts will result in the loss of relevant information and will impair the ability of users of financial statements to make sound economic decisions.

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30 As a result of the revision of IFRS 1 in November 2008, paragraph 27 became paragraph B2.

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

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

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

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