Financial Instruments
Applying IAS 32 and IAS 39
Summaries, Guidance, Examples, and US GAAP Comparisons

October 2001
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FOREWORD

In 1988, the International Accounting Standards Committee (IASC) began a project to develop a comprehensive International Accounting Standard (IAS) on accounting for financial instruments. Financial instruments include cash; accounts, notes, and loans receivable and payable; investments in stocks, bonds, and other securities; and derivatives such as options, rights, warrants, futures contracts, forward contracts, and swaps.

Ten years later, the Standard - IAS 39, Financial Instruments: Recognition and Measurement - was issued. Along the way, the IASC issued three exposure drafts, an issues paper, and a separate Standard on disclosure and presentation - IAS 32, Financial Instruments: Disclosure and Presentation.

Although earlier application of IAS 39 was encouraged by the IASC, for most companies the Standard takes effect in 2001. In response to a considerable number of implementation inquiries from our clients and others, Deloitte Touche Tohmatsu has developed supplemental guidance (in question and answer format) and examples regarding the application of both IAS 32 and IAS 39. This book sets out 165 questions and answers and 151 examples. It also includes comprehensive summaries of the two Standards as well as 52 comparisons with US GAAP.

Since the beginning of 2001, IASC has been reorganised and renamed the International Accounting Standards Board or IASB. IASB has itself published over 200 questions and answers relating to IAS 39 in response to implementation issues that have been brought to the Board’s attention. The matters addressed in this book supplement the IASB’s own guidance.

Large as this book may seem, it does not address all fact patterns. Moreover, the guidance is subject to change. IASB has indicated that it considering some limited revisions to IAS 39. You are encouraged to consult a Deloitte Touche Tohmatsu professional regarding your specific issues and questions. You can also find current information on our website: www.iasplus.com.

John T. Smith
Global Leader, Financial Instruments Group
October 2001

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This book contains guidance developed by Deloitte Touche Tohmatsu for applying IAS 32 and IAS 39. Following issuance of IAS 39, in 1999 the IASC appointed an Implementation Guidance Committee (IGC) to develop guidance on IAS 39 in the form of questions and answers. To date, more than 200 Q&A have been published in final form, and more are expected. (These are available in PDF format without charge at www.iasb.org.uk.) In researching an answer to an IAS 39 question, you should look at the IGC Q&A as well as the guidance in this book. Appendix B of this book sets out a list of the questions addressed in the IGC Q&A.
INTERNATIONAL ACCOUNTING STANDARD (IAS) 39
Financial Instruments: Recognition and Measurement

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<th>Date</th>
<th>IASC Document Relating to Financial Instruments</th>
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<tr>
<td>September 1991</td>
<td>Exposure Draft E40, Financial Instruments</td>
</tr>
<tr>
<td>January 1994</td>
<td>E40 was modified and re-exposed as Exposure Draft E48, Financial Instruments</td>
</tr>
<tr>
<td>June 1995</td>
<td>The disclosure and presentation portion of E48 was adopted as IAS 32, Financial Instruments: Disclosure and Presentation. Work on recognition and measurement continued</td>
</tr>
<tr>
<td>1 January 1996</td>
<td>Effective Date of IAS 32</td>
</tr>
<tr>
<td>December 1998</td>
<td>IAS 32 was revised by IAS 39, Financial Instruments: Recognition and Measurement, effective 1 January 2001</td>
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Objective of IAS 32

The stated objective of IAS 32 is to enhance users’ understanding of the significance of on-balance sheet and off-balance sheet financial instruments to an enterprise’s financial position, performance, and cash flows. IAS 32 addresses this in essentially three ways:

1. Clarifying the classification of a financial instrument issued by an enterprise as a liability or as equity.
2. Prescribing strict conditions under which financial assets and liabilities may be offset in the balance sheet.
3. Requiring a broad range of disclosures about financial instruments, including information as to their fair values.

Scope of IAS 32

IAS 32 applies in presenting and disclosing information about all types of financial instruments, whether recognised in the balance sheet or not, with the following exceptions: [IAS 32.1]

- investments in subsidiaries [see IAS 27], investments in equity method associates [see IAS 28], and investments in joint ventures [see IAS 31];
- obligations for post-employment benefits [see IAS 19 and IAS 26];
- employers’ obligations under employee stock option and stock purchase plans [see IAS 19]; and
- obligations arising under insurance contracts [this is the subject of a current IASB agenda project].
DEFINITION OF A FINANCIAL INSTRUMENT

A financial instrument is a contract that results in a financial asset of one enterprise and a financial liability or equity instrument of another enterprise. A financial asset is cash, a contractual right to receive cash or another financial asset, a contractual right to exchange financial instruments with another enterprise on terms that are potentially favourable, or an equity instrument of another enterprise. A financial liability is an obligation to deliver cash or another financial asset or an obligation to exchange financial instruments with another enterprise on terms that are potentially unfavourable. This is the same definition as is used in IAS 32.

Common examples of financial instruments include:

- Cash;
- Demand and time deposits;
- Commercial paper;
- Accounts, notes, and loans receivable and payable;
- Debt and equity securities. These are financial instruments from the perspectives of both the holder and the issuer. This category includes investments in subsidiaries, associates, and joint ventures;
- Asset backed securities such as collateralised mortgage obligations, repurchase agreements, and securitised packages of receivables;
- Derivatives, including options, rights, warrants, futures contracts, forward contracts, and swaps;
- Leases;
- Rights and obligations with insurance risk under insurance contracts; and
- Employers’ rights and obligations under pension contracts.

Some contracts that themselves are not financial instruments may nonetheless have financial instruments embedded in them. For example, a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity.

CLASSIFICATION AS LIABILITY OR EQUITY

The fundamental principle of IAS 32 is that an instrument should be classified as either a liability or an equity instrument according to its substance, not its legal form. The enterprise must make the decision at the time the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. The key distinguishing feature is that a financial liability involves a contractual obligation either to deliver cash or another financial asset, or to issue another financial instrument, under terms that are potentially unfavourable to the issuer. An instrument that does not give rise to such a contractual obligation is an equity instrument. [IAS 32.18]

To illustrate, if an enterprise issues preference (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation and, therefore, should be recognised as a liability. In contrast, normal preference shares do not have a fixed maturity, and the issuer does not have a contractual obligation to make any payment. Therefore, they are equity.

Some financial instruments - sometimes called compound instruments - have both a liability and an equity element. In that case, IAS 32 requires that the component parts be split, with each part accounted for and presented separately according to its substance. To illustrate, a convertible bond contains two components. One is a financial liability, namely the issuer’s contractual obligation to pay cash, and the other is an equity instrument, namely the holder’s option to convert into common shares. This split is made at the time the instrument is issued and is not subsequently revised as a result of a change in interest rates, share price, or other event that changes the likelihood that the conversion option will be exercised. [IAS 32.25]

Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported in the income statement. This means that dividend payments on preferred shares classified as liabilities are treated as expenses. On the other hand, distributions to holders of a financial instrument classified as equity should be charged directly against equity, not against earnings. [IAS 32.30]

SIC 5, Classification of Financial Instruments - Contingent Settlement Provisions, provides further guidance on liability-equity classification. Where the rights and obligations regarding the manner of settlement of a financial instrument depend on the occurrence or non-occurrence of uncertain future events, or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder, the financial instrument should be classified as a liability unless the possibility of the issuer being required to settle in cash or another financial asset is remote at the time of issuance, in which case the instrument should be classified as equity.

OFFSETTING

IAS 32 also prescribes rules for the offsetting of financial assets and financial liabilities. It specifies that a financial asset and a financial liability should be offset and the net amount reported when, and only when, an enterprise: [IAS 32.53]

- Has a legally enforceable right to set off the amounts; and
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

TREASURY SHARES

SIC 16, Share Capital - Reacquired Own Equity Instruments (Treasury Shares), interprets IAS 32 with respect to treasury shares. Treasury shares are equity shares repurchased and held by the issuing enterprise or its subsidiaries. Where an enterprise holds treasury shares, those shares should be presented in the balance sheet as a deduction from equity. No gain or loss should be recognised in the income statement on the sale, issuance, or cancellation of treasury shares. Consideration received should be presented in the financial statements as a change in equity.
DISCLOSURES
An enterprise should describe its financial risk management objectives and policies, including hedging policies. [IAS 32.43A]

For each class of financial asset, financial liability, and equity, both recognised and unrecognised, IAS 32 requires disclosure of:
- the extent and nature of the financial instruments, including significant terms and conditions (including principal amount, maturity, early settlement or conversion options, amount and timing of cash flows, stated interest or dividend rates, collateral held or pledged, denomination in a foreign currency, and restrictive conditions and covenants); [IAS 32.47]
- accounting policies and methods adopted, including recognition criteria and measurement principles; [IAS 32.47]
- specified information about exposure to interest rate risk (including repricing dates and effective interest rates); [IAS 32.56]
- specified information about exposure to credit risk (including amounts and significant concentrations); [IAS 32.66]
- specified information about the fair value of the financial instrument, or a statement that it is not practicable to provide such information; [IAS 32.77] and
- special information if a financial asset is carried in excess of its fair value (the impairment provisions of IAS 39 would generally prohibit this). [IAS 32.88]

A comprehensive IAS 32-39 disclosure checklist is included in the appendix to this book.

1998 REVISIONS TO IAS 32
Several changes were made to IAS 32 as a result of the introduction of IAS 39, Financial Instruments: Recognition and Measurement, which was effective for periods commencing on or after 1 January 2001. The principal changes made were:
- the addition of a requirement to account for certain commodity based contracts as if they were financial instruments;
- an elaborated definition of financial liability (an enterprise should account for certain obligations that can be settled either by payment of financial assets or in the form of the enterprise’s own equity securities as if they were financial liabilities); and
- deletion of the requirement to adjust for transaction costs in determining fair value.

IAS 32
DTT GUIDANCE, EXAMPLES, AND US GAAP COMPARISONS

IAS 32.5 - SCOPE: CONTRACTUAL ARRANGEMENTS AND ENFORCEABILITY

QUESTION
A FINANCIAL INSTRUMENT IS A CONTRACT THAT RESULTS IN A FINANCIAL ASSET OF ONE ENTERPRISE AND A FINANCIAL LIABILITY OR EQUITY INSTRUMENT OF ANOTHER ENTERPRISE. DOES A CONTRACT EXIST IF IT IS NOT ENFORCEABLE AT LAW?

Even where an arrangement may not be enforceable at law, the existence of clear economic consequences or disincentives for non-performance of either party could imply that a contractual arrangement nevertheless does exist.

IAS 32.23 - LIABILITY VS. EQUITY CLASSIFICATION OF COMPOUND INSTRUMENTS: HOLDER CONSIDERATIONS

QUESTION
IS THE ISSUER’S CLASSIFICATION OF LIABILITY AND EQUITY COMPONENTS RELEVANT TO THE HOLDER?

The distinction between equity and liability is not relevant for holders of such instruments since compound instruments represent either an asset or liability in the holder’s hands. However, provisions of IAS 39 relating to embedded derivatives are applicable and consistent with the requirements in IAS 32 for separating out the various components of a hybrid instrument, where such instrument contains an embedded derivative. Essentially these provisions provide that the embedded derivative should be separated out where it is not closely related to the host contract (and an equity and debt component are not considered to be closely related).

IAS 32.23 - SPLITTING THE DEBT AND EQUITY COMPONENTS OF COMPOUND (HYBRID) INSTRUMENTS

COMPARISON WITH US GAAP
There is currently no equivalent concept under US GAAP that provides for the split presentation of the debt and equity components of compound instruments, either from the issuer’s or the holder’s perspective. Although FASB 133, paragraph 61, regards mandatorily redeemable preferred stock as more akin to debt whereas cumulative participating perpetual preferred shares are more akin to equity instruments, it only requires separation in the case of hybrid contracts that contain embedded derivatives. The SEC requires presentation of redeemable preferred share instruments on the balance sheet under a ‘mezzanine’ section (between debt and equity). These provisions do not, however, require the debt and equity components to be separated and accounted for individually.
IAS 32.28 - SPLITTING THE COMPONENTS OF COMPOUND INSTRUMENTS: MEASUREMENT CONSIDERATIONS

EXAMPLE

IAS 32.28 offers two potential approaches that might be followed in separating and valuing the components of a compound financial instrument on initial recognition. The following example illustrates in greater detail how such valuations may be made from the holder’s perspective.

An enterprise issues 2,000 convertible bonds at the start of Year 1. The bonds have a three-year term, and are issued at par with a face value of £1,000 per bond, giving total proceeds of £2 million. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible, at the holder’s discretion, at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is £3. The dividends expected over the three-year term of the underlying shares amount to £0.14 per share at the end of each year. The risk-free annual interest rate for a three-year term is 5%.

APPROACH 1: RESIDUAL VALUATION OF THE EQUITY COMPONENT

Under this approach, the liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. Note that from the holder’s perspective, since the conversion option is not considered to be closely related to the debt host, the embedded derivative is separated from the host contract and measured at fair value as illustrated in the second approach below rather than the first approach. Under this approach, the fair value of the embedded derivative is determined, and the difference between the proceeds of the bond issue and the fair value of the embedded derivative may be allocated to the remaining component - which is a financial asset (call option) in the holder’s hands.

The present value of the liability component is calculated using a discount rate of nine percent, the market interest rate for similar bonds having no conversion rights, as shown.

| Principal | £ 2,000,000 |
| Present value of the principal payable at the end of three years | £ 1,544,567 |
| Present value of the interest - £120,000 payable annually in arrears for three years | 303,755 |
| Total liability component | 1,848,122 |
| Residual equity component | 144,683 |
| Proceeds of the bond issue | £ 2,000,000 |

As illustrated in the above table, the aggregated fair values of the debt and equity components of the compound instrument do not equal the £2,000,000 proceeds from the issuance of the convertible bonds. The small difference is therefore prorated over the fair values of the two components to produce a fair value for the liability of £1,854,794 and a fair value for the option of £144,683. [IAS 32, Appendix, paragraph A24]

APPROACH 2: SEPARATE VALUATION OF EACH COMPONENT AND ALLOCATION ON PRO-RATA BASIS

Option pricing models may be used to determine the fair value of the embedded conversion option directly rather than by deduction as illustrated above. Financial institutions often use option-pricing models for pricing day-to-day transactions. There are a number of models available and each has a number of variants. This example has been determined using values that have been obtained from a version of the Black-Scholes model.

Pricing the bond conversion option as a call option (assuming a volatility of 30%), results in a fair value of £0.289366 per conversion right. The valuation of the conversion options therefore can be calculated as:

\[ \text{Fair value of the option per share} \times \text{Number of shares per bond} \times \text{Number of bonds} = \text{Total fair value} \]

\[ £0.289366 \times 250 \times 2,000 = £144,683 \]

| Fair value of liability component (determined in approach 1 above) | £1,848,122 |
| Fair value of equity component (determined above) | £144,683 |
| Total fair value (equity + liability components) | £1,992,805 |
| Proceeds of the bond issue | £2,000,000 |
| Difference to be pro-rated between the components based on their relative values | £7,195 |

IAS 32.32 - RECOGNISING DIVIDENDS AS INTEREST EXPENSE

QUESTION

WHEN ARE DIVIDENDS RECOGNISED AS INTEREST EXPENSE?

Under IAS 32, the measurement and recognition of interest and dividends associated with compound instruments follows the classification of the underlying component. Historically, dividends have only been recognised once declared, even where there is an economic obligation on the company to pay them at regular intervals (for example with cumulative preferred stock). Where an instrument (or component of an instrument) obligates the issuer to provide a return to holders in the form of dividends, the fair value of that obligation is classified under IAS 32 as a financial liability. The right to dividends is, in substance, interest and, therefore, should be accrued between payment dates rather than only recognised once declared.
IAS 32.34 - OFFSETTING OF A FINANCIAL ASSET AND A FINANCIAL LIABILITY: DEMONSTRATING INTENT

**QUESTION**

**HOW IS THE INTENT TO SET OFF DEMONSTRATED?**

Intention may be demonstrated through management representations that are not contradicted by past experience or other relevant circumstances and, also, may take into account reference to the enterprise’s risk management policies, if appropriate. There is no requirement for an assessment of the counterparty’s intent and as long as the reporting entity has the legal right, intent only need be considered from the reporting enterprise’s perspective.

IAS 32.36 - OFFSETTING: THREE-PARTY NETTING AGREEMENT

**QUESTION**

**UNDER WHAT UNUSUAL CIRCUMSTANCES WOULD THERE EXIST A THREE-PARTY NETTING ARRANGEMENT?**

IAS 32 does not provide any guidance either as to unusual circumstances or the nature of the agreement amongst the parties. Although three-party netting agreements are not common, IAS permits offsetting when they exist. It is not clear that the legal rights need to be established in a document amongst the three parties. For example, a debtor might obtain set-off rights separately from the third party and from the creditor. In establishing the validity of the legal right to set-off, it is necessary to understand the terms of the particular contracts as well as the context within which set-off is to be applied. The legal right to set-off could, among other ways, be evidenced with reference to a legal opinion, or to established statutory or regulatory provisions which have been clearly established and demonstrated as governing the particular transaction.

IAS 32.41 - OFFSETTING MULTIPLE CASH FLOWS

**EXAMPLE**

Assume that the legal right of set-off exists in the following scenario. Company X owes company Y four payments of $10 million each at the end of each calendar quarter (31 March, 30 June, 30 September, 31 December), totalling $40 million. As part of another contract, company Y owes company X two payments of $15 million at 30 June and 31 December, totalling $30 million.

The intention to settle simultaneously can only be demonstrated in respect of the 30 June and 31 December cash flows. At the beginning of the year, company X will, therefore, reflect a financial liability of $20 million (being the 31 March and 30 September payments) and a separate financial asset of $10 million (representing the difference between the $10 million payable and $15 million receivable from company Y on 30 June and 31 December).

Although company X’s net position over the whole year is a financial liability of $10 million, since it cannot demonstrate the intention to settle net or simultaneously for all payments, the criteria for offset are not satisfied in respect of those unmatched payments and separate presentation is required. Company Y correspondingly has an asset of $20 million and a liability of $10 million.

IAS 32.41 - MASTER NETTING AGREEMENTS AND OFFSETTING

**EXAMPLE**

Bank A, an investment bank enters into several swap transactions having different reset dates to manage the interest rate risk arising from its corporate loans portfolio. Although these transactions are with a range of other banks as counterparties, Bank A’s systems aggregate all exposures on a daily basis to enable them to recognise the net profit or loss due to the change in fair value of all open (unexpired) contracts. Certain contracts have a positive fair value while others are in a loss position. ISDA Master Netting Agreements are in place with some, but not all of these counterparties. Bank A does not net the settlements across swap positions with counterparties on reset dates.

Bank A does not meet the criteria for offsetting financial assets and liabilities related to its swap positions. It does not settle on a net basis and, due to the mismatch in reset dates across its swaps book, cannot demonstrate the simultaneous settlement of swap cash flows. The ISDA Master Netting Agreements are not, in themselves sufficient to provide the Bank with the legal right to set off its settlement cash flows across contracts except in the conditional event of default or termination by one of the parties.
IAS 32.41 - OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

COMPARISON WITH US GAAP

US GAAP differs from IAS 32 with respect to offsetting in two principal areas, namely the ability to offset where a third party is involved and the exception with respect to master netting agreements.

FASB Interpretation (FIN) 39, Offsetting of Amounts Related to Certain Contracts - An Interpretation of APB Opinion No. 10 and FASB Statement No. 105, sets out the criteria for offsetting amounts related to certain financial instrument contracts. These criteria are broadly similar to those under IAS 32 in requiring that a right of set-off must exist. This is demonstrated when all of the following conditions are met:

- each of the two parties owes the other determinable amounts;
- the reporting party has the right to set off the amount owed with the amount owed by the other party;
- the reporting party intends to set off; and
- the right of set off is enforceable at law (FIN 39, paragraph 5).

By restricting the ability to offset to where the right of set off exists between two parties (that is, where a debtor-creditor relationship exists), US GAAP does not permit set off under three-party netting agreements. For example, a loan by the foreign branch of a US bank to a foreign subsidiary of a US parent with the parent simultaneously depositing an amount equal to the loan in the US bank for the same term. The deposit is effectively collateral for the loan and the bank has legal set off by the foreign subsidiary. Under US GAAP, offsetting in this situation would be inappropriate whereas, under IAS 32, (assuming that the collateral does not fall under the paragraph 40(c) exclusion), offsetting would be permitted in terms of paragraph 36 provided that intent can be demonstrated.

The second area of difference relates to master netting agreements. FIN 39, paragraph 10 provides an exception to the above requirements where a master netting arrangement exists and the reporting entity has multiple contracts (whether in respect of multiple types of financial instruments or only single contract types). Even though the master netting agreement only may provide for the net settlement of all contracts through a single payment in a single currency in the event of default or on termination of any one contract, fair value amounts may be offset. This is also the case even where the reporting enterprise’s intention is to only offset in the case of default or termination. This exception recognises that the net presentation is consistent with the credit exposures under such an arrangement and which constitutes useful information for users of the financial statements. Presentation of the aggregate fair values of the individual contracts executed under that arrangement does not provide any extra information about the uncertainty of future cash flows from those contracts other than that which is already contained in disclosure of the net amounts.

IAS 32.64(b) - INTENTION TO OFFSET: OPTIONS

EXAMPLE

Company X, a gold producer in South Africa, manages its exposure to changes in the gold price and locks in the cost of funding future capital expenditure by entering into option strategies with several investment banks. These strategies require company X to both purchase call options and to write put options at various strike prices and with various maturity dates. The transactions are expected to be settled in cash and meet the definition of a derivative in IAS 39. The investment banks require company X to enter into ISDA Master Netting agreements (drafted by the International Swaps and Derivatives Association) that give either party the legal right of set off on termination of the contract, or on default of the other party. These agreements do not provide for the set-off of settlements in the ordinary course of business.

Company X may not set off the financial assets and financial liabilities arising from the premiums paid and received and subsequent measurement of these options to fair value. Since the master netting agreement establishes a legally enforceable right of set-off only in the event of a contingent event (default or on termination by one of the parties) and not in respect of ongoing settlements, the requirement in IAS 32.33(a) is not satisfied. Additionally, by virtue of the different maturity dates, the company does not demonstrate the intention to settle on a net basis or to realise the asset and liability simultaneously and therefore the requirement in IAS 32.33(b) is not satisfied. Even in the case where the premiums are settled on the same date, by virtue of the continuing exposure to credit risk on the party writing the option, the fact that the maturity dates are different precludes set-off.
INTERNATIONAL ACCOUNTING STANDARD (IAS) 39
FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

SUMMARY

History of IAS 39

<table>
<thead>
<tr>
<th>Date</th>
<th>IASC Document Relating to Financial Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 1984</td>
<td>Exposure Draft E26, Accounting for Investments</td>
</tr>
<tr>
<td>March 1986</td>
<td>IAS 25, Accounting for Investments</td>
</tr>
<tr>
<td>1 January 1987</td>
<td>Effective Date of IAS 25</td>
</tr>
<tr>
<td>September 1991</td>
<td>Exposure Draft E40, Financial Instruments</td>
</tr>
<tr>
<td>January 1994</td>
<td>E40 was modified and re-exposed as Exposure Draft E48, Financial Instruments</td>
</tr>
<tr>
<td>June 1995</td>
<td>The disclosure and presentation portion of E48 was adopted as IAS 32. Work on</td>
</tr>
<tr>
<td></td>
<td>recognition and measurement continued</td>
</tr>
<tr>
<td>April 2000</td>
<td>Withdrawal of IAS 25 following the approval of IAS 40, Investment Property</td>
</tr>
<tr>
<td>October 2000</td>
<td>Limited revisions to IAS 39 effective 1 January 2001</td>
</tr>
<tr>
<td>1 January 2001</td>
<td>Effective Date of IAS 39</td>
</tr>
</tbody>
</table>

FINANCIAL INSTRUMENT DEFINED

A financial instrument is a contract that results in a financial asset of one enterprise and a financial liability or equity instrument of another enterprise. A financial asset is cash, a contractual right to receive cash or another financial asset, a contractual right to exchange financial instruments with another enterprise on terms that are potentially favourable, or an equity instrument of another enterprise. A financial liability is an obligation to deliver cash or another financial asset or an obligation to exchange financial instruments with another enterprise on terms that are potentially unfavourable. [IAS 39.8] The same definition is used in IAS 32.

Some contracts that themselves are not financial instruments may nonetheless have financial instruments embedded in them. For example, a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity.
**DERIVATIVES DEFINED**

A derivative is a financial instrument:

1. whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index;
2. that requires little or no initial net investment; and
3. that is settled at a future date.

**SCOPE OF IAS 39**

IAS 39 applies to all financial instruments except: [IAS 39.1]

- investments in subsidiaries [see IAS 27], investments in equity method associates [see IAS 28], and investments in joint ventures [see IAS 31];
- rights and obligations under leases [see IAS 17], though the derecognition provisions of IAS 39 do apply to lease contracts;
- employer’s assets and liabilities under employee benefit plans [see IAS 19];
- rights and obligations under insurance contracts [IASB is currently working on a project on Accounting for Insurance Contracts];
- equity instruments issued by the reporting enterprise [see IAS 32];
- financial guarantee contracts;
- contingent consideration in a business combination [see IAS 22]; and
- weather derivatives that pay off based on climatic or similar physical variables.

**INITIAL RECOGNITION OF FINANCIAL INSTRUMENTS**

IAS 39 requires that all financial assets and all financial liabilities be recognized on the balance sheet. That includes all derivatives. Historically, in many parts of the world, derivatives have not been recognized on company balance sheets. The argument has been that at the time the derivative contract was entered into, there was no amount of cash or other assets paid. Zero-cost justified non-recognition, notwithstanding that as time passes and the value of the underlying variable (rate, price, or index) changes, the derivative has a positive asset or negative liability value.

IAS 39 requires that purchases and sales of each broad category of financial assets be accounted for consistently using either trade date or settlement date accounting. If settlement date accounting is used, certain value changes between trade and settlement dates must be recognized.

**INITIAL MEASUREMENT OF FINANCIAL INSTRUMENTS**

Under IAS 39, financial assets and financial liabilities are measured initially at cost, which is the fair value of whatever was paid or received to acquire or incur them. As noted above, acquisition cost could be zero for some derivatives. Acquisition cost includes transaction costs such as commissions, fees, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include premium or discount, financing costs, or allocations of internal administrative or holding costs. [IAS 39.17 and 39.66]
SUBSEQUENT MEASUREMENT - FINANCIAL ASSETS

All recognised financial assets fall into one of four IAS 39 categories:

1. **Originated loans and receivables.** These are loans and receivables originated by an enterprise and not held for trading. The enterprise need not demonstrate intent to hold originated loans and receivables to maturity.

2. **Held-to-maturity investments.** These are other fixed maturity investments, such as debt securities and mandatorily redeemable preferred shares, that an enterprise intends and is able to hold to maturity. Because this classification depends on management intent rather than objective evidence, IAS 39 imposes a somewhat punitive burden. If an enterprise actually sells a held-to-maturity investment other than in a circumstance that could not be anticipated or in insignificant amounts, all of its other held-to-maturity investments must be reclassified as available-for-sale (category 4 below) for the current and next two financial reporting years. [IAS 39.83]

3. **Financial assets held for trading.** These are financial assets acquired for the purpose of generating a profit from short-term fluctuations in price. For this purpose, derivative assets are always deemed held for trading (unless they are designated as hedging instruments - see discussion later in this summary).

4. **Available-for-sale financial assets.** These are all financial assets that are not in one of the above three categories. This includes all investments in equity instruments that are not held for trading.

Principles for measuring each of the four categories of financial assets subsequent to their acquisition under IAS 39 are as follows: [IAS 39.69-79]

**Originated loans and receivables** that are not held for trading are measured at amortised cost, less reductions for impairment or uncollectibility. Amortised cost means after amortisation of premium or discount arising at initial acquisition using the effective interest method.

**Held-to-maturity investments** are measured at amortised cost, less reductions for impairment or uncollectibility.

**Financial assets held for trading** are measured at fair value, with changes in fair value reported in net profit or loss for the period.

**Available-for-sale financial assets** are measured at fair value - with a measurement reliability exception that IASC expects to be rare (see next paragraph). For available-for-sale financial assets that are remeasured to fair value, an enterprise will have a single, enterprise-wide option to adopt one or the other of the following accounting policies:

- Recognise fair value changes in net profit or loss for the period.
- Recognise the fair value changes directly in equity until the financial asset is sold, at which time the realised gain or loss is reported in net profit or loss.

The only exception to fair value measurement of available-for-sale assets is if a reliable estimate of fair value cannot be made, in which case the basis of measurement is cost. Quoted market price in an active market is the best measure of fair value. However, the fact that a debt or equity security is not quoted in an active market does not automatically mean that it escapes the fair valuation requirement of IAS 39. Indeed, IAS 39 states a presumption that “fair value can be reliably determined for most financial assets classified as available for sale or held for trading”. And it provides guidance for determining fair value in the absence of quoted prices.

Fair value does not include transaction costs. And transaction costs that may be incurred on sale are not deducted in measuring the fair value of a financial asset. Therefore, if a financial instrument is acquired at a cost of 100 plus transaction costs of 2, it is initially measured at total cost of 102. If at the subsequent measurement date the quoted market price is 100 and transaction costs of 3 would be incurred on sale of the asset, it would be measured at 100 and a loss of 2 would be recognised. [IAS 39.69]

The following table summarises the classification and measurement scheme for financial assets under IAS 39:

<table>
<thead>
<tr>
<th>IAS 39 Category of Financial Asset</th>
<th>Description</th>
<th>Measurement Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originated loans and receivables</td>
<td>Loans and receivables created by an enterprise by providing money, goods, or services directly to the debtor</td>
<td>Amortised cost, subject to impairment recognition</td>
</tr>
<tr>
<td>Held-to-maturity investments</td>
<td>Fixed maturity investments that the enterprise intends and is able to hold to maturity</td>
<td>Amortised cost, subject to impairment recognition</td>
</tr>
</tbody>
</table>
| Available for sale financial assets - normal case | Includes:  
  - Fixed maturity investments that the enterprise either does not intend or is not able to hold to maturity  
  - Equity investments with a quoted market price  
  - Equity investments with no quoted market price but able to estimate fair value | Fair value. Enterprise has a one-time, enterprise-wide choice of reporting changes in fair value (a) in net profit or loss or (b) in equity until the asset is sold or otherwise disposed of, at which time the cumulative gain or loss is reported in net profit or loss. |
| Available for sale financial assets - unusual | Equity investments with no quoted market price and the enterprise is not able to estimate fair value | Cost subject to impairment recognition |
| Financial assets held for trading | Financial assets acquired for the purpose of generating a profit from short-term fluctuations in price. This includes all derivative assets and liabilities. | Fair value, changes in fair value in net profit or loss |
SUBSEQUENT MEASUREMENT - FINANCIAL LIABILITIES

After acquisition most financial liabilities are measured at original recorded amount less principal repayments and amortisation of discounts and premiums. Only derivatives with a negative market value and liabilities held for trading (such as an obligation for securities borrowed in a short sale, which have to be returned in the future) are remeasured to fair value. [IAS 39.93]

DERECOGNITION (REMOVAL) OF FINANCIAL ASSETS AND LIABILITIES

IAS 39 establishes conditions for determining when control over a financial asset or liability has been transferred to another party and, therefore, should be removed from the balance sheet (derecognised). For financial assets, derecognition is normally appropriate if:

- the transferee has the right to sell or pledge the asset; and
- the transferor does not have the right to reacquire the transferred assets. However, such a right does not prevent derecognition if either the asset is readily obtainable in the market or the reacquisition price is fair value at the time of reacquisition. [IAS 39.35-43]

With respect to derecognition of liabilities, the creditor must legally release the debtor from primary responsibility for the liability either judicially or contractually, to derecognise the liability. [IAS 39.57]

If part of a financial asset or liability is sold or extinguished, the carrying amount is split based on relative fair values. If fair values are not determinable, IAS 39 prescribes a cost recovery approach to profit recognition.

Although financial guarantees are generally excluded from the scope of IAS 39, a guarantee obligation may have to be recognised in connection with a derecognition transaction in which the seller guarantees the collectability of a financial asset that has been sold. If a guarantee is recognised as a liability, thereafter it is remeasured to fair value until it expires (there is a reliability exception if fair value cannot be measured reliably).

IMPAIRMENT OF FINANCIAL ASSETS

If it is probable that the holder of a financial asset that is carried at amortised cost (loans, receivables, and held-to-maturity investments) will not be able to collect all of the principal and interest amounts due according to the original contractual terms, IAS 39 requires that an impairment or bad debt loss be recognised. The impairment calculation compares the carrying amount of the financial asset with the discounted present value of the currently estimated amounts and timings of payments. Thus, impairment is recognised if any interest or principal payments are reduced, forgiven, or delayed. The financial instrument’s original effective interest rate is the rate to be used for discounting. Any impairment loss is charged to net profit or loss for the period. Impairment or uncollectability must be evaluated individually for material financial assets. A portfolio approach may be used for items that are individually small. [IAS 39.109]

Once impairment has been recognised, if the fair value of the financial asset increases in a subsequent period such that the impairment loss is reduced or eliminated, a reversal of the impairment loss is recognised, up to what the amortised-cost carrying amount would have been at the time of reversal. [IAS 39.114]

Impairment is also an issue for a financial asset carried at fair value, particularly if the fair value change is reported directly in equity. IAS 39 requires that impairment be assessed for these financial assets as well and, if impaired, any loss reported in equity is charged against net profit or loss. [IAS 39.117]

COLLATERAL

Though IAS 39 as originally adopted had required a recipient of collateral to recognise collateral received as an asset and the obligation to repay the collateral as a liability in circumstances where the recipient was permitted to sell or repledge the collateral without constraint, in late 2000 IASC amended IAS 39 to substitute a note disclosure requirement for that accounting rule. The recipient will recognise collateral received in cash. [IAS 39.170]

HEDGE ACCOUNTING

Hedging, for accounting purposes, means designating a derivative financial instrument as an offset in net profit or loss, in whole or in part, to the change in fair value or cash flows of a hedged item. A non-derivative financial instrument may also be a designated hedging instrument, but only with respect to hedges of foreign currency risks. The designation must be in writing, up front (no retrospective designations), and be consistent with an established risk management strategy. In essence, under IAS 39 hedge accounting is not mandatory. If an enterprise does not want to use hedge accounting, it simply does not designate a hedging relationship.

Hedge accounting is permitted under IAS 39 in certain circumstances, provided that the hedging relationship is:

- Clearly defined: what risk is being hedged and what is the expected relationship between that risk and the hedging instrument,
- Measurable: what technique will be used to assess hedge effectiveness, and
- Actually effective: if, despite strategies and expectations, the hedge was not effective, or was only partially effective, the ineffective portion is not eligible for hedge accounting.

The enterprise must designate a specific hedging instrument as a hedge of a change in value or change in cash flows of a specific hedged item, rather than as a hedge of an overall net balance sheet position. However, the approximate income statement effect of hedge accounting for an overall net position can be achieved, in some cases, by designating part of one of the underlying items as the hedged position. For example, an enterprise’s overall net interest rate risk cannot be macro-hedged, but it may be able to qualify for hedge accounting by hedging a similar amount of interest rate risk inherent in a specific asset. Also, the hedged risk must be transferred to an independent party, for example by entering into a derivative contract.
IAS 39 recognises three types of hedges. They are: [IAS 39.137]

**Fair value hedge**: a hedge of the exposure to changes in the fair value of an asset or liability that is already recognised in the balance sheet (such as a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in interest rates). The gain or loss from the change in fair value of the hedging instrument is recognised immediately in net profit or loss. At the same time, the carrying amount of the hedged item is adjusted for the corresponding gain or loss since the inception of the hedge, which also is recognised immediately in net profit or loss.

**Cash flow hedge**: a hedge of the exposure to variability in cash flows relating to (a) a recognised asset or liability (such as all or some future interest payments on variable rate debt), (b) an unrecognised firm commitment (such as a non-cancellable fixed price purchase order), or (c) a forecasted transaction (such as an anticipated purchase or sale). To the extent that the hedge is effective, the portion of the gain or loss on the hedging instrument is recognised initially directly in equity. Subsequently, that amount is included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss (for example, when cost of sales, depreciation, or amortisation are recognised). For hedges of forecasted transactions, the gain or loss on the hedging instrument will adjust the recorded carrying amount of the acquired asset or liability.

**Hedge of a net investment in a foreign entity (as defined in IAS 21)**: These are accounted for as cash flow hedges.

**DISCLOSURE AND PRESENTATION OF FINANCIAL INSTRUMENTS - CONTINUING IAS 32 REQUIREMENTS**

Since 1996, IAS 32 has required quite comprehensive disclosures about financial instruments - including the fair values of all financial assets and all financial liabilities, whether on- or off-balancesheet. Here is a summary of the main IAS 32 disclosures:

- For each class of financial asset and liability, and equity, both recognised and unrecognised, disclose information about:
  - financial risk management policies, including hedging policies [IAS 32.41A];
  - the extent and nature of the financial instruments, including significant terms and conditions [IAS 32.47];
  - accounting policies and methods adopted [IAS 32.47];
  - specified information about exposure to interest rate risk [IAS 32.56];
  - specified information about exposure to credit risk [IAS 32.66]; and
  - specified information about fair value, or a statement that it is not practicable to provide such information. [IAS 32.77]

- IAS 32 also prescribes rules for the offsetting of financial assets and financial liabilities for balance sheet presentation purposes. It specifies that a financial asset and a financial liability should be offset and the net amount reported when, and only when, an enterprise:
  - has a legally enforceable right to set off the amounts; and
  - intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. [IAS 32.13]

**PRESENTATION - TREASURY SHARES**

Where an enterprise holds its own equity instruments (treasury shares), those shares should be presented in the balance sheet as a deduction from equity. No gain or loss should be recognised in the income statement on the sale, issuance or cancellation of treasury shares. Consideration received should be presented in the financial statements as a change in equity. [see SIC 16]

**DISCLOSURE AND PRESENTATION OF FINANCIAL INSTRUMENTS - ADDITIONAL IAS 39 REQUIREMENTS**

IAS 39 supplements the disclosure requirements of IAS 32 regarding financial instruments. These are the principal new disclosure requirements of IAS 39: [IAS 39.166-170]

- methods and assumptions used in estimating fair values;
- accounting policy for changes in fair value of available-for-sale financial assets;
- whether purchases of financial assets are accounted for at trade date or settlement date;
- a description of the enterprise’s financial risk management objectives and policies;
- for each category of hedge: a description of the hedge, which financial instruments are designated as hedging instruments; and the nature of the risks being hedged;
- significant items of income and expense and gains and losses resulting from financial assets and financial liabilities, and whether they are included in net profit or loss or as a separate component of equity and, if in equity, a reconciliation of movements in and out of equity;
- details of securitisations and repurchase agreements;
- nature, effect, and reasons for reclassifications of financial assets from amortised cost to fair value; and
- nature and amount of any impairment loss or reversal of an impairment loss.

**EFFECTIVE DATE**

IAS 39 is effective for financial years beginning on or after 1 January 2001. This includes interim periods of those financial years. Earlier application is encouraged. [IAS 39.171]

**TRANSITION**

On initial adoption of IAS 39, adjustments to bring derivatives (including embedded derivatives) and other financial assets and liabilities onto the balance sheet and adjustments to remeasure certain financial assets and liabilities from cost to fair value will be made by adjusting retained earnings directly. [IAS 39.172]

If an enterprise applies International Accounting Standards in full for the first time in a period subsequent to the effective date of IAS 39, for example, in 2003, comparative information presented for 2001 and 2002 should not be restated to comply with IAS 39.
IAS 39 IMPLEMENTATION GUIDANCE

An Implementation Guidance Committee (IGC), chaired by John T. Smith of Deloitte & Touche (USA), is developing implementation guidance on IAS 39 in the form of questions and answers. These are exposed for public comment before final issuance by the IGC. Six batches of Q&A have already been exposed. Of those, five batches containing over 200 Q&A have been approved for issuance in final form.

In July 2001, IASC issued a consolidated document that includes the Batches 1 to 5 of the questions and answers. Appendix B to this book identifies the titles of each of the questions included in Batches 1 to 5. You can download the combined batch 1-5 publication from IASC’s website: http://www.iasb.org.uk (PDF 1.035k).

In late June 2001, IGC published for comment a proposed Batch 6 of IAS 39 implementation guidance. Batch 6 includes 24 Q&A and illustrative examples. One of the questions and related examples address the particularly thorny issue of applying hedge accounting when a bank or other financial institution manages its interest rate risk on an enterprise-wide basis. The guidance includes an example of a methodology that allows for the use of hedge accounting and takes advantage of existing bank risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

OCTOBER 2000 LIMITED REVISIONS TO IAS 39

The IASC Board approved five limited revisions to IAS 39, Financial Instruments: Recognition and Measurement, and other related Standards. None of the revisions alters a fundamental principle in IAS 39. Instead, the changes address technical application issues that have been identified following the approval of IAS 39 in December 1998. IAS 39 went into effect for financial years beginning 1 January 2001, and the revisions were effective the same date.

- One change brings about symmetry in the dates for recognising purchases and sales of financial assets. As revised, IAS 39 requires that purchases and sales of each broad category of financial assets be accounted for consistently using either trade date or settlement date accounting. As originally approved, IAS 39 had allowed an enterprise to choose between trade date and settlement day for purchases but had permitted only settlement date accounting for sales.

- Another change replaces the original IAS 39 requirement for a lender to recognise certain collateral received from a borrower in its balance sheet with a requirement for note disclosure about collateral.

- The revisions clarify that impairment of financial assets (for instance, bad debt and loan loss provisions) should be recognised individually for significant financial assets. A portfolio basis is only acceptable for individually insignificant items.


- Certain disclosure requirements for hedges in IAS 32, Financial Instruments: Disclosure and Presentation, that are regarded as redundant to the IAS 39 disclosures, have been eliminated.

IAS 39

DTT GUIDANCE, EXAMPLES, AND US GAAP COMPARISONS

IAS 39.1(a) - SCOPE: TEMPORARY INVESTMENTS

QUESTION

ARE ASSOCIATES AND SUBSIDIARIES ALWAYS EXEMPT FROM THE REQUIREMENTS OF IAS 39?

No. They are exempt if they are accounted for under IAS 27. If they are excluded from the provisions of IAS 27 because, at acquisition, control was intended to be temporary or they operate under severe long-term funds transfer restrictions (paragraph 13 of IAS 27), they are accounted for under IAS 39 as available-for-sale or held-for-trading financial assets in the parent company’s financial statements.

IAS 39.1(b) - SCOPE: LEASE EXCEPTION NOT APPLICABLE TO FINANCE LEASES

QUESTION

ARE ALL LEASES EXCLUDED FROM THE SCOPE OF IAS 39?

No. A finance lease is considered to be a financial instrument and it is within the scope of IAS 39. An operating lease is not a financial instrument and it is outside the scope of IAS 39. However, recognised operating lease receivables and payables are financial instruments and are subject to IAS 39. [IAS 32, Appendix, paragraph A6]

IAS 39.1(c) - SCOPE: EQUITY-BASED COMPENSATION ARRANGEMENTS

QUESTION

ARE EQUITY-BASED COMPENSATION ARRANGEMENTS EXCLUDED FROM THE SCOPE OF IAS 39?

No. Only equity-based compensation provided under employee benefit plans is excluded from the scope of IAS 39. Forwards and options on an entity’s own equity that are required to be settled by delivery issued in exchange for goods or services are equity instruments, not derivative financial instruments, and they are not required to be carried at fair value while they are outstanding. However, they are measured and recognised initially at fair value in equity with a corresponding expense for services obtained or, depending on the circumstances, as an asset or expense for the goods obtained.

IAS 39.1(d) - CREDIT RATING CONTRACT

EXAMPLE

Company B owns £100 million of Company X bonds that mature in 20 years. Company X is rated BBB by the rating agencies. Company B is concerned that X may be downgraded and the value of bonds would decline. To protect against such a decline, Company B enters into a contract with a banker that will pay Company B for any decline in the fair value of the Company X bonds related to a credit downgrade to B or below. The contract is for a five-year period. Company B pays £1 million for the credit contract. Because the contract pays Company B in the event of a downgrade, and not in the event of a failure by Company X to pay, it is a derivative instrument.
IAS 39.1(f) - ACTUAL CREDIT LOSS CONTRACT

EXAMPLE

Company X owns £100 million of single-family residential mortgage loans. Company X is concerned that defaults may increase as a result of a recession, and it purchases a guarantee contract from Company B, a mortgage insurance entity. The contract requires Company B to pay any loan deficiency to Company X upon a default and foreclosure by Company X. The contract has a £5 million cap. Company X pays Company B a £2 million fee for the contract. Because the contract provides for payments to Company X in the event of a failure of a debtor to pay when due, it is a financial guarantee contract that is outside the scope of IAS 39.

IAS 39.1(h) - CONTRACTS BASED ON PHYSICAL VARIABLES

COMPARISON WITH US GAAP

Under US GAAP, an exemption is provided for physical variables similar to IAS 39. However, the exemption is limited to contracts that are not traded on an exchange. As a result of the increased use of these contracts, FASB’s Emerging Issues Task Force issued EITF Abstract 99-2 to address the accounting for weather derivatives. EITF 99-2 requires entities that enter into weather derivatives for trading purposes or for the purpose of speculation should account for such contracts at fair value (which mirrors the provisions of FASB 133 in the absence of the specific exemption). Contracts entered into under non-trading activities (such as for risk management purposes by end-users) are not required to be marked to fair value.

Under US GAAP, if the underlying of a contract (that is not exchange traded) is the price or value of a non-financial asset or liability as described below, the contract is exempted from scope of FASB 133:
- a non-financial asset of one of the parties to the contract provided that the asset is not readily convertible to cash; or
- a non-financial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash.

IAS 39 does not provide a similar exception because it is not relevant whether the contract can be settled in net cash. The test is whether the enterprise intends to take or make delivery and whether there has been a past practice of settling in cash.

IAS 39.1 - SALES VOLUME OR SERVICE REVENUES AS THE UNDERLYING

COMPARISON WITH US GAAP

Under US GAAP, contracts that are not exchange traded in which the underlying is a specified volume of sales or service revenues by one of the parties would not be considered derivative instruments. That exception is intended to apply to contracts with settlements based on the volume of items sold or services rendered (such as royalty agreements). It is not intended to apply to contracts based on changes in sales or revenues due to changes in market prices. [FASB 133, paragraph 10 (e)] IAS 39 does not provide a similar exception.

As a result of the exception for volume of sales, royalty arrangements are not treated as derivatives under US GAAP. Royalty agreements, also, are not treated as derivatives under IAS 39 as specified in IGC Q&A 13-1.

IAS 39.2 - EXAMPLES OF WEATHER DERIVATIVES

QUESTION

WHAT ARE SOME EXAMPLES OF CLIMATIC, GEOLOGICAL, AND OTHER PHYSICAL VARIABLES?

Examples of climatic, geological, and other physical variables include the number of inches of rainfall or snow in a particular area, temperature in a particular area or for a specified period of time, and the severity of earthquakes. If the underlying is a physical variable, the contract is not subject to the scope and requirements of IAS 39.
**IAS 39.2 - HEATING DEGREE-DAYS**

**EXAMPLE**

A utility company in the United States enters into a contract with an intermediary or counterparty that is based on heating degree-days. A heating degree-day in the United States is defined as the deviation of a day’s average temperature from 65 degrees Fahrenheit. The utility knows that if its heating degree-days exceed a certain level, profit margins increase due to higher consumption. However, if heating degree-days are below a certain level, the utility will suffer a loss due to lower consumption. The contract requires no initial investment and requires a payment by the counterparty if heating degree-days are less than a specified amount during January, February, and March. If heating degree-days exceed a specified amount during January, February, and March, the utility will make a fixed payment to the intermediary or counterparty. Because the underlying on which settlement is based is a physical variable, heating degree-days, the utility company is not subject to the provisions of IAS 39 in respect of the contract, which would otherwise meet the definition of a derivative. The counterparty, also, is not subject to the provisions of IAS 39.

**IAS 39.2 - RAINFALL DURING THE GROWING SEASON**

**EXAMPLE**

A wheat farmer enters into a contract with an intermediary or counterparty that is based on rainfall in July, August, and September. Lack of rain during these three months will have an adverse effect on the value of the wheat crop. If less than 30 millimetres of rain falls in July, August, or September, the wheat farmer will receive a fixed payment of £20 million from the intermediary or counterparty. The contract will have an initial investment of £3 million. Because the underlying on which settlement is based is a physical variable, millimetres of rain, the contract is not subject to the provisions of IAS 39 for either the wheat farmer or the intermediary or counterparty.

**IAS 39.2 - DAYS OF SUNSHINE DURING RESORT SEASON**

**EXAMPLE**

A hotel operator in an Australian beach resort community enters into a contract with an intermediary or counterparty that is based on the number of sunny days in December, January, and February. Lack of sun during these three months will have an adverse impact on the earnings of the hotel. If there are 10 or fewer days of sunshine during any of the months, the hotel operator will receive a fixed payment of A$10 million, per month. The contract has an initial investment of A$4 million. Because the underlying on which settlement is based is a physical variable, days of sunshine, the contract is not subject to the provisions of IAS 39 for either the hotel operator or the intermediary or counterparty.

**IAS 39.2 - WRITTEN OPTION INDEXED TO RAINFALL**

**EXAMPLE**

A hotel operator enters into a contract with an intermediary or counterparty that is based on the number of days of rain in June, July, and August. Significant rain during this period would have an adverse impact on the hotel operator’s financial position. If there are less than five days of rainfall, as defined, the hotel operator will pay the investment banker $10 million per month. The hotel operator received a cash payment of $5 million from the investment banker for the contract. The contract is a written option with a physical underlying, number of days of rain, and, therefore, the contract is not subject to the provisions of IAS 39 for either the hotel operator or the intermediary or counterparty.

**IAS 39.6 - COMMODITY-BASED FORWARD CONTRACT: SETTLEMENT BY DELIVERY**

**EXAMPLE**

Company X enters into a fixed-price forward contract to purchase one million pounds of copper. Copper is traded on the London Metals Exchange (LME) and is readily convertible to cash. The contract permits X to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. The contract is a derivative instrument because there is no initial net investment, the contract is based on an index, copper, and it is to be settled at a future date. However, if Company X intends to settle the contract by delivery and has no history of settling in cash or entering into offsetting contracts, the contract qualifies for the exemption and is not considered a derivative under IAS 39.

**IAS 39.8 - DEFINITION OF EQUITY-BASED COMPENSATION CONTRACTS OF AN ISSUER**

**QUESTION**

ARE EQUITY-BASED COMPENSATION CONTRACTS OF AN ISSUER ACCOUNTED FOR AS EQUITY INSTRUMENTS OR DERIVATIVE FINANCIAL INSTRUMENTS?

Generally, such equity-based contracts are equity instruments of the issuer and are outside of the scope of IAS 39. However, to the extent they are required to be settled in cash or can be settled in cash at the option of the holder of the instrument, they do not meet the definition of equity [IAS 32.20] and would be accounted for as derivatives.

**IAS 39.8 - SHARE OPTIONS ISSUED TO EMPLOYEES**

**EXAMPLE**

Company ABC issues share appreciation rights to its employees whereby its employees benefit from any gains in the company’s share price but do not actually hold the underlying shares. While a share appreciation right is a derivative instrument, ABC does not account for it as a derivative under IAS 39 because it is an equity instrument of the issuer.
**IAS 39.10 - DEFINITION OF A DERIVATIVE: UNDERLYING FURTHER EXPLAINED WITH EXAMPLES**

**QUESTION**

**WHAT IS AN UNDERLYING?**

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. Examples of an underlying include:

- a security price or security price index;
- a commodity price or commodity price index;
- an interest rate or interest rate index;
- a credit rating or credit index;
- an exchange rate or exchange rate index;
- an insurance index or catastrophe loss index; and
- a climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index. [FASB 133, paragraph 57(a)]

An underlying may be any variable whose changes are observable or otherwise objectively verifiable. The value or related cash flows of all assets and liabilities and purchase and sales commitments change in response to changes in the market factors in which they are founded. There is nothing unique in this regard about derivatives, except that the market factor is referred to as an index, a variable, or an underlying and, in many instances, the underlying is not delivered at settlement but is used as a basis for computing a settlement in cash or net cash.

**IAS 39.10 - UNDERLYING: ORDINARY SHARES**

**EXAMPLE**

Company ABC enters into a contract with a counterparty that requires ABC to purchase one share in company XYZ in one year for €110, the market forward price. The current share price of shares in company XYZ is €105 per share. In this example, the share price of company XYZ’s ordinary shares represents the underlying variable.

**IAS 39.10 - PREPAID FORWARD**

**EXAMPLE**

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

**IAS 39.10 - EXECUTORY CONTRACTS**

**QUESTION**

**IS ANY CONTRACT THAT REQUIRES SETTLEMENT AT A FUTURE DATE IN WHICH NEITHER PARTY HAS PERFORMED A DERIVATIVE?**

Executory contracts based on agreements to perform services where there is an underlying would not fall under the definition of a derivative since these are settled by performance in the normal course of business. See paragraph 29(b) of IAS 39.

The characteristic of a derivative having future settlement could result in many contracts being scoped into IAS 39. However, IAS 39 provides two significant exceptions that limit the extent to which settlement at a future date results in a contract being a derivative. Normal commitments to purchase and sell non-financial assets and regular-way purchase contracts that require delivery of a financial asset are not defined as derivatives under IAS 39. In addition, the other criteria for an underlying and initial net investment must be met for the contract to meet the definition of a derivative.

**IAS 39.10 - DERIVATIVE DEFINITION: INTEREST RATE SWAP**

**EXAMPLE**

Company ABC enters into an interest rate swap with a counterparty that requires ABC to pay a fixed rate of 8% and receive a variable rate of three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a A$100 million notional amount. ABC and the counterparty do not exchange the notional amount. XYZ pays or receives a net cash amount each quarter based on the difference between 8% and three-month LIBOR, reset quarterly.

The contract meets the definition of a derivative because there is no initial net investment. Furthermore, under the terms of the swap, settlements are made in cash, not by delivery of a financial instrument on a regular-way basis, and they occur at future quarterly dates.
there is a high turnover rate in the portfolio of financial instrument contracts. Prepaid.

The general definition of a derivative, however, is narrower under IAS 39 than under US GAAP. It excludes contracts that require delivery of a non-financial asset (provided, among other things, that there is no practice of not taking or making delivery) and it excludes contracts that require delivery of a financial asset within a time frame established by regulation or convention in the market (known as ‘regular-way’ delivery).

The interest rate constitutes a series of forward contracts to exchange and receive cash on potentially favourable or unfavourable terms. Each of the forward contracts by their nature is settled at a future date. They meet the definition of a derivative instrument because they also have a notional amount and an underlying, accordingly, the whole contract would be accounted for as a derivative.

**Example**

Company ABC enters into an interest rate swap with a counterparty that requires ABC to pay a fixed rate of 8% and receive three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a $100 million notional amount. ABC and the counterparty do not exchange the notional amount. ABC pays the fixed-rate amount on a semi-annual basis to the counterparty. ABC receives the variable amount on a quarterly basis from the counterparty. The interest payments are not settled on a net basis.

The interest rate constitutes a series of forward contracts to exchange and receive cash on potentially favourable or unfavourable terms. Each of the forward contracts by their nature is settled at a future date. They meet the definition of a derivative instrument because they also have a notional amount and an underlying, accordingly, the whole contract would be accounted for as a derivative.

**Comparision with US GAAP**

Under US GAAP, the definition of a derivative is similar to the definition in IAS 39 with the exception that, under US GAAP, contracts that have an explicit or implicit net settlement provision are also regarded as derivatives.

Under US GAAP, a contract is considered to have a net settlement provision if delivery of the underlying is not required (even if it can be settled as a cash in a result of a default of one of the parties), if there is an established market mechanism that facilitates net settlement outside the contract (for example, the futures exchange), or if the asset is readily convertible to cash (for example, if the security is publicly traded) or is itself a derivative.

Certain contracts that are firm commitments and provide for a significant penalty as a disincentive for non-performance also may be derivatives.

Under IAS 39, the ability to settle net is not a consideration in determining whether a contract is a derivative. Instead, it focuses on an enterprise’s intent to make or take delivery and the practice of the enterprise. It excludes contracts that require delivery of a non-financial asset (provided, among other things, that there is no practice of not taking or making delivery) and it excludes contracts that require delivery of a financial asset within a time frame established by regulation or convention in the market (known as ‘regular-way’ delivery).

The general definition of a derivative, however, is narrower under IAS 39 than under US GAAP. IAS 39 requires settlement at a future date and therefore appears to exclude contracts for goods and services that are prepaid.

**Question**

**What are key indications of trading activities?**

The term ‘trading’ generally reflects active and frequent buying and selling. Determining whether or when an enterprise is involved in trading financial instruments is a matter of judgement that depends on the relevant facts and circumstances. The facts and circumstances can be assessed based on an evaluation of various activities of the enterprise rather than solely on the terms of the individual transactions. Inherent in that assessment is an evaluation of the enterprise’s intent in entering into financial instrument contracts and using particular types of financial instruments. Indications that financial instruments are entered into for trading purposes are set out below. These indications are based on guidance contained in EITF 98-10 under US GAAP. The absence of any or all of the indicators in any category, by itself, would not necessarily avoid the classification of financial assets or liabilities as held-for-trading. All available evidence should be considered to determine whether, based on the weight of that evidence, an operation is involved in trading activities.

**Organisational Characteristics (nature of operations):**

- the primary assets/liabilities of the operation are financial instrument contracts;
- the operation does not use its own capital as the primary source of funding its activities and instead makes extensive use of other techniques such as leveraging and credit enhancement as sources of risk capital; and
- the operation offers financial instruments as a dealer, not as a user.

**Customers, Counterparties, and Competitors:**

- the majority of the counterparties to the financial instrument contracts and competitors are banks, brokers/ traders, or fund managers;
- volume and prevalent direction (buying/selling) of transactions;
- the volume of transactions differs significantly from the operation’s historical requirements for such contracts;
- there has been a change in the volume of transactions that is significant relative to the change in demand arising from the entity’s primary operating environment and financial structure;
- contracted quantities far exceed normal needs and exposure levels or result in opposite exposures;
- the operation does not consume the financial instruments to meet its normal needs (or make use of physical delivery to settle the contracts); and
- there is a high turnover rate in the portfolio of financial instrument contracts.
Management and Controls

- Compensation and/or performance measures are tied to the short-term results generated from financial instrument transactions (that is, the operation is measured based on trading profits or changes in the market values of its positions);
- The operation communicates internally in terms of trading strategy (that is, management reports identify contractual positions, fair values, hedging activities, risk exposure etc.);
- The operation sets limits on market positions and related strategies, sets policies governing what types of contracts it will transact in, and sets the controls it will follow; in addition, management is involved in reviewing compliance with those limits, strategies, policies, and controls on a daily or frequent basis;
- The word ‘trading’ appears in the name of or documentation of the operation for internal or external purposes;
- Employees of the operation are referred to as ‘traders’ or ‘dealers’ or have prior experience in banking, broking, derivative trading or risk management activities;
- An infrastructure of the operation is similar to that of a trading operation of a bank or investment bank’s front office, middle office, and back office (that is, there is a segregation of back office processing and front office trading functions);
- An infrastructure exists that enables the operation to capture price and other risks on a real-time basis;
- The activities are managed on a portfolio or ‘book’ basis; and
- Management searches for opportunities to take advantage of favourable price spreads, arbitrage opportunities, or outright positions in the marketplace.

Transactions/Contracts

- The operation has a history of pairing off (entering into offsetting contracts) or otherwise settling the transactions without physically receiving or delivering the underlying item. In other words, past practices of the operation have resulted in net cash settlement, offsetting, as well as netting out, and the type of settlement has changed quickly from one type to another to maximise profits/mitigate losses;
- The contracts do not permit physical delivery and must be settled net in the market or in cash; and
- The financial instrument contracts are not customarily used for general commercial (operational) business purposes or by the industry in general.

IAS 39.10 - INVESTMENT STRATEGY MAY INDICATE TRADING CLASSIFICATION

**EXAMPLE**

Assume enterprise L, a non-public entity, has an investment portfolio of debt and equity securities with a market value of €4,000 million. The documented portfolio guidelines specify that the equity exposure of the portfolio should be limited to between 60 and 90 percent of total portfolio value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt securities, to change the effective asset allocation of the underlying portfolio. The portfolio manager actively buys and sells securities to generate short-term profits, and the portfolio turnover is typically a few days.

The financial instruments in the investment portfolio in this example should be classified as held-for-trading. In actively balancing the portfolio, the investment manager’s objective is to generate short-term profits based on its view of the market. The approach to accomplishing this objective is to implement a dynamic investment strategy by transacting a significant volume of purchase and sales transactions over a short period.

IAS 39.10 - LOANS AND SECURITISED LOANS

**COMPARISON WITH US GAAP**

Certain differences exist between US GAAP and IAS in the classification of securitised mortgage loans. US GAAP currently contains specific provisions applicable to securitised mortgage loans that are not specified by IAS provisions. FASB 115 considers two types of mortgage-backed securities (resulting from the securitisation of mortgage loans):

- Securitisations of mortgage loans held for sale; and
- Securitisations of mortgage loans reported at amortised cost.

In terms of amendments to FASB 65, US GAAP specifically requires that securities that result from the securitisation of a mortgage loan held for sale must be classified as a trading security at fair value since these loans were originated or acquired specifically with the intent to resell. This intent is more akin to the trading concept in FASB 115 than the available-for-sale (AFS) category [FASB 115 and 140]. Loans reported at amortised cost, once securitised, may be designated as held for trading, AFS or held-to-maturity (HTM) upon satisfaction of the relevant HTM or AFS criteria. [FASB 115, paragraph 12].

Under IAS 39, only loans and receivables originated with the intent to be sold immediately or in the short term should be classified as held for trading (IAS 39 paragraph 19). Where loans are securitised, the derecognition provisions in IAS 39, paragraphs 31 to 65, are applied and, in the event that a new financial asset or liability has been created, the classification of that asset or liability is required to be made based on the classification criteria for purchased loans in IAS 39.10.
IAS 39.10 - APPROPRIATE USE OF HELD-TO-MATURITY CLASSIFICATION

QUESTION

WHEN IS THE USE OF HELD-TO-MATURITY CLASSIFICATION APPROPRIATE?

The decision to classify a financial investment as held-to-maturity is indicative that the investor is indifferent to future profit opportunities of the overall portfolio and, therefore, to the purchase prices offered by others over the investment’s term, since the investor represents that it has the positive intent to hold the security to maturity irrespective of market value fluctuations. The enterprise, therefore, has no intention of selling the financial asset.

IAS 39.10 - PURCHASED LOANS VS. SECURITIES

COMPARISON WITH US GAAP

The held-to-maturity, available-for-sale, and trading categories for financial assets are the same under US GAAP and IAS. However, under US GAAP, only securities are subject to the classification scheme. Under IAS 39, purchased loans that are not in security form are subject to the classification scheme. For example, whole commercial mortgage loans and revolving loans that were purchased in the secondary market are not subject to the classification scheme under US GAAP as long as they are not securities, but under IAS 39 these loans would be subject to the classification scheme regardless of their form because they were purchased in the secondary market.

US GAAP does not permit such loans to be classified in the HTM category and although both standards would achieve the same accounting on an amortised cost basis, the entity that holds HTM assets cannot sell them without tainting this category.

Securities acquired by an investor in connection with their initial offering (origination) may be considered to be originated loans and are not required to be classified as held-to-maturity, held for trading, or available-for-sale under IAS 39.

IAS 39.10 - ORIGINATED LOANS AND RECEIVABLES NOT DISTINGUISHED IN US GAAP

COMPARISON WITH US GAAP

Although this specific classification does not exist in US GAAP, the effect of other classification provisions could produce the same accounting result. For example, loans that are not included in the definition of securities (such as ordinary mortgage loans) are excluded from the scope of FASB 115 and hence are recorded at amortised cost.

IAS 39.10 - AVAILABLE-FOR-SALE DEFAULT CLASSIFICATION

COMPARISON WITH US GAAP

Both IAS 39 and US GAAP permit classification of securities as available-for-sale (AFS). This classification, while an option under US GAAP, only results by default under IAS 39 (although the representation of intent provides some latitude in determining this classification). Hence whereas an entity may, to a certain extent, make an election between held-for-trading and AFS based on management’s intent under US GAAP, the use of AFS under IAS 39 is solely the result of the transaction not meeting the criteria for classification in the other three categories. IAS 39 does not permit an entity to make a prima facie election to use the AFS classification based on management’s intent.
IAS 39.10 - DEFINITION OF FIRM COMMITMENT: LEGALLY ENFORCEABLE

QUESTION

WHEN IS A FIRM COMMITMENT BINDING?

A commitment is binding if it is legally enforceable. Commitments among related parties generally are not legally enforceable. To be legally enforceable, the agreement should provide for legal remedies that are available to the parties to the contract in the event of non-performance. For example, a penalty could be specified at a fixed amount or equal to the change in market price of the item under the contract. Alternatively, the penalty may not be specifically stipulated in the agreement but may otherwise be applicable (for example remedies under law).

IAS 39.10 - COMMITMENT AT MARKET

QUESTION

IF A COMMITMENT REQUIRES DELIVERY OF A SPECIFIED NUMBER OF UNITS AND THE PRICE SPECIFIED IS MARKET AT THE TIME OF DELIVERY, IS THE COMMITMENT CONSIDERED TO BE FIRM?

No. Although there is a legal obligation to deliver the units, the commitment is not considered to be a firm commitment unless the price is fixed. A price that varies with the market price of the item, which is the subject of the firm commitment, results in a transaction that has a cash flow exposure rather than a fair value exposure. Such a commitment is treated as a forecasted transaction rather than a firm commitment and can be hedged using a cash flow hedge.

IAS 39.10 - PROBABLE PERFORMANCE: SUFFICIENTLY LARGE DISINCENTIVE

COMPARISON WITH US GAAP

US GAAP requires that for a firm commitment to exist and, therefore, for performance to be probable, there needs to be a sufficiently large disincentive for non-performance. This criterion is necessary under US GAAP because the absence of such a penalty could result in a net settlement, which would cause the instrument to meet the definition of a derivative instrument.

Under IAS 39, a net settlement provision does not necessarily mean the instrument is a derivative. IAS 39 focuses on the history and practice of delivery and on the use of the underlying in the normal operations of the entity. Accordingly, under IAS 39, it is not necessary to require a significant, fixed penalty for the commitment to be firm, however, the existence of a penalty for default is an indication that the commitment legally is enforceable. Also, under IAS 39, it does not matter whether the commitment is firm because in either case, it can only qualify for cash flow hedge accounting. If a commitment is firm, however, there is no requirement to assess whether the transaction is probable of occurring.

IAS 39.11 - LIABILITY VS. EQUITY CLASSIFICATION: SETTLEMENT METHODS

QUESTION

HOW DO VARIOUS SETTLEMENT METHODS AFFECT THE CLASSIFICATION OF AN INSTRUMENT AS A LIABILITY OR EQUITY?

IAS 39 provides limited guidance in this area. However, the primary consideration is whether the issuer may be required to settle in cash. [IAS 32.20] Considerable guidance in this area is provided under US GAAP, EITF 00-19, which deals specifically with the classification of derivative instruments indexed to and potentially settled in an enterprise’s own equity instruments. These provisions draw a distinction between three possible methods of settlement, namely:

- physical settlement, where the stipulated buyer delivers cash in return for the full stated number of shares from the seller;
- net share settlement, where shares are delivered having a current fair value equal to the amount of the gain to the relevant party (that is, the underlying notional is not exchanged, either in cash or in shares); and
- net cash settlement, where the one party’s net gain is settled in cash and no shares are exchanged.

Contracts requiring net cash settlement are considered to be either financial assets or liabilities whereas contracts requiring either physical settlement or net share settlement are considered to be equity instruments. Since both physical settlement and net share settlement involve the exchange of only the enterprise’s own equity instruments and not a financial asset, there is no contractual obligation to deliver a financial instrument under conditions that are potentially unfavourable to the issuer.

If the counterparty has discretion regarding the choice between net cash settlement and net share settlement, then net cash settlement is assumed from the issuer’s perspective (and hence the issuer treats the financial instrument as a financial liability). Since the contractual obligation contains conditions that are potentially unfavourable to the issuer (in the event that the issuer is required to settle in cash or another financial instrument), this does not meet the definition of an equity instrument and, therefore, is a financial liability because of the potential outflow of cash.
### IAS 39.11 - SETTLEMENT ALTERNATIVES AFFECT LIABILITY VS. EQUITY CLASSIFICATION

**QUESTION**

**HOW DOES AN ISSUER DETERMINE WHETHER IT SHOULD CLASSIFY AN INSTRUMENT AS A LIABILITY OR AS EQUITY UNDER DIFFERENT SETTLEMENT ALTERNATIVES?**

The following table summarises the determination of issuer accounting based on the classification of an enterprise’s obligations that may be settled by the payment of financial assets, by its own equity securities, or a combination of these methods:

<table>
<thead>
<tr>
<th>Method of Settlement</th>
<th>Classification by the Issuer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or other financial assets (gross and net settlement):</td>
<td>Financial asset or liability (see IAS 39.8)</td>
</tr>
<tr>
<td>Shares (physical settlement):</td>
<td></td>
</tr>
<tr>
<td>Fixed number of shares (for example, share options, warrants)</td>
<td>Equity instrument (see IAS 32.16)</td>
</tr>
<tr>
<td>Variable number of shares:</td>
<td></td>
</tr>
<tr>
<td>Number of shares to be issued is indexed to share price (that is, total fair value of obligation is substantially fixed)</td>
<td>Financial liability (see IAS 39.11)</td>
</tr>
<tr>
<td>Only the net gain/loss on the change in the value of the shares is settled in shares (net share settlement) (for example, equity forwards)</td>
<td>Equity instrument (see IAS 32.16)</td>
</tr>
<tr>
<td>Derivative is settled in shares but the value of the derivative is not indexed to changes in the price of the enterprise’s equity instruments</td>
<td></td>
</tr>
<tr>
<td>Optional settlement method:</td>
<td></td>
</tr>
<tr>
<td>Counterparty alone can select method of settlement</td>
<td>Debt instrument because counterparty can force cash settlement (see IAS 32.16)</td>
</tr>
<tr>
<td>Issuer can elect to settle in shares or other financial assets:</td>
<td></td>
</tr>
<tr>
<td>Number of shares to be issued is indexed to share price (that is, total fair value of obligation is substantially fixed)</td>
<td>Financial liability (see IAS 39.11)</td>
</tr>
<tr>
<td>Number of shares to be issued is fixed</td>
<td>Equity instrument (see IGC Q&amp;A 11-1, Equity Settlement Option)</td>
</tr>
<tr>
<td>Contingent settlement method:</td>
<td></td>
</tr>
<tr>
<td>Event triggering the method of settlement is beyond both the issuer and the holder’s control</td>
<td>Financial liability (see SIC 5.8)</td>
</tr>
<tr>
<td>The possibility of issuer having to settle in a financial asset as a result of the contingency being remote</td>
<td>Equity instrument (contingent settlement provision is ignored) (see SIC 5.5-6)</td>
</tr>
</tbody>
</table>

### IAS 39.11 - LIABILITY VS. EQUITY: MINIMUM CONTRACTUAL RIGHTS

**QUESTION**

**IF A COUNTERPARTY HAS A CHOICE OF SETTLING FOR A FIXED RETURN OR FOR THE RETURN ON AN ISSUER’S EQUITY, SHOULD THE ISSUER ACCOUNT FOR THE INSTRUMENT AS DEBT OR EQUITY?**

The issuer should account for the instrument as debt. The ability of the counterparty to settle at a fixed return indicates there is a minimum contractual obligation.

### IAS 39.11 - LIABILITY VS. EQUITY: COMBINED FIXED AND VARIABLE SETTLEMENTS

**QUESTION**

**IAS 39.11 STATES THAT THE ABILITY TO SETTLE IN CASH OR SHARES IS A FINANCIAL LIABILITY IF THE NUMBER OF SECURITIES REQUIRED TO SETTLE THE OBLIGATION VARIES WITH CHANGES IN THEIR FAIR VALUE SUCH THAT THE TOTAL FAIR VALUE OF EQUITY SECURITIES ISSUED ALWAYS EQUALS THE AMOUNT OF THE CONTRACTUAL OBLIGATION. NO GUIDANCE IS GIVEN FOR THE PHRASE ‘ALWAYS EQUALS’. HOW SHOULD AN ISSUER CLASSIFY AN INSTRUMENT IF SETTLEMENT IS BASED ON FIXED AND VARIABLE AMOUNTS?**

If settlement is in shares and a portion is fixed, the instrument should be split into its equity component and liability component. The fixed portion should be treated as a liability.

### IAS 39.11 - CLASSIFICATION OF REDEEMABLE PREFERRED SHARES

**COMPARISON WITH US GAAP**

IAS 32.22 classifies mandatorily redeemable preferred shares as a financial liability and not as an equity instrument. Under FASB 115 paragraph 137, convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor is specifically excluded from the scope of that Standard and instead treated as temporary equity.

From the holder’s perspective, as a result of measurement considerations, US GAAP specifies that private equity securities should be recorded at cost or under the equity method as appropriate. IAS 39 requires that private placement equity securities acquired in the secondary market should be classified either as available-for-sale or held for trading (and, therefore, recorded at fair value), unless their fair value cannot be reliably determined. In that case, the amount may be carried at cost.

Where the issuer may select the method of settlement between net share and net cash settlement, net share settlement is presumed under EITF 96-13, and therefore, the issuer treats the instrument as an equity instrument. Since there is no obligation to settle in cash, application of the guidance in IAS 32.16 suggests that such instruments be considered equity instruments.
EXAMPLE
Company X enters into a contract with counterparty B. The contract is a call option indexed to gold prices with a strike of $400 per ounce. B pays a premium to X to purchase the call option. If settlement is required, X will settle the call option by issuing its own shares at a value equal to the intrinsic value of the option upon exercise. The call option does not meet the exception because it is indexed to gold. The settlement provision that requires X to issue its own shares does not exempt the contract from the scope of IAS 39 because the contract is not indexed to X’s equity.

EXAMPLE
Company A enters into a forward contract to purchase an asset. The contract requires physical settlement. In this example, the underlying is a security price, ABC stock. However, there is no notional amount to determine the settlement amount. Instead, there is a payment provision that is based on changes in the underlying.

EXAMPLE
XYZ enters into a contract that requires XYZ to pay £10 million if ABC stock decreases by £5 per share during a six-month period; XYZ will receive £10 million if ABC stock decreases by £5 per share during the same six-month period. In this example, the underlying is a security price, ABC stock. However, there is no notional amount to determine the settlement amount. Instead, there is a payment provision that is based on changes in the underlying.

EXAMPLE
Company X enters into a contract with counterparty B. The contract is a call option indexed to gold prices with a strike of $400 per ounce. B pays a premium to X to purchase the call option. If settlement is required, X will settle the call option by issuing its own shares at a value equal to the intrinsic value of the option upon exercise. The call option does not meet the exception because it is indexed to gold. The settlement provision that requires X to issue its own shares does not exempt the contract from the scope of IAS 39 because the contract is not indexed to X’s equity.
**IAS 39.14 - INABILITY TO CONTROL WHETHER SETTLEMENT IS BY DELIVERY**

**EXAMPLE**

Company XYZ owns an office building in Milan. XYZ enters into a European put option with an investor that permits XYZ to exercise the option to sell the building to the investor for €150 million. The current value of the building is €175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ’s option. Although the contract meets the definition of a derivative, it is not accounted for as a derivative if XYZ intends to settle the contract by delivering the building if it exercised its option. The investor, however, accounts for the contract as a derivative because the investor does not control settlement.

**IAS 39.14 - NORMAL PURCHASES AND SALES BASED ON PROBABILITY OF PHYSICAL DELIVERY**

**COMPARISON WITH US GAAP**

Like IAS 39, US GAAP also provides an exception for normal purchases and normal sales of non-financial instruments and non-derivative instruments. Following the FASB 133 amendment to FASB 133, the exemption is available for contracts where it is probable (both at inception and during the contract’s term) that the contract will not settle net and will result in physical delivery. The exception is further limited to contracts that provide for delivery of quantities that are expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. Contracts also, must not have a price based on an underlying index that is not clearly and closely related to the asset. Contracts that require cash settlement of the gains or losses or are otherwise settled net on a periodic basis do not qualify for this exception. Net settlement of contracts in a group of contracts classified as ‘normal’ would call into question the classification of all such contracts. Entities are required to document the basis for concluding that it is probable that the contract will result in physical delivery. IAS 39 does not specify these limitations.

**IAS 39.14 - OPTION ON UNDERLYING NOT READILY CONVERTIBLE TO CASH**

**COMPARISON WITH US GAAP**

The writer of an option on a non-financial asset that can be settled by the holder in cash or by delivery must account for the option as a derivative because the writer does not control whether settlement is by delivery or in cash.

Under US GAAP, because the underlying to the option contract is a non-financial asset (real estate) of one the parties to the contract and the underlying is not readily convertible to cash, the option is not considered a derivative instrument.

**IAS 39.15 - INITIAL NET INVESTMENT: DEEP-IN-THE-MONEY OPTION**

**EXAMPLE**

Company XYZ purchases a deep-in-the-money call option on ABC stock. ABC’s stock price is €100 per share. The option is an American option with a 180-day maturity. The option has a strike price of €85 per share and XYZ pays a premium of €15. The initial investment in the option of €95 is less than the notional amount applied to the underlying, €100 (notional amount is one share and the underlying is €100 per share). Although the option has a significant initial net investment, it is smaller than the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors. The invested amount of €85 does not approximate the notional amount applied to the underlying and, therefore, the option meets the initial net investment criteria for a derivative instrument. If the initial net investment were 90 or greater, considerable judgement would be required in determining whether the contract meets the initial net investment criteria and therefore should be considered a derivative instrument.

**IAS 39.15 - INITIAL NET INVESTMENT: INTEREST RATE SWAP**

**EXAMPLE**

Company B enters into a contract with a counterparty that requires it to pay a LIBOR-based variable rate of interest on a notional amount of ¥10 billion while the counterparty pays B an 8% fixed rate of interest. The contract is a typical interest rate swap with a notional amount of ¥10 billion. The contract does not require an initial net investment by either party. In some instances, the terms of the interest rate swap may be favourable or unfavourable and would require one of the parties to make an upfront initial investment in the contract. If the initial investment represents a premium or discount for market conditions, the initial net investment normally would not approximate the notional amount of the contract and, thus, the contract meets the initial net investment criteria of a derivative instrument.

**IAS 39.15 - INITIAL NET INVESTMENT: CURRENT PURCHASE VS. FORWARD**

**EXAMPLE**

ABC wishes to participate in the changes in the fair value of 10,000 shares of Company XYZ. ABC can either purchase 10,000 shares of XYZ common stock or ABC may enter into a forward purchase contract with a notional amount of 10,000 shares of XYZ common stock and an underlying that is the forward price of XYZ.

Purchasing the shares would require an initial investment equal to the current price for 10,000 shares and would result in benefits such as the receipt of dividends, if any, and the ability to vote the shares. A simple forward contract entered into at the current forward price for 10,000 shares of the equity instrument would not require an initial investment equal to the notional amount, but would offer the same opportunity to benefit or lose from changes in the price of that security. [FASB 133, paragraph 230]
IAS 39.16 - REGULAR-WAY EXEMPTION APPLICABLE TO INSTRUMENTS NOT TRADED

**QUESTION**

**HOW IS REGULAR-WAY DETERMINED?**

The notion of a regular-way security trade is based on marketplace regulations or conventions rather than on the normal practices of an individual entity. For example, if it is either required or customary for certain securities on a specified exchange to settle within three days, a contract that requires settlement in more than three days is not a regular-way security trade even if the entity customarily enters into contracts to purchase such securities more than three days forward. Regulations or conventions may be more difficult to determine for less-developed markets or less-active exchanges.

The regular-way exemption may be applied in situations where an instrument is not traded provided the transaction ultimately will result in the delivery of a financial asset and the time period of the forward commitment is not longer than reasonably required for the parties to complete normal underwriting and prepare and execute closing documents.

**IAS 39.16 - REGULAR-WAY PURCHASE OF PUBLICLY TRADED SECURITIES**

**EXAMPLE**

A contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days (‘T+3’). If a contract for purchase of that type of security requires settlement in three business days, the regular-way exception does not apply. [FASB 133, paragraph 58] Trades of financial instruments with settlement terms outside those prescribed by normal market convention do not typically qualify for the regular-way exception and are considered derivative instruments if the other criteria are satisfied.

**IAS 39.16 - REGULAR-WAY EQUITY PURCHASES IN DIFFERENT MARKETS**

**EXAMPLE**

Company X purchases one million shares of Company B, a NYSE listed entity, through a US broker on October 1, 200X. The settlement date of the contract is October 9, 200X. Trades for equity securities on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular-way contract.

Assume X purchases the same one million shares of Company B on a foreign exchange where the customary settlement period is six business days. The contract to purchase B on the foreign exchange would meet the exemption for a regular-way trade.

**IAS 39.16 - REGULAR-WAY PRIVATE TRANSACTION COMPARED TO PUBLIC MARKET**

**EXAMPLE**

Company B enters into a forward contract to purchase one million ordinary shares in Company M in three months for $10 per share. The contract is with an individual and is not an exchange-traded contract. M’s ordinary shares are publicly traded on NASDAQ with an average daily volume of 250,000 shares. The contract requires B to take physical delivery of the shares and pay the counterparty $10 million in cash. Regular-way delivery is three days.

Although the contract is not through the exchange, three days is the customary settlement for purchases and sales of traded equities in the public market, and generally it should serve as a reference for assessing what is normal. This situation is complicated by the fact that the transaction is large and the market could not rapidly absorb the quantities. From that perspective, a three-month time period may be normal given the size of the transaction. However, if instead Company B purchased the one million shares from Company M, it is not clear from the facts presented why settlement could not occur in a very short period of time, for example within one week. Assuming Company M owns the million shares and absent other factors, the transaction is not considered normal and it should be accounted for as a derivative instrument.

**IAS 39.16 - EXEMPTION LIMITED TO TRANSACTIONS IN PUBLIC MARKET**

**COMPARISON WITH US GAAP**

Under US GAAP, an exception, also, is made for contracts that are regular way securities trades and require delivery within the time generally established by regulation or convention in the marketplace. However, the exemption is limited to contracts for the purchase of securities that are readily convertible to cash, and the exception is only available if the contract has no net settlement provision (as defined) and there is no market mechanism (as defined) that facilitates net settlement. IAS 39 provides the exception for contracts to buy financial assets, not just securities, and in situations in which there are net settlement provisions and market mechanisms that facilitate net settlement.

**IAS 39.22 - DEFINITION OF EMBEDDED DERIVATIVE: ASSESSING ‘CLOSELY RELATED’ BY ANALOGY**

**QUESTION**

**WHAT FACTORS ARE USED TO DETERMINE WHETHER AN EMBEDDED DERIVATIVE IS CLOSELY RELATED TO THE HOST CONTRACT?**

Considerable judgement is required to make this determination because there is no clear guidance in IAS 39. Most of the guidance provided is in the form of examples. Absent fact patterns that are specifically identified in the examples in IAS 39, the determination is based on analogy to such examples.
IAS 39.22 - DETERMINING THE HOST INSTRUMENT

QUESTION

IF A HYBRID CONTRACT HAS BOTH EQUITY AND DEBT FEATURES, WHEN IS THE HOST CONTRACT AN EQUITY INSTRUMENT?

IAS 39 does not provide guidance for making this determination. However, there is guidance in US GAAP that provides a reasonable basis for making the distinction on whether or not the equity-indexed component provides a holder with residual equity rights. Under US GAAP, if the host contract encompasses a residual interest in an entity, its economic characteristics and risks should be considered that of an equity instrument, and an embedded derivative would need to possess equity characteristics (related to the same entity) to be closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract should be considered that of a debt instrument. For example, even though the overall hybrid instrument that provides for repayment of principal may include a return based on the market price (the underlying as defined by IAS 39) of XYZ Corporation common stock, the host contract does not involve any existing or potential residual interest rights (that is, rights of ownership) and, thus, would not be an equity instrument. The host contract, instead, would be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be closely related to the host contract. [FASB 133, paragraph 60]

IAS 39.23(a) - EMBEDDED TERMS HAVING CASH SETTLEMENTS

QUESTION

IF A DEBT INSTRUMENT PROVIDES FOR AN ADJUSTMENT OF INTEREST THAT IS A MULTIPLE OF THE MARKET RATE, IS THAT ADJUSTMENT CLOSELY RELATED TO THE DEBT INSTRUMENT SINCE IT IS BASED ON INTEREST?

Generally no. The adjustment appears to be a leveraging feature that is not closely related to interest. However, if the adjustment does not result in the holder being exposed to loss on substantially all of its investment or in the issuer having to pay more than twice the market rate, the adjustment is considered closely related to risks of the host instrument as per IAS 39.25(b). Also, an adjustment that results from and is related to the additional risk from credit deterioration would be considered closely related to the debt host.

IAS 39.23(a) - PERPETUAL PREFERRED SHARES: CONDITIONAL CASH RETURN

EXAMPLE

Company A issues $100 million of perpetual preferred shares that pay a fixed dividend rate of 8%. Embedded in the shares is a provision that states if LIBOR increases to 12% or more, the holders will receive LIBOR minus 200 basis points instead of the 8% dividend.

Assuming that the holder classifies the shares as available-for-sale and has made the enterprise-wide election to recognize changes in the fair value directly in equity, both the issuer and the holder would separately account for the embedded derivative because it would result in the payment of cash. A derivative embedded in an equity instrument that results in the payment of cash rather than the issuance of equity securities is not considered to be closely related to the host instrument and, in the hands of the issuer, is not regarded as an equity instrument. A requirement to pay cash is a financial liability under IAS 32.

IAS 39.23(a) - EMBEDDED DERIVATIVES: CREDIT ADJUSTMENTS DEBT INSTRUMENTS

QUESTION

ARE ADJUSTMENTS TO THE TERMS OF A DEBT INSTRUMENT AS A RESULT OF DEFAULTS, CHANGES IN CREDIT RATINGS, AND CHANGES IN A DEBTOR’S CREDITWORTHINESS CONSIDERED TO BE DERIVATIVE FEATURES EMBEDDED IN A DEBT INSTRUMENT?

IAS 39 does not specifically address adjustments to the terms of a debt instrument as a result of defaults, changes in credit ratings, or changes in a debtor’s creditworthiness. However, adjustments to the terms of a debt instrument that protect the investor or compensate the investor for credit risks related to the issuer are considered closely related to debt instruments of a issuer.

IAS 39.23(a) - ISSUER-CREDIT SENSITIVE PAYMENT

EXAMPLE

Company X issues bonds with a BBB rating. The bonds have a provision that if Company X violates a certain debt-to-equity ratio covenant, or Company X’s credit rating is downgraded, the interest rate will reset to the then current market rate for the Company.

The interest rate reset is considered to be closely related to the host contract and, since it relates to default in a credit risk-related covenant which would not be treated as a derivative on a stand-alone basis, the embedded derivative would not be accounted for separately.
**IAS 39.23(a) - Indexed-Credit Sensitive Payment**

**Example**

Company X issues bonds with a AA rating. At the date of issue, the yield on AA rated bonds is the equivalent maturity treasury rate plus a credit spread. The bonds have a provision that requires the interest rate to reset in the event that a competitor of Company X receives a credit downgrade.

The embedded credit-related provision would be accounted for separately because the credit of a competitor is not considered to be closely related to the host debt instrument.

**IAS 39.23(b) - Embedded Derivatives: One of Two Variables Exempt**

**Question**

How is a contract accounted for if it contains two or more variables and one of them qualifies for the exception for physical variables?

The component that does not qualify for the exemption for physical variables is required to be separated and accounted for as a derivative if on a stand-alone basis it meets the definition of a derivative. See paragraphs 22 and 23.

**IAS 39.23(b) - Multiple Underlyings, Including a Physical Underlying**

**Example**

Company X enters into a forward contract to purchase one million shares of Company B, which is a public company that owns and manages holiday resorts in the Greek Isles. The forward is priced at market. The forward has a conditional underlying that is based on the number of sunny days in Greece in June. If there are less than three days of sunshine in Greece in June, the forward contract is terminated.

The contract has two underlyings: (1) B’s equity price and (2) days of sunshine. The number of days of sunshine is a physical variable that, on a standalone basis, would exempt a contract from the provisions of IAS 39. However, the equity forward is not exempt and given the complexity of the contract does not meet the exemption for regular-way. Given the interdependency of the underlyings, separation of the derivative appears to be difficult and, accordingly, the entire instrument should be accounted for as a derivative.

**IAS 39.23(b) - Embedded Derivatives: Death Benefit Based on Underlying**

**Question**

If the terms of a variable annuity life insurance contract provide for a payment upon the death of the policyholder equal to the greater of the premium plus a return on the premium or the market value of the account, does it have an embedded option representing the minimum payment that should be separated from the contract and accounted for as a derivative instrument?

No. Indexed death benefits are not accounted for as derivatives.

**IAS 39.23(b) - Equity Conversion Triggered by an Unrelated Factor**

**Question**

From the perspective of the issuer, if the conversion feature in a convertible preferred stock is conditioned on a change in an underlying unrelated to the equity of the issuer, is the convertible feature treated as a derivative?

No. Although such a feature is not closely related to the equity instrument, the conversion itself results in another equity instrument being issued that is not a derivative on a stand-alone basis. The instrument, however, is a compound instrument that should be separated into its liability and equity components.

**IAS 39.23(b) - Equity Option Dependent on Interest Rate Changes**

**Example**

Company A issues €100 million of perpetual preferred shares that pay a fixed dividend rate of 10%. Embedded in the shares is a provision stating that if interest rates increase 200 basis points, the holders will receive 100,000 ordinary shares in Company A. Assume that the holder wishes to classify the preferred shares as available-for-sale and has made the enterprise-wide election to recognise changes in the fair value directly in equity.

The embedded call option would not be separated by the issuer because it and the host instrument are both equity instruments of the issuer. Although the option is triggered by a change in rates, it is indexed to the change in value of the shares and settled in the issuer’s shares.

Provided that the fixed dividend of 10% is not a contractual liability, the holder would not account for the embedded derivative separately since both components of the instrument are equity of the issuer.

**IAS 39.23 - Embedded Derivatives: US GAAP Considers Predominant Characteristics**

**Comparison with US GAAP**

Under US GAAP, if a contract’s underlying is the combination of two or more variables, and one or more would not qualify for the exception for physical variables discussed above, the application of the definition of a derivative instrument depends on the predominant characteristics of the combined variable. The contract is considered a derivative instrument if the changes in its combined underlying are highly correlated with changes in one of the component variables that would not qualify for an exception.

[FASB 133, paragraph 58 (c)]

There is no exemption in IAS 39 for not bifurcating embedded derivatives based on the predominant characteristic of the hybrid instrument.
IAS 39.24(a) - PUT OPTION EMBEDDED IN AN EQUITY SECURITY

**EXAMPLE**

Company A issues to investors common stock that is puttable to the Company at the end of three years. The put option can be settled in net cash or shares at the option of the investors. Assume that the investors classify such securities as available-for-sale and have made the enterprise-wide election to recognise changes in the fair value directly in equity.

The embedded put option would be separated from the host contract and accounted for as a derivative by both the issuer and the holder because the ability to settle the option on a net cash basis is inconsistent with the notion of residual equity. Since the net cash or net share settlement option is held by the investor, it would not be considered to be an equity instrument of the issuer.

However, if terms of the put option specified settlement in net shares of the company, the issuer would not separate the put option from the host contract because a separate instrument with the same terms would be classified in shareholders equity.

IAS 39.24(a) - PUTTABLE REDEEMABLE PREFERRED SHARES

**EXAMPLE**

Company A issues $100 million mandatorily redeemable preferred shares to investors with a dividend rate of 10%. The preferred shares are puttable to the Company if interest rates move 200 basis points.

The embedded put option would not be separated from the host contract under the embedded derivative provisions because mandatorily redeemable preferred shares are more akin to a debt instrument and the put feature is an option that would be considered to be closely related to the debt host, assuming that, upon redemption, the settlement of the preferred is not at a significant gain or loss.

IAS 39.24(b) - CONVERTIBLE PREFERRED SHARES

**EXAMPLE**

Company X issues perpetual preferred shares convertible into its ordinary shares at the option of the holder. The conversion feature represents an embedded call option on Company X’s ordinary shares. Company X would not account for the embedded option separately because on a free-standing basis, the option would be an equity instrument of Company X. However, the investor would have to account for the embedded option separately.

IAS 39.24(b) - CALL AND PUT OPTIONS ON EQUITY INSTRUMENTS

**COMPARISON WITH US GAAP**

Under US GAAP, because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of the preferred stock (other than the conversion option) must be analysed to determine whether the preferred stock (and, thus, the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument. [FASB 133, paragraph 61(i)]

Although IAS 39 does not specifically address mandatorily redeemable preferred stock, IAS 32 requires the identification of the debt and equity components from the perspective of the issuer. Guidance contained in IAS 32.24, would result in a similar conclusion to that obtained under US GAAP, however, it takes it a step further by requiring the separation of liability and equity into two components for the purpose of presentation on the issuer’s balance sheet.

IAS 39.24(c) - TERM EXTENDING OPTION: RESET AT MARKET

**EXAMPLE**

Company X issues $10 million in debt at par with an 8% coupon and maturity of five years. However, if LIBOR increases by 250 basis points or more during the term of the debt, the issuer of the bonds has the option to extend the maturity for an additional three years. If the issuer exercises its option to extend the maturity, the coupon will reset to the current market rate for a company with a similar credit rating.

The embedded derivative is closely related and would not be accounted for separately from the host contract because, although it significantly extends the maturity of the debt instrument, the coupon will reset to the current market rate for a company with a similar credit rating.

IAS 39.24(c) - TERM-EXTENDING OPTION: RESET NOT AT MARKET

**EXAMPLE**

Company X issues $10 million in debt with an 8% coupon and a maturity of five years. However, if LIBOR increases by 200 basis points within any one year, the maturity of the bonds will be extended for another three years at the stated coupon rate.

The embedded derivative would be accounted for separately from the host contract because the term is extended but the coupon does not reset to the current market rate at each renewal date and it is considered to be reasonably possible that LIBOR could increase 200 basis points in a year.
IAS 39.24(c) - TERM-EXTENDING OPTIONS

COMPARISON WITH US GAAP
Under US GAAP, a term-extending option is not closely related if it significantly extends the remaining term to maturity and if it does not reset the interest rate to the then current rate.

IAS 39 does not qualify its guidance by the extent to which the term is extended.

IAS 39.24(d) - EQUITY INDEXED INTEREST PAYMENTS

EXAMPLE
Company X issues 10-year notes to a bank. The notes have no stated coupon rate. However, embedded in the notes is a provision that requires interest to be paid or received based on changes in the stock price of Company Y. Payments will be net cash settled.

Both parties would account for the embedded equity-related derivative separately because the interest payments are based on changes in the stock price of a company and are therefore not closely related to the host debt instrument. Since the embedded derivative is accounted for separately and does not represent an equity instrument of the issuer because it is settled in cash, the compound instrument provisions in IAS 32.23-29 are not applicable.

IAS 39.24(d) - EQUITY INDEXED MATURITY SETTLEMENT

EXAMPLE
Company X issues 10-year notes with a coupon of 5% to a bank. At maturity, the investor receives cash equal to the higher of the initial proceeds or an amount based on the S&P 500.

Both the issuer and the holder would account for the embedded cash-settled S&P 500 call option separately because payments made based on changes in the S&P are not closely related interest.

IAS 39.24(e) - COMMODITY-INDEXED INTEREST PAYMENTS

EXAMPLE
Company X issues 10-year notes with no stated coupon. Embedded in the notes is a provision that requires interest to be paid or received based on changes in the price of corn (or any other traded commodity). The embedded commodity-related derivative would be accounted for separately because interest payments made based on changes in a commodity price are not closely related to the host debt instrument.

IAS 39.24(f) - CONVERTIBLE DEBT: ISSUER VS. HOLDER

EXAMPLE
Company X issues debt that is convertible into its common stock in five years. The conversion feature represents an embedded call option on the stock of Company X, settled in shares.

Company X would not account for the embedded option separately because, on a free-standing basis, the option would be an equity instrument of Company X which is exempted from the scope of IAS 39. The investor would, however, have to account for the embedded option separately.

IAS 39.24(g) - SIGNIFICANT PREMIUM OR DISCOUNT

QUESTION
WHAT IS CONSIDERED A ‘SIGNIFICANT’ PREMIUM OR DISCOUNT IN ASSESSING WHETHER A CALL OR PUT ON DEBT IS CLOSELY RELATED TO THE DEBT?

IAS 39 does not specify what is meant by a ‘significant premium or discount’. Although judgement is necessary, 10 percent of the par value generally would be considered substantial. Until further guidance is provided regarding: (1) the relationship between the interest rate on the debt, (2) the fair value and rights attaching to the embedded option and (3) the impact of these factors on the determination of the level of the discount or premium, considerable judgement will be required in applying this provision.

IAS 39.24(h) - PUTTABLE DEBT TRIGGERED BY CHANGES IN THE FTSE

EXAMPLE
Company X issues 10-year bonds with a par value of £1 million for proceeds of £950,000. The bonds have a coupon of 10%. Embedded in the bonds is a provision that allows the investors to put the bonds in the event the FTSE declines by 20 percent.

The embedded put option would not be accounted for separately even though the put is indexed to a trigger that is not considered closely related to the host instrument (that is, a trigger other than interest rates or credit). The tests in IAS 39 are whether the bonds were issued at a substantial premium or discount and whether the prepayment resulted in a significant gain or loss. In the example, the five percent discount is not considered substantial.
**IAS 39.24(g) - EMBEDDED DEFAULT PUT OPTION**

**EXAMPLE**

Company X issues 10-year bonds with a par value of R100 million and a coupon of 16%. Embedded in the bonds is a provision that allows the investors to put the bonds in the event that Company X defaults on its financial debt ratio covenants.

Assuming that the bonds were not issued at a substantial discount or premium, the embedded put option would not be accounted for separately because the option relates to credit risk of the issuer which is considered closely related to the debt. The embedded put option, also, would be considered closely related if the settlement price would not result in a significant gain or loss on prepayment as per paragraph 25(e).

**IAS 39.24(g) - PUTTABLE DEBT**

**EXAMPLE**

Company X issues 10-year bonds with a par value of €1 million for proceeds of €800,000. The bonds have a coupon of 8%. Embedded in the bonds is a provision that allows the investors to put the bonds back to Company X in the event interest rates move 150 basis points.

The embedded put option would be accounted for separately because the bonds were issued at a substantial discount. However, if the bonds were not issued at a substantial discount, for example, for proceeds of €950,000, the put option would not be accounted for separately.

**IAS 39.24(g) - SUBSEQUENTLY EMBEDDED PUT BONDS**

**EXAMPLE**

Company X issued 10-year bonds with a 6% coupon to a banker and receives proceeds of €103. The debt is puttable by the holder at the end of three years. Three-year debt rates for non puttable/callable debt are 6%. The banker attaches a call option and sells the bonds to an investor for a €3 premium.

A party other than the issuer has embedded the call option into the debt instrument. Thus, the investor would not be able to consider the call option to be closely related to the host instrument. The holder of the call option would have a free-standing derivative that would be marked to market. In addition, Company X does not have to consider the accounting for the call option because Company X is not a party to the option.

**IAS 39.24(g) - CONTINGENT EMBEDDED DERIVATIVE: EXCEPTION FOR PUT OPTIONS**

**EXAMPLE**

Company X issues $10 million in debt with an 8% coupon and a maturity of eight years. However, if LIBOR increases by 200 basis points within any one year, the debt is puttable at the end of year five. In this example, it is reasonably possible that LIBOR could increase by 200 basis points.

The embedded contingent put option in this instance would not be automatically accounted for separately because, as noted in paragraph 24(g), a put option embedded in a debt instrument that is indexed to interest rates is considered to be closely related (assuming the debt was not issued at a substantial discount or premium).

**IAS 39.24(h) - HIGHLY CORRELATED INDEXED CREDIT**

**QUESTION**

IF A CREDIT DERIVATIVE IS EMBEDDED IN A DEBT INSTRUMENT AND IS INDEXED TO DEBT INSTRUMENTS OF COMPETITORS OF THE ENTITY IN THE SAME INDUSTRY, AND GENERAL CREDIT SPREADS CAN BE SHOWN TO BE HIGHLY CORRELATED IN THE INDUSTRY, IS THE CREDIT DERIVATIVE REQUIRED TO BE SEPARATED?

Yes. The exception is limited to the issuer’s own credit.

**IAS 39.25(b) - EMBEDDED INTEREST RATE CAP**

**EXAMPLE**

Company X issues $1 million variable-rate debt with a five-year maturity. The variable rate is indexed to LIBOR, which is 4.5% at the date of issue. Embedded in the debt is a provision that caps the variable rate at 10%.

The cap would not be accounted for separately because the cap is both related to interest rates and above the market rate when the debt is issued. Thus, the cap is considered to be closely related to the host instrument.
IAS 39.25(d) - A ‘SUBSTANTIAL PARTY’ TO A CONTRACT

QUESTION

WHAT IS A ‘SUBSTANTIAL PARTY’ TO A CONTRACT FOR PURPOSES OF EVALUATING WHETHER THERE IS AN EMBEDDED FOREIGN CURRENCY DERIVATIVE IN THE CONTRACT?

A substantial party to the contract could be a principal or an agent that is being engaged by an entity solely to comply with the requirement that payments be denominated in the functional currency of any substantial party to the contract. The criterion would not be satisfied if the substantial party is an agent for the entity although if the third party is acting as principal, likely this would be satisfied.

IAS 39.25(d) - LIMITATIONS ON CURRENCY OF PRIMARY ECONOMIC ENVIRONMENT

QUESTION

IF PAYMENT UNDER A CONTRACT IS IN A FOREIGN CURRENCY THAT IS THE CURRENCY OF THE PRIMARY ECONOMIC ENVIRONMENT IN WHICH A SUBSTANTIAL PARTY TO THE CONTRACT OPERATES, IS THE FOREIGN CURRENCY COMPONENT ALWAYS CONSIDERED TO BE CLOSELY RELATED TO THE HOST CONTRACT?

Generally, yes. However, the exemption applies to non-financial instruments (including executory contracts) but only to the extent that all other aspects of the contract are closely related. Hence, for example, a leveraged embedded foreign currency forward would be required to be separated from a foreign currency based goods or services contract.

IAS 39.25(d) - EMBEDDED FOREIGN CURRENCY PROVISIONS: PRIMARY CURRENCY

EXAMPLE

Company X, a Dutch company, leases property from Company Y, a UK company. The lease payments are denominated in Sterling (£). The functional (or primary) currency of X is the Euro and the functional (or primary) currency of Y is Sterling.

The provision to pay in Sterling would not require separate accounting because Sterling is the currency of the primary economic environment of Y, who is a substantial party to the lease. An operating lease is not a financial instrument (see IAS 32.14).

IAS 39.25(d) - EMBEDDED FOREIGN CURRENCY PROVISION: NON-QUALIFYING CURRENCY

EXAMPLE

Company X, a New Zealand company, leases property under an operating lease from Company Y, an Australian company. The lease payments are denominated in US dollars. The primary currency of X is the New Zealand dollar (NZ$) and the primary currency of Y is the Australian dollar (A$).

The provision to pay in US dollars would require separate accounting because it is not the currency of the primary economic environment of any substantial party to the contract. The price of this asset is not denominated routinely in that currency in international commerce. If the property was leased under a finance lease (which is a financial instrument), the lease payments would represent monetary items.

IAS 39.25(d) - EMBEDDED FOREIGN CURRENCY PROVISION: INVOLVEMENT OF A THIRD PARTY

EXAMPLE

Company X would like to lease property from Company Y under an operating lease and have the payments denominated in US dollars. The measurement currency of both companies is the Brazilian Real. To accomplish a US dollar-denominated lease, Company Y leases the property to an investment banker whose functional currency is US dollars. The investment banker then subleases the property to Company X. The sublease agreement requires Company X to pay US dollars. The investment banker is a principal to each lease and cannot offset the lease transactions.

The provision to pay in US dollars would not require separate accounting because the US dollar is the measurement currency of the investment banker who is acting as a principal, that is, the party that is subject to the risk of loss.

If, however, the investment banker was acting solely as an agent for Company X to the transaction and, accordingly, was not at risk, that is, the investment banker would be indemnified for any losses incurred due to a default by Company X, the parties would look through the investment banker to Company X to assess whether the US dollar was the currency of the primary economic environment of any substantial party to the contract. In this example, the foreign currency provision would require separate accounting because the US dollar is not the currency of the primary economic environment of any substantial party to the contract.
**IAS 39.25(d) - EMBEDDED FOREIGN CURRENCY DERIVATIVES**

**COMPARISON WITH US GAAP**

Under US GAAP, unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both of these denominated in a foreign currency are subject to the requirement in FASB 52 to recognise any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency. [FASB 133, paragraph 15]

IAS 39 does not specify guidance in this area, however, applying IAS 21.15, results in the same treatment as under US GAAP. IAS 21 states that any foreign currency gains or losses on unsettled foreign currency transactions that are monetary items are recognised in net profit or loss. As a result, the criterion in IAS 39.23(c) is not satisfied; therefore, there is no requirement to separate the embedded derivative from the host contract.

**IAS 39.25(f) - QUALIFYING INTEREST-ONLY STRIP**

**EXAMPLE**

Transferor X securitises £100 million of financial assets with an 8% coupon in a securitisation structure that meets the requirements for sale accounting. The beneficial interests issued consist of Class A and B and an interest-only certificate. The Class A and B certificates have a principal amount of £100 million and a 6% coupon. The interest-only strip is entitled to any residual interest cash flows after the Class A and B certificate holders are paid. As an embedded derivative, the interest-only strip is not considered to be closely related in terms of IAS 39.25(e) since it could potentially cause the holder to recover less than substantially all of its initial investment.

The interest-only certificate contains no unusual features. The interest-only strip results from separating the rights to receive contractual cash flows from a financial instrument that did not contain an embedded derivative that otherwise would be required to be accounted for separately and did not incorporate any new terms. Thus, the interest-only strip would not be accounted for as a derivative since paragraph 25(f) considers the prepayment option to be closely related to the debt host.

**IAS 39.25(g) - INFLATION-INDEXED PAYMENTS: DOMESTIC ENVIRONMENT**

**EXAMPLE**

Company X leases property with a lease term of 10 years. The functional currency of Company X is the Euro. Lease payments, also, are to be made in Euros. Embedded in the lease is a provision that requires the lease payment to be adjusted every two years for the change in the Euro-land consumer price index. The provision has no additional unusual features.

The embedded inflation indexed payment would not be accounted for separately because the rate of inflation is not leveraged and is in the same economic environment of the enterprise.

**IAS 39.25(g) - INFLATION-INDEXED PAYMENTS: FOREIGN ENVIRONMENT**

**EXAMPLE**

Company X leases property with a lease term of 10 years. The functional currency of Company X is the Euro. Lease payments, also, are to be made in Euros. Embedded in the lease is a provision that requires the lease payment to be adjusted every two years for the change in the UK consumer price index.

The embedded inflation indexed payment would be accounted for separately because, although the rate of inflation is not leveraged, the inflation index is in a different economic environment from the enterprise’s.
IAS 39.25(g) - INFLATION-INDEXED PAYMENTS: LEVERAGED

EXAMPLE

Company X leases property with a lease term of 10 years. The functional currency of Company X is the Hong Kong dollar. Lease payments are also to be made in Hong Kong dollars. Embedded in the lease is a provision that requires the lease payment to be adjusted every two years for two times the change in the consumer price index.

The embedded inflation indexed payment would be accounted for separately because the rate of inflation is leveraged. In this instance, the leveraged portion of the embedded inflation provision would be accounted for as a derivative. This would be valued based on the extent to which it is leveraged over and above the change in the consumer price index since the non-leveraged portion is not a derivative under IAS 39.

IAS 39.25(h) - SUBSTANTIALLY ALL

QUESTION

HOW IS ‘SUBSTANTIALLY ALL’ INTERPRETED WHEN ASSESSING WHETHER THE HOLDER WOULD NOT RECOVER SUBSTANTIALLY ALL OF ITS RECORDED INVESTMENT?

IAS 39 does not specify what is meant by the term ‘substantially all’. Under US GAAP, the term ‘substantially all’ generally has been interpreted to mean greater than or equal to 90 percent, and the use of 90 percent, although not required under IAS 39, provides an appropriate indicator of how this term should be interpreted.

IAS 39.25(h) - SUBSTANTIALLY ALL TEST BASED ON CONTRACT, NOT PARTIES

QUESTION

IF A HOLDER ACCOUNTS FOR A CONTRACT AS A DERIVATIVE BECAUSE IT COULD LOSE SUBSTANTIALLY ALL OF ITS INVESTMENT OR OBTAIN A RATE MORE THAN TWICE THE MARKET RATE AT INCEPTION, IS THE ISSUER ALSO REQUIRED TO ACCOUNT FOR THE CONTRACT AS A DERIVATIVE?

Yes. The test is based on the contract provisions and, therefore, the determination is made for both parties to the contract based on the return or loss to the investor.

IAS 39.25(h) - SUBSTANTIALLY ALL TEST BASED ON PROBABILITY

QUESTION

FOR THE PURPOSES OF DETERMINING WHETHER AN INVESTOR COULD LOSE SUBSTANTIALLY ALL OF ITS INVESTMENT OR OBTAIN A RATE MORE THAN TWICE THE MARKET RATE AT INCEPTION, IS THE TEST APPLIED BASED ON WHAT IS POSSIBLE UNDER THE CONTRACTUAL TERMS UNDER ANY CIRCUMSTANCES, OR BASED ON A PROBABILITY ASSESSMENT?

IAS 39 does not specify how these tests should be applied. However, if the likelihood of the investor losing substantially all of its investment or of obtaining a rate more than twice the market rate is judged to be remote, it seems reasonable to conclude that the embedded derivative does not alter the cash flows in such a way as to meet the loss or recoverability tests.

IAS 39.25(h) - VARIABLE-RATE INSTRUMENTS

QUESTION

DOES A VARIABLE-RATE INSTRUMENT CONTAIN AN EMBEDDED DERIVATIVE, SINCE THE ISSUER COULD “PAY A RATE MORE THAN TWICE THE MARKET RATE AT INCEPTION”?

No. A rate that is always equal to the current market rate is not an embedded feature.

IAS 39.25(h) - ISSUER’S RATE DOUBLES

EXAMPLE

Company A issues £10 million in debt with a coupon of 8% and a term of 10 years. Company A’s market rate for 10-year debt is 8.25%. Embedded in the debt is an interest rate adjustment that resets the interest rate to 16.50% if three-month LIBOR increases to 7% or greater during the first three years of the debt.

The adjustment feature is a written cap but would not be accounted for separately because it could result in a rate of return on the host contract that is at least double the issuer’s initial rate on the host contract but not more than twice the market rate at inception.

IAS 39.25(h) - EMBEDDED DERIVATIVE: INVESTOR’S INITIAL RATE OF RETURN DOUBLES

EXAMPLE

Company A issues $10 million in debt with a coupon of 8% and a term of 10 years. Company A’s market rate for 10-year debt is 8%. Embedded in the debt is a provision that states if interest rates increase, the holder of the debt must give the issuer an additional $1 million in borrowings maturing in 10 years on which the holder will receive a return of zero.

The adjustment feature is a written option issued by the holder. The embedded derivative would not be accounted for separately because the holder will recover all of its initial recorded investment, and there is no provision that can result in the issuer paying a rate that is more than double the market rate at inception.
IAS 32 and IAS 39: Summaries, Guidance, Examples, and US GAAP Comparisons

Deloitte Touche Tohmatsu Analysis

IAS 39.25(h) - Contingent Embedded Derivative: Probability Assessment

Example

Company X issues $10 million in debt with an 8% coupon. However, if LIBOR increases by 500 basis points within any one year, the bonds mature and the holder receives $8 million in total.

An embedded derivative exists because there is a payment provision based on LIBOR. The holder could receive only $8 million at maturity, if LIBOR increases by 500 basis points within any one year, and would not recover substantially all of its investment. However, it is not likely that LIBOR would increase by 500 basis points in any one year. Since it is not likely that the contingent event would occur, the embedded derivative would not be accounted for separately.

IAS 39.25(h) - Contingent Embedded Derivative: Issuer’s Rate Doubles

Example

Company X issues $10 million in debt with a variable coupon rate that is factored at 1.99 multiplied by the change in LIBOR. Although there could be a negative yield, there is a floor such that the investor could not lose more than one million of the principal investment.

The embedded derivative would be accounted for separately because although the investor would not lose substantially all of its investment (the investor can only lose up to 10 percent of the investment), rates could change such that the issuer may pay more than twice the market rate at inception. For example, if the current market rate at inception is 5% and rates increase by 260 basis points, the issuer would pay 10.17% which is more than double the initial market rate.

IAS 39.25(h) - Contingent Embedded Derivative: Rate Indexed Payment

Example

Company X issues €10 million in debt with a variable coupon rate. If rates go up or down one hundred basis points, the holder will pay Company X €1 million.

The embedded derivative would not be accounted for separately because the investor will receive €10 million at maturity and the €1 million payment is not a substantial loss in the initial investment because it represents only 10 percent of the investment. In addition, there is no provision that can result in the issuer paying a rate that is more than double the market rate at inception.

IAS 39.25(h) - Cash Settled Put Option

Example

If a put option embedded in a debt instrument provides the holder with a cash settlement alternative based on the difference between the coupon rate in the debt and the current market rate and, under that alternative, the debt would remain outstanding, is the embedded option closely related to the debt if the debt is not issued at a substantial discount or premium?

This feature is evaluated under paragraph 25(h) to determine whether the issuer would pay a rate more than twice the market rate at inception. If the settlement could double such market rate at inception, the embedded derivative should be accounted for separately.

IAS 39.25(h) - Substantially All Test Based on What Is Possible

Comparison with US GAAP

Under US GAAP [FASB 133, paragraph 309], the test of losing substantially all of its investment or doubling its return is based on what is possible, not what is probable.

IAS 39.25(h) - Cash Settled Options

Comparison with US GAAP

US GAAP specifies that call options (or put options) that do not accelerate the repayment of principal on a debt instrument, but instead require a cash settlement that is equal to the price of the option at the date of exercise, would not be considered to be clearly and closely related to the debt instrument in which it is embedded and would be separated from the host contract. [FASB 133, paragraph 61(d)] In this case, the cash settlement provision effectively achieves an adjustment to the interest rate on the debt. There is no similar requirement under IAS 19.
### IAS 39.26 - EMBEDDED DERIVATIVES: EXAMPLES OF CLOSELY RELATED

**EXAMPLE**

The table below provides a summary of examples illustrating the application of the closely-related criteria to derivative instruments embedded in hybrid instruments. Specifically, each example (i) provides a brief discussion of the terms of an instrument that contains an embedded derivative and (ii) analyses the instrument (as of the date of inception) to determine whether the embedded derivative is closely related to the host contract. Unless otherwise stated, the examples are based on the assumption (1) that if the embedded derivative and host portions of the contract are not closely related, a separate instrument with the same terms as the embedded derivative would meet the IAS 39 scope requirements, (2) that the contract is not remeasured at fair value under IAS 39, and (3) that otherwise-applicable generally accepted accounting principles are followed with changes in fair value currently included in earnings. [FASB 133, paragraphs 176-200]

<table>
<thead>
<tr>
<th>Type of Instrument</th>
<th>Economic Characteristics</th>
<th>Embedded Derivative</th>
<th>Closely Related</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inverse Floater</strong></td>
<td>Bond: Coupon = 5.25% for three months to July 1999; thereafter at 8.75% six-month LIBOR to January 2000. Stepping option allows for spread and caps to step semi-annually to maturity.</td>
<td>Fixed-for-floating rate interest rate swap</td>
<td>No (i)</td>
</tr>
<tr>
<td><strong>Levered Inverse Floater</strong></td>
<td>Bond: Accrues interest at 6% to June 2000; thereafter, at 14.57% - (2.5 x 3-month LIBOR).</td>
<td>Leveraged interest rate swap</td>
<td>No (i)</td>
</tr>
<tr>
<td><strong>Delevered Floater</strong></td>
<td>Bond: Coupon = (0.5 x 10-year constant maturity treasuries (CMT)) + 1.25%.</td>
<td>Deleveraged swap or a series of forward agreements</td>
<td>Yes (2)</td>
</tr>
<tr>
<td><strong>Range Floater</strong></td>
<td>Bond: The investor receives 5.5% on each day that 3-month LIBOR is between 3% and 4%, with the upper limit increasing annually after a specified date. The coupon will be equal to zero percent for each day that three-month LIBOR is outside that range.</td>
<td>Two written conditional exchange option contracts with notional amounts equal to the par value of the fixed-rate instrument</td>
<td>Yes (2)</td>
</tr>
<tr>
<td><strong>Ratchet Floater</strong></td>
<td>Bond: Coupon = three-month LIBOR + 50 basis points. In addition to having a lifetime cap of 7.25%, the coupon will be collared each period between the previous coupon and the previous coupon plus 25 basis points.</td>
<td>Combinations of purchased and written options that create changing caps and floors</td>
<td>Yes (2)</td>
</tr>
<tr>
<td><strong>Fixed-to-Floating Note</strong></td>
<td>A bond that pays a varying coupon (first-year coupon is fixed; second- and third-year coupons are based on LIBOR, Treasury bills, or prime rate).</td>
<td>Forward-starting interest rate swap</td>
<td>Yes (2)</td>
</tr>
<tr>
<td><strong>Indexed Amortising Note</strong></td>
<td>A bond that repays principal based on a predetermined amortisation schedule or target value. The amortisation is linked to changes in a specific mortgage-backed security index or interest rate index. The maturity of the bond changes as the related index changes.</td>
<td>Conditional exchange option that requires partial or early payment of the note</td>
<td>Yes (2)</td>
</tr>
<tr>
<td><strong>Equity-Indexed Note</strong></td>
<td>A bond for which the return of interest, principal, or both is tied to a specified equity security not of the issuer or index (for example, the Standard and Poor’s 500 [S&amp;P 500] index). This instrument may contain a fixed or varying coupon rate and may place all or a portion of principal at risk.</td>
<td>Forward exchange contracts or option contracts</td>
<td>No (2)</td>
</tr>
<tr>
<td><strong>Variable Principal Redemption Bond</strong></td>
<td>Bond: A supplemental principal payment will be paid to the investor, at maturity, if the final S&amp;P 500 closing value (determined at a specified date) is less than its initial value at date of issuance and the 10-year CMT is greater than 2% as of a specified date. In all cases, the minimum principal redemption will be 100 percent of face amount.</td>
<td>Purchased option</td>
<td>No (3)</td>
</tr>
<tr>
<td>Type of Instrument</td>
<td>Economic Characteristics</td>
<td>Embedded Derivative</td>
<td>Closely Related</td>
</tr>
<tr>
<td>--------------------------</td>
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</tr>
<tr>
<td>Crude Oil Knock-in Note</td>
<td>A bond that has a 1% coupon and guarantees repayment of principal with upside potential based on the strength of the oil market.</td>
<td>Option contracts</td>
<td>No (1)</td>
</tr>
<tr>
<td>Gold-Linked Bull Note</td>
<td>A bond that has a fixed 3% coupon and guarantees repayment of principal with upside potential if the price of gold increases.</td>
<td>Option contracts</td>
<td>No (1)</td>
</tr>
<tr>
<td>Step-up Bond</td>
<td>A bond that provides an introductory above-market yield and steps up to a new coupon, which will be below then-current market rates or, alternatively, the bond may be called in lieu of the step-up in the coupon rate.</td>
<td>Call option and changing interest rate feature</td>
<td>Yes (2)</td>
</tr>
<tr>
<td>Credit-Sensitive Bond</td>
<td>A bond that has a coupon rate of interest that resets based on changes in the issuer’s credit rating.</td>
<td>Conditional exchange contract or option</td>
<td>Yes (2)</td>
</tr>
<tr>
<td>Inflation Bond</td>
<td>A bond with a contractual principal amount that is indexed to the inflation rate, but cannot decrease below par; the coupon rate is typically below that of traditional bonds of similar maturity.</td>
<td>Conditional exchange contract or option</td>
<td>Yes (2)</td>
</tr>
<tr>
<td>Disaster Bond</td>
<td>A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.</td>
<td>Conditional exchange contract or option</td>
<td>No (4)</td>
</tr>
<tr>
<td>Specific Equity-Linked Bond</td>
<td>A bond that pays a coupon slightly below that of traditional bonds of similar maturity; however, the principal amount is linked to the stock market performance of an equity investee of the issuer.</td>
<td>Series of forward contracts or option contracts</td>
<td>No (3)</td>
</tr>
</tbody>
</table>
### Type of Instrument | Economic Characteristics | Embedded Derivative | Closely Related
--- | --- | --- | ---
Participating Mortgage | A mortgage in which the investor receives a below-market interest rate and is entitled to participate in the appreciation in the market value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage. | Call option | N/A (1)
Convertible Debt | An investor receives a below-market interest rate and receives the option to convert its debt instrument into the equity of the issuer at an established conversion rate. The terms of the conversion require that the issuer deliver shares to the investor. | Call option | Issuer - Yes (6)

#### Notes:

1. Underlying is linked to interest rates and could result in the investor’s failing to recover substantially all of its initial recorded investment in the bond.
2. Underlying is linked to interest rates, credit, or inflation and (a) does not result in the investor’s failing to recover substantially all of its initial recorded investment in the bond, and (b) appears to be no possibility of increasing the investor’s rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract.
3. Underlying is linked to an equity index, commodity index, or foreign currency index.
4. Underlying is linked to a specific disaster event that does not entitle the holder of the option to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk as a result of an identified insurable event.
5. Subject to the requirements of IAS 21.
6. A separate contract with the same terms would be excluded from the scope, because settlement is based on the value of a non-financial asset of one of the parties that is to be settled by delivery.

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### IAS 39: 29(b) - INITIAL RECOGNITION: EQUITY FOR GOODS AND SERVICES

**COMPARISON WITH US GAAP**

Commitments to exchange an enterprise’s equity for goods and services specifically are not addressed in IAS 39. Under US GAAP the fair value of the equity instrument given in the exchange is determined on the measurement date. The measurement date is the date the counter party has performed under the agreement or is committed to perform because there is a significant disincentive for non-performance.

### IAS 39.34 - TRADE DATE VS. SETTLEMENT DATE: SALE OF A SECURITY CARRIED AT FAIR VALUE

**EXAMPLE**

Enterprise X has a portfolio of debt securities, which are classified as held-for-trading. This portfolio contains a Danish government bond with a carrying value (corresponding to its fair value) of DKK80 million that the enterprise sells on 30 March for settlement on 2 April. Assuming that the bonds were sold for DKK80 million and that the market value of the bonds was DKK76 million on 31 March and DKK82 million when the transaction was settled on 2 April.

The following journal entries would be recorded:

#### Journal Entry: 30 March

No entries are made (assuming there is no change in fair value since the previous reporting date).

#### Journal Entry: 31 March

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealised loss - Held-for-Trading Securities</td>
<td>DKK 4,000,000</td>
</tr>
<tr>
<td>Held-for-Trading Securities</td>
<td>DKK 4,000,000</td>
</tr>
</tbody>
</table>

To record the change in fair value between 30 and 31 March.

#### Journal Entry: 2 April

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>DKK 80,000,000</td>
</tr>
<tr>
<td>Held-for-Trading Securities (Balance Sheet)</td>
<td>DKK 76,000,000</td>
</tr>
<tr>
<td>Realised gain - Held-for-Trading Securities</td>
<td>4,000,000</td>
</tr>
</tbody>
</table>

To record the sale of the securities and the change in fair value since the previous period.
**IAS 39.34 - TRADE DATE/SETTLEMENT BASED PRIMARILY ON INDUSTRY PRACTICE UNDER US GAAP**

**COMPARISON WITH US GAAP**

For US GAAP, the use of trade or settlement date accounting generally is based on industry practice. Trade date accounting is used for purchases and sales of securities as well as commitments to buy and sell securities in a trading account. Settlement date accounting is used for loan origination commitments and sales of loans and securities out of the available-for-sale category. Under US GAAP for derecognition, the use of trade or settlement date accounting only occurs once the transfer criteria in FASB 140 have been met, based on the need to give up control.

IAS 39 provides enterprises with discretion in the choice of trade or settlement date accounting, provided the enterprise applies its election consistently for all purchases and sales of financial assets belonging to the same category of financial instruments.

**IAS 39.35 - DERECOGNITION OF A FINANCIAL ASSET: DESECURITISATION**

**QUESTION**

**IS A DESECURITISATION TRANSACTION ACCOUNTED FOR AS A SALE?**

No. In a desecuritisation, a holder of a security rescinds the securitisation in order to obtain the assets underlying the security. For example, an entity may desecuritise mortgage-backed securities to obtain the underlying mortgage loans or desecuritise related interest-only and principal-only strips in order to obtain the underlying security. Similar to a securitisation in which the transferor retains all the beneficial interests not being treated as a sale, a desecuritisation in which the entity retains all the underlying assets also is not accounted for as a sale. Thus, if an entity were to transfer the securities or beneficial interest in a pool of financial assets in exchange for the financial assets underlying those securities or beneficial interests, the financial assets received would be accounted for as retained interests, and no gain or loss on the transfer would be recognised.

Sometimes the holder of the securities will exchange securities held and cash for the underlying instruments. For example, an entity may exchange an interest-only security, a principal-only security, and cash for the underlying asset-backed security. In this circumstance, because the beneficial interests have not been exchanged, the transaction is not accounted for as a sale. The transferor should recognise no gain or loss on the exchange, but should record the asset-backed security at the carrying amount of the securities surrendered plus the monetary consideration paid.

**IAS 39.38(a) - READILY OBTAINABLE**

**QUESTION**

**WHAT IS MEANT BY THE TERM ‘READILY OBTAINABLE’?**

The term ‘readily obtainable in the market’ is not defined or otherwise explained in IAS 39 and, as a result, application of this provision involves some judgement. Ordinarily, it is expected that to qualify under this test, a market must exist where the assets are either traded on a formal exchange or are considered liquid and are traded in a market where price quotations either are published or are obtainable through another verifiable source.

In addition, the following factors provide useful guidance in determining whether the assets are readily obtainable from the perspective of the transferee:

- whether the financial assets that would satisfy the call option or forward contract may have to be purchased from a third party at a price significantly above its estimated fair value, thus indicating that the assets are not liquid;
- whether the normal settlement period for obtaining financial assets that would satisfy the call option or forward contract is approximately equal to or greater than the period within the delivery terms of the option or forward contract (for instance, the normal settlement period requires 30 days to obtain an asset, and the forward contract requires delivery of the asset within 15 days of the original transfer);
- whether the quantity of financial assets available for satisfying the call option or forward contract is insufficient in comparison to the quantity required in the call option or forward contract; and
- whether the majority of the financial assets available to satisfy the call option or forward contract are held by one or a few entities, thus indicating that the assets are not liquid.

Intuitively, the wider the range of assets that may be used to satisfy the call option, the more likely the requirement of being readily obtainable will be satisfied. For instance, assets identical to those originally transferred may not be readily obtainable, but, if the call option permits delivery of assets that are similar to the transferred assets, they may be readily obtainable, and the condition would be satisfied.

Some call options may permit settlement in cash as an alternative to delivering the financial asset. Since cash is a readily obtainable asset, call options and forward contracts that permit settlement in cash will not preclude sale treatment, provided that the cash settlement alternative does not contain an economic penalty rendering this alternative unfeasible.
IA 39.38(a) - READILY OBTAINABLE: BASIS FOR ASSESSING CONTROL

QUESTION

WHY IS A DISTINCTION MADE IN PARAGRAPH 38 OF IAS 39 ON WHETHER A TRANSFER HAS OCCURRED BASED ON WHETHER THE TRANSFERRED ASSET IS READILY OBTAINABLE?

Generally, whenever a call option on transferred assets is held by a transferor and the transferred assets are not readily obtainable elsewhere, the transferee’s right to enjoy all the benefits of ownership has been diminished. If the transferor is compelled to hold the transferred assets to enable it to transfer them back to the original transferor pursuant to a call option, the transferee is constrained from exchanging or pledging those assets with a third party, and the transferor has therefore surrendered control over the right to the benefits comprising the assets.

If the assets are readily obtainable, however, the transfer will generally be accounted for as a sale since the transferor is usually not constrained legally or economically by a call option. This is because the existence of a liquid market enables the transferee to freely exchange or pledge the transferred assets within a short period of time to realise their full value (and, also, to obtain other assets necessary to satisfy the call option if exercised). When assets that are callable by the transferee are readily obtainable, the transferor clearly has surrendered control because of the potential to get back assets that are not identical to the assets sold. The transferee may deliver assets that are substantially the same but not necessarily the same assets that were sold.

IA 39.38(a) - ACCOUNTING AT EXPIRATION OF A CALL OPTION

QUESTION

IF DERECONNECTION IS PRECLUDED BECAUSE THE TRANSFEROR RETAINS A CALL OPTION ON TRANSFERRED ASSETS THAT ARE NOT READILY OBTAINABLE, IS DERECONNECTION PERMITTED SUBSEQUENTLY WHEN THE CALL OPTION EXPIRES?

If the transferor allows the call option to expire unexercised, thereby releasing the transferor’s control over the transferred assets, any remaining assets no longer subject to the call option should be treated as sold by the transferor. For the transferor, this requires the derecognition of any remaining financial assets and the related borrowing. The transferee should recognise the financial assets and eliminate any remaining receivable due from the transferor.

IA 39.38(a) - CALL OPTION ON READILY OBTAINABLE ASSETS

EXAMPLE

Transferor X transfers Euro bonds maturing in 2015 to a third party, Transferee Y. Transferor X also has an agreement with Transferee Y that permits it to repurchase the bonds at any time prior to maturity. Because identical securities can be readily obtained from a third party in the marketplace, the call option does not prevent accounting for the transfer as a sale.

IA 39.38(a) - CALL OPTION ON NOT-READILY OBTAINABLE ASSETS

EXAMPLE

Assume the same facts as in the above example, except that the transferred assets subject to Transferor X’s call option are a pool of mortgage loans, and the mortgage loans are not readily obtainable elsewhere. Under this circumstance, the call option would prevent accounting for the transfer as a sale, and both parties would be required to report the transaction as a secured borrowing. The agreement contains no explicit conditions restraining Transferee Y from selling, exchanging, or pledging the assets to a third party; however, it cannot prudently do so since it must have access to the original mortgage loans that were transferred in the event Transferor X exercises its call option. In other words, at the exercise date of the call option, the buyer must have the assets on hand; since they are not readily obtainable from another source, the buyer can only perform under the contract if the assets are held. In this situation, the transferor has not surrendered control of the assets and the transaction should be accounted, by both the transferor and transferee, as a secured borrowing.

IA 39.38(a) - CALL OPTION ECONOMICALLY CONSTRAINS TRANSFEREE

EXAMPLE

Transferor X invested in certain high-yield bonds in Canada several years ago, and these bonds have a current book value of C$90,000,000. On December 24, 20X1, Transferor X sells the bonds subject to a call option. The bonds are not traded in the marketplace and are not readily obtainable. The call option is an attached option because the transferee is permitted to sell the bonds subject to the call option. The fair value of the bonds is estimated to be C$110,000,000.

The terms of the call option are:

- Strike price - C$25,000,000 (that is, it is deep in-the-money)
- Exercise date - 10 January 20X2

Transferor X receives net proceeds of C$24,900,000, consisting of cash of C$10,000,000 and a note with a fair value of C$14,900,000. Transferor X allocates the purchase price as follows:

<table>
<thead>
<tr>
<th></th>
<th>C$</th>
</tr>
</thead>
<tbody>
<tr>
<td>110,000,000</td>
<td>Value assigned to bonds</td>
</tr>
<tr>
<td>85,100,000</td>
<td>Less value assigned to call option retained</td>
</tr>
<tr>
<td>24,900,000</td>
<td>Net proceeds</td>
</tr>
</tbody>
</table>

Transferor X records a gain of C$10,000,000 (C$110,000,000 - C$100,000,000). On 10 January 20X2, Transferor X calls the bonds and pays the Transferee C$25,000,000 (C$10,000,000 cash and C$14,900,000 offset against receivables) and records the bonds at C$110,100,000 (C$25,000,000 + C$85,100,000).

Because the call option is so deep in-the-money and has such a short time period to expiration, the actual fair values assigned to the components would only impact on the amount of gain or loss, without affecting the net proceeds received. Its time value is assumed to be C$100,000, but, instead, it could be C$0, with the C$100,000 considered a transaction fee.
In this example, the transferee is not constrained from selling the bonds in the marketplace subject to the call. However, it is not relevant whether the transferee has the ability to sell the bonds because the instrument being offered is not the bonds. The bonds only provide collateral for the cash (financing) that is given to the transferor, which is only for a fraction of the value of the bonds, and the return on the investment is a specified fee, in this case, C$100,000. In the example, the transferor and transferee negotiated a single transaction, and the individual components are not relevant to it. More importantly, the individual components are not validated by the exchange. The transferee does not care what value is assigned to the call option by the transferor or what the real value of the call option is in the marketplace. The only important economic consideration to the transferee is the sufficiency of the collateral to ensure the safe return of its cash and collection of a fee.

It could be argued that the transferor would be in the same position as if the transferor never owned the assets and simply bought an in-the-money call option on them. However, in that situation, the value of the option would have been validated by a transaction with a third party who had a reason to care about the value. In addition, the transferor would be concerned only with the price of the option because there would be no corresponding sale of assets. Accordingly, the transferor would not be concerned with an allocation of net proceeds to the components because there would be no gain or loss to be recognised at the inception of the transaction.

In this example, the transferee is economically constrained. Not only are the assets not traded, but also they are subject to a deep-in-the-money call option with a short expiration period. The transferee may be free to sell the bonds subject to the call, but it is doubtful whether an investor could be found in a short period of time who would be willing to invest in an instrument with such unusual terms. Any such investor could only be a lender because the bonds provide only collateral value since there are no economic benefits of ownership. Even if the transferee could sell the bonds subject to the call, the transferor has not surrendered control because the transferor is entitled to get back the very same assets it sold. Sale accounting is not permitted.

**IAS 39.38(b) - COMBINATIONS OF DERIVATIVES**

**QUESTION**

**HOW SHOULD COMBINATIONS OF BOTH PUT AND CALL OPTIONS BE EVALUATED FOR PURPOSES OF ASSESSING THE TRANSFER OF CONTROL?**

A put option and a call option can be combined to be equivalent of a forward (also known as a synthetic forward); a forward and a put option can be combined to create the equivalent of a call option. Different combinations of derivatives may impact the degree of control that the transferee has over the financial assets that have been transferred. Combinations of derivatives that may be created in connection with a transfer of financial assets should be evaluated carefully to ensure that control rests with the transferee and that the transferee is not physically, legally, or economically constrained. Factors to consider in evaluating combinations of derivatives include whether the transferred assets are readily obtainable and how the derivatives affect the transferee’s ability to use the transferred assets.

The assessment of whether the strike prices of combined put and call options are approximately equal should be evaluated relative to a forward which would result in the same exposure to changes in fair value of the underlying. Combination put and call options transacted with a single counterparty which result in both of the parties being exposed to changes in value of the underlying (even if this exposure is limited for one of the parties) typically would not meet the requirement of having approximately equal strikes. However, depending on the circumstances, such options may preclude sale accounting if they result in the transferor retaining substantially all the risks and returns or in the transferee being constrained.

**IAS 39.38(b) - REPURCHASE AGREEMENTS AND SECURITIES LENDING TRANSACTIONS**

**QUESTION**

**HOW DO TYPICAL REPURCHASE AGREEMENTS AND SECURITIES LENDING TRANSACTIONS OPERATE?**

An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets before their maturity on terms that effectively provide the transferee with a lender’s return on the assets received in exchange for the transferred asset maintains the transferor’s control over those assets. These transactions should be accounted for as secured borrowings. Repurchase agreements and securities lending transactions are common agreements that fall under this provision.

Financial institutions and other enterprises often transfer financial assets with a concurrent forward contract to reacquire the transferred assets, commonly referred to as repurchase agreements. In a typical repurchase agreement, the enterprise might, for example, own government securities that it sells to a third party with an agreement to repurchase the securities at a specified price, generally within a short period of time. At inception, the lender transfers the securities to the borrower and receives cash or other consideration as collateral; if the consideration is cash, it is then invested in other assets that earn a return. At a defined date, the transferor repurchases the securities. Dollar repurchase agreements (dollar rolls) are similar transactions in which the transferor repurchases similar but not identical assets to those originally sold. Economically, the lender is motivated in these transactions by the liquidity afforded by the agreement and/or the excess returns it expects to earn on the collateral. These transactions historically have been viewed as secured financing by some entities (for example, depository institutions) while being treated as sales and purchases by others (for example, broker-dealers).

Repurchase agreements are commonly referred to as ‘repos’. In many countries, these are actively traded on listed exchanges or in the over the counter market and often are used as a source of funding or yield enhancement mechanism. The terminology, however, varies from country to country, and the form taken can also be different. In some countries, a distinction is made between a repurchase agreement where legal title passes (also known as ‘sell/buy-backs’) and a carry (typically a short-term repo that is sometimes known as a ‘classic repo’) where title does not pass. Terminology also differs depending on which party is ‘buying’ or ‘selling’ the security (hence the use of terms such as reverse repos, inward and outward carries). For the purpose of applying the derecognition criteria, rather than specifying the treatment of specific types of repo, which are likely to differ from country to country, the particular terms (and market conventions where appropriate) should be analysed to determine whether or not the substance of control is transferred.
Enterprises also enter into securities lending transactions on a regular basis. In these transactions, the transferor (lender of the security) transfers a security to the transferee (borrower of the security) for a period of time. The transferee generally is required to provide collateral, which may be cash, other securities, or a standby letter of credit with a value that can be slightly higher than the value of the security borrowed (sometimes referred to as a ‘haircut’). These transactions are typical when an entity needs a specific security to cover a short sale or a customer’s failure to deliver securities sold. The transferor is compensated for lending the security by earning a fee or a return on the collateral invested if the collateral is cash.

**IAS 39.38(c) - ‘SUBSTANTIALLY ALL’ RISKS AND RETURNS**

**QUESTION**

**HOW IS THE PHRASE IN PARAGRAPH 38(C) ‘SUBSTANTIALLY ALL’ OF THE RISKS AND RETURNS OF OWNERSHIP INTERPRETED?**

Under US GAAP, substantially all is interpreted to refer to the right to at least 90 percent of the cash flows (or other economic benefits) associated with a financial asset. IAS 39 does not provide guidance and, accordingly, judgment is required. In the case of a total return swap, these risks and returns primarily represent the exposure to both interest rate and credit risk in respect of the underlying asset, and these should be quantified in determining the extent to which the transferor has retained control. Application of this guidance is considered appropriate under IAS 39.

**IAS 39.38(c) - EVALUATION OF PUT OPTIONS HELD BY TRANSFEREE**

**QUESTION**

**HOW ARE PUT OPTIONS HELD BY THE TRANSFEREE EVALUATED IN DETERMINING WHETHER CONTROL HAS BEEN TRANSFERRED?**

The primary factor to consider is whether the transferor has retained control because the assets transferred are not readily obtainable and the option features, such as the exercise period and strike price, limit the transferee from taking any action other than to exercise the put option. These conditions are indicative that the transferor has retained substantially all of the risks and returns of ownership. In making this assessment, the probability that an in-the-money option will not be exercised is ordinarily not a consideration, because the transferee generally will be constrained until such time in the future when the option is no longer in-the-money or expires worthless.

It should be noted debt instruments that are not traded and are not readily obtainable typically are not rated and tend to have values that fluctuate more with movements in credit than with movements in interest rates. In this situation, it would be difficult enough to resell assets that are not readily obtainable because there is usually a wide bid-ask difference (spread). It would be much more difficult to sell such assets at a price in excess of the estimated value, which would be required for the transferee to recoup the value of its put option. A potential investor would be reluctant to purchase such assets and pay an additional amount for an in-the-money put option without obtaining assurance that the investment would be realised. It also, would be difficult if not impossible to sell the put separately in the marketplace and realise any value for it. Even if the put option is in-the-money, it has no value without access to the referenced assets because they are necessary to satisfy the put. If a transaction involves an in-the-money put option, the only rational action a transferee may be able to take to realise its investment is to exercise the option. Although it is necessary to assess the extent to which the value attributed to the put option constrains the transferee, in the absence of any evidence to the contrary, the transferee will always be constrained economically to some extent if the assets are not readily obtainable.

**IAS 39.38(c) - RETENTION OF RISKS AND REWARDS: IN-THE-MONEY PUT OPTION**

**EXAMPLE**

Transferor X sells South African government bonds that are readily obtainable in the marketplace with a book value of R100 to Transferee Y for R103. The transfer includes an option for Transferee Y to put the assets back to Transferor X up to one year after the transfer date at R103.30. Transferee Y exercises its option 30 days after the initial sale. The option had a fair value of R2 at the exchange date consisting of time value of R1.50 and intrinsic value of R0.50. Should the transfer be accounted for as a sale?

In this example, the transferor has not retained control because the assets are readily obtainable. This put option does not therefore preclude sale treatment.

**IAS 39.38(c) - RETENTION OF RISKS AND REWARDS: DEEP-IN-THE-MONEY PUT OPTION**

**EXAMPLE**

Transferor X transfers receivables with a carrying value of $50 and a put option which expires in 10 days to Transferee Y. Transferee Y pays $150 for the receivables, which have a fair value of $150. Under the terms of the put option, Transferee Y may put the receivables to Transferor X for $151. The possibility of the fair value of the receivables increasing to $151 in 10 days is considered remote and, therefore, exercise of the option appears virtually assured at inception.

Because at inception it appears virtually assured that the put option will be exercised, Transferor X has retained substantially all of the risks of ownership over the receivables, and this transaction should be accounted for as a secured borrowing of $150.
**IAS 39.41(a) - ELIMINATION OF CONSTRAINTS SUBSEQUENT TO THE TRANSFER**

**QUESTION**

**IF A RESTRICTION IMPOSED BY A TRANSFEROR IS DETERMINED TO PRECLUDE DERECOGNITION, WHAT IS THE ACCOUNTING CONSEQUENCE IF SUCH RESTRICTION IS SUBSEQUENTLY REMOVED OR LAPSES?**

If a restriction that precludes derecognition is removed or lapses, derecognition would then be appropriate, providing all of the other conditions for derecognition are met.

**IAS 39.41(a) - EXTERNAL CONSTRAINT MAY NOT PRECLUDE SALE TREATMENT**

**EXAMPLE**

Entity X owns stock in entity B. Entity B desires to restrict the number of shareholders; thus, a condition contained in the shareholder agreement requires that holders of B’s stock cannot transfer such stock without the approval of B or the stock must be sold to B. X transfers the stock to Y, a buyer approved by B, for cash and has no other involvement with such stock.

The shareholder agreement precludes Y from selling the stock without the approval of B. The transfer should be accounted for as a sale (provided the transfer meets all other derecognition criteria) because X surrendered all control it had in the financial asset to Y and the external constraint does not involve X, provide X with a means for repurchasing the stock from Y, or permit X to obtain any other advantage with respect to the stock.

**IAS 39.41(a) - TIME-BASED CONSTRAINT ON FINANCIAL ASSETS**

**EXAMPLE**

Transferee Y is prohibited by Transferor X from pledging or exchanging, for the first year after the transfer, a financial asset that matures in five years. X otherwise controls the risks and returns of the asset. Upon expiration of this period, the transferee is free to pledge or exchange approximately the full fair value of the asset.

In this example, the transferor and transferee should account for this transfer as a secured borrowing along with a forward sale/purchase contract until the restriction expires. Upon the expiration of the constraint, both parties should account for the transfer as a sale.

However, if, in this example, it could be demonstrated that Y is prohibited from pledging or exchanging the asset to preserve the relationship of Y with the party issuing the financial asset and provided that the transferor does not have the right or ability to reacquire the asset, sale accounting is appropriate under IAS 39.42.

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**IAS 39.41(b) - SPECIAL PURPOSE ENTITIES**

**QUESTION**

WHAT ARE SPECIAL PURPOSE ENTITIES (SPEs) AND WHY ARE THEY COMMONLY USED IN CONNECTION WITH SECURITISATION TRANSACTIONS?

SPEs, which may take the form of a corporation, trust, partnership, or unincorporated entity, are often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee, or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (in other words, they operate on so-called ‘autopilot’).

Structured transactions, such as securitisations and certain other asset-based financing arrangements, typically seek, as their primary economic objective, to legally isolate the assets from the party providing the assets (and from that party’s creditors) to avoid a credit exposure to the transferor. This isolation is often achieved through a special purpose entity. For many sellers of financial assets, structured arrangements that isolate the assets permit access to capital markets at more favourable prices than might otherwise be available since credit agencies and investors require a lower return from structures that avoid the consequences arising from bankruptcies. This ability is particularly important for those enterprises whose credit ratings may reflect the adverse effects of financial, operational or environmental risks not directly attributable to the assets being transferred. It does not, however, necessarily protect the sponsor from the requirement to consolidate the SPE for accounting purposes which may, through its impact on the sponsor’s financial ratios, negate certain of the benefits of isolating the SPE.

A special purpose entity may issue different types of beneficial interests, multiple classes of interests, and classes of interests with different maturities. Several forms of SPE are common, depending on the asset being securitised, the securities issued by the entity and the legal framework governing the entity’s operations. These include grantor trusts, owner trusts, revolving trusts, master trusts, special purpose corporations, and REMICS (real estate mortgage investment conduits).

Typically, the special purpose entity is prevented from selling, assigning, or pledging its direct interest in any financial asset it holds; however, the owners of the beneficial interests generally have the right to pledge or exchange their beneficial interests.
**IAS 39.41(b) - TRANSFER TO SPECIAL PURPOSE ENTITY: IMPACT ON DERECOGNITION**

**QUESTION**

**HOW DOES THE TRANSFER TO A SPECIAL PURPOSE ENTITY AFFECT DERECOGNITION?**

When an enterprise transfers assets to an SPE, two tests of control need to be applied. The first test determines whether control over the contractual rights comprising the financial assets has been surrendered (in terms of the derecognition criteria in IAS 19) and therefore whether sale accounting is permitted. The second test determines whether the transferor retains sufficient control such that consolidation of the SPE is required in the transferor’s financial statements in terms of SIC 12. If consolidation is required, the sale becomes a borrowing transaction. This second test must be applied regardless of the results of the first test.

As a result of the application of these two tests, it is possible that instances could occur where, despite the criteria for derecognition being satisfied, the effects of sale accounting in that enterprise’s financial statements would be nullified because the transferor is required to consolidate the SPE. The structure, terms, and conditions of the beneficial interest as well as the nature of the special purpose entity’s activities must be analysed carefully in applying the derecognition criteria when assets are transferred to an SPE. These factors are useful indicators of the extent to which control over the contractual rights comprising the transferred financial assets has been surrendered.

**IAS 39.41(b) - QUALIFYING SPECIAL PURPOSE ENTITIES**

**COMPARISON WITH US GAAP**

Under US GAAP, an exception to the normal consolidation criteria is made for ‘qualifying special purpose entities’ (QSPE). If an SPE meets the conditions for being a QSPE, it is not consolidated and derecognition is permitted to the extent that the transferor receives consideration other than a beneficial interest in the QSPE. The holders of the beneficial interests in the QSPE must have the right, free of constraining conditions, to exchange or pledge those beneficial interests, thus indicating that the transferor has surrendered effective control. If an SPE fails to meet the criteria for a QSPE, derecognition may be permitted if derecognition criteria are met and there is sufficient third party equity capital invested in the SPE so as to avoid its consolidation with the transferor.

There is no QSPE exception to the consolidation criteria under IAS 39. However, a transaction between an SPE and a third party investor may qualify for derecognition and such transaction would not be affected by the consolidation of the SPE.

**IAS 39.41(b) - BENEFICIAL INTEREST**

**QUESTION**

**WHAT IS MEANT BY THE TERM ‘BENEFICIAL INTERESTS’?**

IAS 39 does not define the term ‘beneficial interests’. It generally refers to the rights issued by a special-purpose entity (usually in the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease) and not the transferred assets held by the special-purpose entity. However, it can refer, also, to an interest retained by the transferor in a partial sale.

**IAS 39.41 - CONSIDERATIONS FOR ASSESSING CONTROL**

**QUESTION**

**WHAT ARE SOME FACTORS TO CONSIDER IN ASSESSING THE TRANSFER OF CONTROL UNDER IAS 39?**

Historically, the accounting for sales of financial assets, in which the seller does not have any continuing involvement with the assets subsequent to the sale, has not been controversial. The accounting for the sale of marketable securities to a third party is often without continuing involvement and is relatively straightforward. However, if the enterprise continues to have some involvement with the assets after the transfer, particularly in cases where a portion of the assets is transferred and a portion retained, the appropriate accounting is not always clear and the derecognition criteria have been developed to address these instances. Examples of continuing involvement are recourse, servicing, agreements to reacquire assets, written or held options on the transferred assets, and pledges of collateral.

The derecognition criteria are based primarily on a control approach, similar to the financial components approach under US GAAP. This approach involves an analysis of the contractual rights comprising the transferred financial asset by examining the component assets and liabilities that exist subsequent to the transfer. The determination of control is therefore broader than just a physical ownership or custody notion. Certain elements of a risk and rewards approach have, however, been included in the derecognition model prescribed in IAS 39. These elements are included to clarify the control requirements of the derecognition model and to provide further guidance in respect of instances where control is surrendered.

The derecognition approach in IAS 39 is a combination of a control approach and a risks and returns approach. The Statement does not indicate clearly, however, which approach takes precedence and instead alternates between attributes of each approach in the various provisions. Inevitably therefore, the substance of control and the extent to which the risks and returns are transferred (that is, whether the transferee is free to pledge or exchange substantially the full fair value of the asset) should both be assessed in determining whether derecognition is appropriate.

It is important to note that the accounting between the transferor and transferee is intended to be symmetrical. If the transferor surrenders control over the transferred assets, the transferee also, must have obtained control, and therefore the transaction should be accounted for as a sale by the transferor and a purchase by the transferee. Otherwise, when control has not been surrendered, the transferor should account for the transaction as a borrowing, and the transferee should account for it as secured lending.
Transfers, particularly those involving derivatives, must be considered in terms of their control aspects. The concept of control, as developed in IAS 39, focuses on the ability of the transferee to obtain all or most of the rights to benefits comprising a financial asset (essentially the risks and returns of ownership). This condition usually is considered to be met if the transferee has the ability to exchange or pledge approximately the full fair value of the transferred asset (see paragraph 41). The wording of paragraph 41 requires the use of judgement in determining whether sale accounting is appropriate, having regard to the substance of the transaction rather than its legal form. In many instances, derivatives are embedded in a transfer or securitisation structure or are not explicitly defined as derivatives. For example, the amortisation terms of a revolving credit card securitisation may call for the allocation of all principal cash flows to outside investors during the amortisation period, with any remaining going to the retained interest of the seller. This provision may be in the form of a call option, put option, or forward contract. Identifying the implicit derivative in this example requires a thorough understanding of the transfer structure, terms, and conditions. A further assessment is required in these circumstances to determine the applicability of the embedded derivative provisions in IAS 39 (see IAS 39.22).

Derivatives often are included in transfers of financial assets, either explicitly or implicitly. The identification and evaluation of derivatives that are included in a transfer of financial assets is crucial in applying the derecognition criteria because certain derivatives have control elements that may preclude sale treatment. Derivatives commonly found in transfers of financial assets include put options, call options, forward or repurchase contracts, forward sales contracts, and swap agreements. Put options provide the transferee with the right to require the transferor to repurchase some or all of the financial assets that were sold, for example, to repurchase delinquent receivables. Call options provide the transferor with the right to repurchase some or all of the financial assets sold to the transferee. Forward or repurchase agreements require the transferor to sell and the transferor to buy some or all of the financial assets that were sold before their scheduled maturity. Forward sales contracts require the transferor to sell and the transferee to buy additional financial assets in the future. Swap agreements effectively change one or more cash flows of the underlying transferred assets (or debt issued by a special purpose entity). For example, an interest rate swap may convert a variable rate asset to a fixed rate.

Any derivative instrument that constraints a transferee from using a transferred asset in a manner that best realises the economic benefits encompassed in the asset should be carefully evaluated in the context of control. In most situations, it will be appropriate to evaluate derivatives based on their type or form. However, different types of derivatives can result in identical economic outcomes. There are a number of factors to consider when evaluating derivatives. Derivatives can operate automatically or require exercise by one of the parties; they can be exercised freely or only after the occurrence of a future event. Such a future event may be certain of occurring, such as the passage of time, or may be conditional upon an event, such as a loan becoming delinquent. The certainty of occurrence varies with conditional events. Some conditional events may be probable of occurring, possible of occurring, or their occurrence may be considered remote. In some instances, it may not be possible to assess the likelihood of occurrence. The exercise price of a derivative can be fixed above, below, or equal to the market value of the financial assets at inception or it can be variable, equal to the market value at exercise date, or the result of a formula that is a function of market conditions or other future events. Derivatives can be combined to form different types of derivatives. Each of these factors impacts the degree of control retained by the transferor over the financial assets that have been transferred and the degree of control obtained by the transferee. Judgement is required in making these assessments.

There are many different terms that can be incorporated in a transaction that result in the transferor retaining control and/or economically constraining a transferee from actually selling the transferred assets, even if there is no legal constraint. A call option does not have to be in-the-money, and a put option does not have to be deep in-the-money to constrain the transferee. A very short time period to the exercise date of a call option or put option, for example, may be sufficient to constrain a transferee when the assets transferred are not readily obtainable, even though a transferee has the legal right to sell the assets subject to the call or repurchase agreement.

IAS 39.42 - LOAN PARTICIPATIONS AND SYNDICATIONS

QUESTION

HOW ARE LOAN PARTICIPATIONS AND SYNDICATIONS EVALUATED IN DETERMINING WHETHER A PORTION OF A LOAN SHOULD BE DERECOGNISED?

Loan participations occur when groups of banks or other entities jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities. The transfer by the originating lender (transferor) may take the legal form of either an assignment or participation. The transfer is usually on a non-recourse basis, and the transferor continues to service the loan. The participating entity (transferee) may or may not, depending on the terms of the participation agreement, have the right to transfer its participation during the term of the loan. If the loan participation agreement gives the transferee the right, free of constraint, to pledge or exchange approximately the full fair value of those participations and the other derecognition criteria are met, the transfer of the loan participation to the transferee must be accounted for as a sale. However, loan participations often have constraints on the transferee’s rights to pledge or exchange financial assets. A determination should be made regarding the significance of the constraint. Significant constraints preclude sale treatment, whereas minor constraints might not preclude necessarily sale treatment. The constraint is considered significant if the loan participation agreement constrains the transferee from pledging or exchanging approximately the full fair value of its participation. In this circumstance, the transferee has not obtained control over the loan and the transfer generally should be accounted for as a secured borrowing, assuming that the transferor has retained certain risks and returns of ownership.

A loan syndication is similar to a loan participation in that it is the formation of a group of lenders to jointly fund large loans. However, in a syndication under which several lenders agree to lend to a single borrower, each lender originates a loan of a specific amount to the borrower and has the right to repayment from the borrower. Because each lender in the syndication originates its loan with the borrower and does not receive the loan in a transfer, the transaction is not subject to the transfer and derecognition principles of IAS 39. Each lender should account for the amounts it is owed by the borrower.

In some loan syndications, repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances where there is a lead lender that collects and distributes repayments, the lead lender is simply functioning as a servicer and should not recognise the aggregate loan as an asset.
IAS 39.42  •  CONDITIONAL EXCHANGE DERIVATIVES

QUESTION

HOW ARE CONDITIONAL EXCHANGE DERIVATIVES, FOR EXAMPLE A CONDITIONAL REPURCHASE AGREEMENT, EVALUATED IN DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECOGNISED?

Derivatives are conditional if they come into existence as a result of some event that may occur in the future, or if they come into existence as a result of information obtained in the future evidencing a condition that was not known to exist at the origination date (for example, a recourse provision). The mere passage of time is not a conditional event because the effectiveness of the derivative in the future is assured.

At the time the derivative becomes effective or is no longer conditional, the derivative may operate automatically and require repurchase of some or all of the transferred assets, or may permit one of the parties to require the other to purchase or sell the transferred assets. Repurchase or payment requirements that operate automatically and that do not always benefit one party at the expense of another or that are neutral to both parties are considered forward contracts rather than options.

Conditional repurchase requirements that operate automatically are conditional forward repurchase agreements. Those that provide one of the parties with the ability to buy or sell the transferred assets from or to the other party (respectively) can be considered to be conditional put options if the transferee may acquire the exercise right, or conditional call options if the transferor may acquire the exercise right.

Although IAS 39 does not specifically address the control implications of conditional derivatives, these are evaluated in terms of the derecognition criteria in the same manner as unconditional derivatives. In the circumstances listed below, conditional or contingent derivatives generally are not considered to be a significant factor in assessing whether the sale accounting criteria have been met:

- the transferred assets are readily obtainable;
- the occurrence of the condition or contingent event is considered to be remote; or
- the transferee will not be constrained by the derivative if it becomes effective provided that the transferor does not retain certain risks and returns of ownership.

When transferred assets are not readily obtainable and it is reasonably possible that the derivative will come into existence because the contingent event may occur, judgement is required to determine whether a transferee may be constrained. In making this assessment:

- conditional call options on assets that are not readily obtainable generally benefit the transferor and should preclude sale accounting, unless the contingent event provides the transferee with a choice of calling or repurchasing delinquent receivables or remitting the delinquent payments to the transferee;
- conditional put options generally benefit the transferee and will have no impact on sale accounting, unless there is some provision or term of the option that constrains the transferee;
- conditional forward repurchase agreements that protect the transferee generally will have no impact on sale accounting, unless there is a provision or term that constrains the transferor. A requirement to repurchase delinquent receivables does not constrain the transferee and generally should be evaluated as a put option held by the transferor; and
- conditional forward repurchase agreements that are not structured to benefit either party or that benefit the transferor should be assessed to determine the likelihood of the event occurring and whether it will constrain the transferee.

IAS 39.43  •  EVALUATION OF RECOUSE PROVISIONS

QUESTION

HOW ARE RECOUSE PROVISIONS EVALUATED FOR PURPOSES OF DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECOGNITION?

Recourse obligations may take several forms, including a call option held by the transferor, a forward contract requiring the transferee to sell and the transferor to buy any defaulted assets, or a put option held by the transferee. However, because a recourse obligation always benefits the transferee at the expense of the transferor, the repurchase requirement created by the recourse provision generally should be evaluated as a put option held by the transferee. As described above, these types of options generally do not preclude sale treatment unless the transferor substantially retains all of the risks of ownership.
Certain revolving period securitisations additionally contain ‘removal of accounts’ provisions entitling the transferor to withdraw certain individual accounts from a pool of receivables subject to certain conditions. The effect of these withdrawals is to reduce the seller’s interest and increase the investor’s relative interests in the remaining account balances. The removal of receivable balances can be considered a call option, which would prejudice sale treatment since it is indicative of the transferor retaining control over the assets. This should be evaluated in the light of the terms of the particular securitisation.

IAS 39.42 • BANKER’S ACCEPTANCES AND RELATED RISK PARTICIPATIONS

QUESTION

HOW ARE BANKER’S ACCEPTANCES AND RELATED RISK PARTICIPATIONS EVALUATED FOR PURPOSES OF DETERMINING WHETHER A TRANSFER QUALIFIES AS A SALE?

Banker’s acceptances provide a way for a bank to finance a customer’s purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer’s liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its acceptance of the liability to make payment on the draft on its due date. An accepted draft is a negotiable financial instrument.

When the bank accepts a draft, it has a receivable from the customer that is payable when the draft matures. The bank also has a liability to the vendor for the acceptance of the draft. The vendor can wait until the draft matures for the receipt of cash or it can sell the accepted draft at a discount either to the accepting bank or to another third party in order to receive the cash earlier than the maturity date of the draft.

A risk participation is a contract between the bank accepting the draft (accepting bank) and a third party (participating bank) in which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank for a portion of the receivable from the customer drawing the draft in the event that the customer defaults. The participating bank in effect guarantees the credit of the customer.

The acceleration event, however, may be certain to occur in the future or may be probable of occurring. For example, it could be based on the mere passage of time, on the level of the outstanding balances of the transferred assets, or some other factor that eventually will occur. Acceleration provisions that are probable or certain of occurring should be considered a forward repurchase agreement since they operate automatically, which suggests that the portion of the transferred assets subject to the acceleration provisions were not sold. In some instances, acceleration provisions are contingent on future events and benefit the transferee. Such provisions may be considered contingent put options, which should not preclude sale accounting in respect of the portion subject to the acceleration provisions. This argument is appropriate when the benefit protects the transferee from loss on specific loans, such as a repurchase provision on delinquent loans.

In some instances (for example with revolving period securitisations where a liquidation period is specified), securitisations have acceleration provisions whereby cash flows (principal repayments) are allocated to certain designated (senior) securities first. These allocations can result in the investors in the senior securities receiving a disproportionate distribution and are referred to as acceleration clauses, turbo-mechanisms, sequential pay classes, or pre-set percentages. This is often done both as a yield enhancement mechanism and to provide the senior classes with greater protection against credit risk. Although this is not seen as affecting the determination of whether or not sale accounting is permissible, any disproportionate allocations should be considered in determining the fair value of both the assets sold and the assets retained by the transferor.
**IA 39.42** FACTORING RECEIVABLES

**QUESTION**

**DOES FACTORING RECEIVABLES QUALIFY FOR DERECOGNITION UNDER IAS 39?**

Factoring receivables usually consists of transferring receivables on a discounted basis to a bank without recourse. Factoring arrangements that meet the sales criteria should be accounted for in the same manner as a sale of receivables.

**IA 39.42** IMPACT OF A CONDITIONAL CALL OPTION

**EXAMPLE**

Transferor X sells mortgage loans with an expected life of 15 years to Transferee Y. The loans are not readily obtainable. Transferor X retains a call option that is not embedded in the loans and is not transferable. The call option permits Transferor X to call the loans if the 30-year US Treasury bond rate drops below 3%. In the past 30 years, the 30-year US Treasury bond rate has not dropped below 3%. It is considered remote that the call option will ever be exercisable. Does the call option preclude sale treatment? What if the call option were exercisable if rates dropped below 6%?

The call option is a contingent derivative and should be evaluated based on the likelihood of the contingent event occurring. The 3% option would not preclude sale treatment because the likelihood of the contingent event occurring is remote. Depending on the level of interest rates, the 6% option may preclude sale treatment. When the likelihood of the contingent event occurring is reasonably possible, judgement always should be used in evaluating contingent derivatives. Factors to consider consist primarily of the likelihood that a contingent event will occur and whether the transferee is constrained. In evaluating such a contingency, historical market conditions, expected volatility, and other factors should be considered. In instances where there is a remote likelihood that a contingent event will occur, the option should not affect the accounting for the transfer.

**IA 39.42** ACCELERATION PROVISION

**EXAMPLE**

Transferor X uses a special purpose entity, Y, to securitise financial assets that are not readily obtainable. The issued beneficial interests consist of two classes: Class A represents 80 percent of the total interests and is held by Transferee Y, Class B represents the remaining 20 percent and is held by Transferor X. The securitisation structure includes an acceleration provision in which the Class B beneficial interest holders do not receive any principal payments until the principal on the Class A interests has been paid in its entirety.

The acceleration provision is not considered a forward contract because Transferor X is not required to use its own funds to repurchase the Class A interest. In accounting for this transfer, 80 percent of the underlying financial assets (Class A) would be considered sold and the remaining 20 percent (Class B) would be considered a retained interest. However, if the SPE is consolidated under SIC 12, the sale effectively would be ignored, and the total assets would be reflected on X’s balance sheet.

**IA 39.42** FAIR VALUE REPURCHASE OPTION (CALL OPTIONS)

**COMPARISON WITH US GAAP**

US GAAP does not include the exception where the reacquisition price is fair value at the time of reacquisition.
IAS 39.42 - CLEAN-UP CALLS

**COMPARISON WITH US GAAP**

US GAAP provides a specific exception by permitting sale accounting in the case of ‘clean-up calls’ and ‘clean-ups’ structured as forwards. No such exception is provided under IAS 39. These features generally would preclude sale accounting under IAS 39 to the extent of the call. (Clean-up calls are options held by a servicer, who also may be the transferor, to purchase transferred financial assets when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome).

IAS 39.42 - REPURCHASE AGREEMENTS (FORWARDS)

**COMPARISON WITH US GAAP**

US GAAP follows a slightly different approach where the transferor is both entitled and obligated to repurchase or redeem an asset. Its starting point is based on specific, narrowly defined criteria that need to be satisfied for the agreement to be accounted for as a secured borrowing. IAS evaluates these transactions from the perspective of whether or not the transferee receives a lender’s return and whether or not the repurchase is to be effected at fair value. US GAAP does not specify that the terms of the transfer effectively provide the transferee with a lender’s return on the assets received in exchange for the transferred asset.

Additionally, US GAAP specifies that where a forward purchase contract can be satisfied with readily obtainable assets, further criteria must be met to treat it as a secured borrowing. These criteria require that the assets to be repurchased or redeemed must be substantially the same, the transferor must be able to repurchase or redeem the assets on substantially the agreed terms, even in the event of default by the transferee, the agreement to repurchase or redeem must be at a fixed or determinable price and the agreement must be entered into concurrently with the transfer [FASB 140, paragraph 47]. Further guidance is provided in SOP 90-3 as interpretation of the term ‘substantially the same’.

Under US GAAP, in order for the transferor to be able to redeem financial assets subject to a repurchase agreement on substantially the agreed terms, even in the event of default by the transferee, the transferor must at all times have obtained sufficient collateral to fund substantially all (90 percent or greater) of the purchase price of replacement securities from other parties in case the transferee defaults. The determination of whether this requirement has been met requires judgement, considering the contract provisions, and facts and circumstances at the transfer date.

IAS 39 neither specifically mentions any requirement in respect of whether or not the asset is readily obtainable where the transferor is entitled and obligated to repurchase or redeem the asset, nor sets out additional criteria to be satisfied over and above the agreement providing a lender’s return.

IAS 39.43 - RETENTION OF RISKS AND RETURNS

**COMPARISON WITH US GAAP**

The transfer of the risks and returns associated with ownership is not a determining criterion under U.S. GAAP in evaluating whether a transfer should be accounted for as a sale.

The transfer of control in respect of total return swaps specifically is not addressed under US GAAP. However, the retention of risk under a total return swap may cause the transfer to fail to isolation test under US GAAP and result in the transaction being accounted for as a financing.

IAS 39.47 - DERECOGNITION OF PART OF A FINANCIAL ASSET: ESTIMATING FAIR VALUES OF COMPONENTS ON DERECOGNITION

**QUESTION**

**WHAT ARE THE KEY FACTORS TO CONSIDER IN ESTIMATING THE FAIR VALUE OF FINANCIAL COMPONENTS IDENTIFIED IN CONNECTION WITH A TRANSFER OF A PORTION OF FINANCIAL ASSETS?**

The fair value of an asset or liability is determined using the principles set out in paragraphs 95-102.

When valuation techniques are used, the determination of fair value should incorporate those assumptions that market participants would use in their estimates of value, future revenues, and future costs. This includes assumptions about the timing and amounts of cash flows, including contractual terms, interest rates, defaults, prepayments, and volatility. Estimates of expected future cash flows should be based on appropriate and supportable assumptions and projections that are readily determinable. Some of the adjustments for risks, such as defaults and prepayments, can be based on historical patterns and known trends. All available evidence should be considered, and the weight given to the evidence should be commensurate with the extent to which the evidence can be objectively verified. If the estimate of cash flows is a range, the best estimate of the future cash flows should be determined by considering the likelihood of the possible outcomes. In addition, the assumptions and methodologies used in estimating the fair value of similar instruments should be consistent.

The transferor should ensure that all possible cash flows are contemplated. For example, the expected cash flows of a recourse obligation should be based on all probable credit losses over the life of the transferred receivables and should consider reasonably possible losses. Adjustment of cash flows may be appropriate to consider losses where the probability may be reliably determined. This adjustment, however, is usually made through the discount rate.

Determining the market discount rate requires considerable judgement. Conceptually, if the timing and amounts of future cash flows could be determined absolutely, the discount rate would be the risk-free rate. However, an adjustment to the risk-free rate or risk premium is necessary to recognize that defaults, prepayments, and other adjustments cannot be estimated precisely.
There are a number of methods that can be used to determine the appropriate discount rate for each cash flow. For example, rates may be constructed by building each component, starting with the risk-free rate. The components would include factors for accepting risk (such as risk of credit losses and prepayments), unavoidable expenses (such as servicing), volatility (such as volatility relating to credit and prepayments), and liquidity considerations. Rates also can be obtained directly or developed from market interest rates of comparable instruments. Discount rates are developed by isolating the risk premium of the comparable instrument and adding it to the applicable risk-free rate. The risk premium can be isolated by computing the embedded spread to a risk-free rate or the implied option-adjusted spread.

While recognizing the considerable subjectivity needed to estimate fair values of components, without objective evidence of values, it would be inappropriate to recognize a gain from allocating the basis between the various components such that the carrying value of the sum of the parts plus the recognized gain is greater than the fair value of the total asset without substantiating market transactions. It is often the case in instances in which the value of the parts exceeds the fair value of the whole that some aspect of the valuation is not being fully comprehended by the model. is indicative either of a failure to recognize a financial asset or liability or of measurement errors in arriving at a reliable fair value.

**IAS 39.47 - CARRYING AMOUNT: COMPONENTS**

**QUESTION**

**WHAT IS THE CARRYING AMOUNT OF AN ASSET FOR PURPOSES OF ALLOCATING BASIS?**

While IAS 39 does not define the term ‘carrying amount’, this term is defined in various other pronouncements, including IAS 16.5, and IAS 38.7. In these Statements, the carrying amount is defined to encompass unamortised premiums or discounts, acquisition costs, and impairment amounts, such as an allowance for uncollectable amounts.

When only a portion of the financial assets is transferred, the allocation of any valuation allowances and impairment amounts to those assets transferred and retained generally should be done based on the relative fair values of the portion of the asset sold and the portion retained. For example, the percentage of the fair value of credit card loans transferred determined by dividing the fair value of the amount transferred by the total fair value of all credit card loans held at the time of the transfer is used to allocate a portion of the allowance for uncollectable amounts to the amount transferred.

**IAS 39.47 - CARRYING AMOUNT: ACCRUED INTEREST**

**QUESTION**

**IS ACCRUED INTEREST PART OF THE CARRYING AMOUNT OF THE TRANSFERRED ASSET?**

Accrued interest is a separate financial asset that may or may not be transferred in the same transaction. Accrued interest that is retained is not included in the carrying amount of the transferred asset because it is a separate financial asset and a present benefit that already has been recognized. If retained accrued interest were to be included in the carrying amount of the transferred assets, its basis could be reduced as a result of the allocation of the carrying amount based on fair values, and an additional gain would result when the interest was collected.

**IAS 39.47 - CARRYING AMOUNT: RETAINED INTERESTS**

**QUESTION**

**WHAT ARE RETAINED INTERESTS?**

Retained interests relate to identifiable, contractual rights to receive that portion of the economic benefits (or cash flows) that comprise financial assets over which the transferor does not relinquish control. Examples of retained interests in a transfer of financial assets include servicing assets, retained undivided interests in the transferred assets (for instance, a retained interest-only strip or a percentage interest in the subject receivables), securities backed by the transferred assets, and retained interests in securitisation trusts. Distinguishing characteristics of retained interests are that they are always assets held by the transferor and represent the portion of those expected cash flows from the assets being transferred that is retained by the transferor.

**IAS 39.47 - SECURITISATION WITH 100 PERCENT BENEFICIAL INTERESTS RETAINED**

**QUESTION**

**UNDER WHAT CIRCUMSTANCES WOULD AN ENTITY ENTER INTO A SECURITISATION TRANSACTION AND RETAIN ALL OF THE BENEFICIAL INTERESTS?**

Often the entity securitising collateralised loans will sell all or a portion of the resulting asset-backed securities. However, an entity securitising collateralised loans may also retain all of the resulting asset-backed securities. One reason why this is done is to improve regulatory capital ratios of the entity securitising loans. Another reason is to facilitate repurchase transactions, because it is easier to enter into repurchase agreements with asset-backed securities than with loans.

**IAS 39.47 - ACCOUNTING: 100 PERCENT BENEFICIAL INTERESTS RETAINED**

**QUESTION**

**HOW ARE BENEFICIAL INTERESTS ACCOUNTED FOR IF, IN A SECURITISATION, AN ENTITY SECURITISES FINANCIAL ASSETS AND RETAINS ALL OF THE RESULTING SECURITIES?**

The transaction is accounted for as neither a sale nor a financing. Even though the form of the asset changes as a result of the securitisation, the carrying amount of the assets that are the subject of the securitisation is not allocated to the individual securities. The separation of financial assets is not permitted under IAS 39 unless they include derivative instruments that are required to be separated under IAS 39 or debt and equity components that are required to be separated under IAS 32.
IAS 39.47 • ALLOCATION OF THE CARRYING AMOUNT IN A SECURED BORROWING TRANSACTION

QUESTION


No. The separation of financial assets is not permitted under IAS 39 unless they include derivative instruments that are required to be separated under IAS 39 or debt and equity components that are required to be separated under IAS 32. For example, a transferor may securitise receivables and the securities issued consist of senior and subordinated securities. The transfer of receivables represented by the senior securities fails to meet the criteria for a derecognition because the transferor retains a call option. In this situation, the carrying amount of the receivables should not be allocated to the senior securities, subordinated securities, and, if applicable, to any servicing asset retained. Rather, the asset should retain its original classification. Even though the transferred assets are retained in a different form, the carrying amount of the transferred assets is not allocated to the asset’s components to recognize this new form.

IAS 39.47 • RETENTION OF ALL BENEFICIAL INTERESTS WITH INTENT TO SELL

QUESTION

IS BASIS ALLOCATION PERMITTED IF A TRANSFEROR INITIALLY RECEIVES ALL OF THE BENEFICIAL INTERESTS RESULTING FROM A SECURITISATION WITH THE INTENT TO TRANSFER THE BENEFICIAL INTERESTS TO UNRELATED THIRD PARTIES AT A LATER DATE?

No. Basis allocation is not appropriate until beneficial interests are transferred to the unrelated third parties and that portion of the transferred assets qualifies for derecognition.

IAS 39.47 • FORWARD AGREEMENT ON A PORTION OF THE TRANSFERRED ASSETS

EXAMPLE

Transferor X uses a special purpose entity, Y, to securitise financial assets that are not readily obtainable. Assume that consolidation of the SPE is not required under SIC 12. The issued beneficial interests consist of two classes: Class A represents 70 percent of the total interests held by Transferee Y, Class B represents the remaining 30 percent. While both classes receive interest payments while the interests are outstanding, under this structure, the Class A holders receive all principal payments from the underlying assets until their interest is paid in its entirety, after which the Class B interests receive the remaining cash flows. Transferor X sells all the beneficial interest to Transferee Y. However, the Class B interests are subject to a forward commitment that requires Transferor X to repurchase these interests when the Class A interests have been paid in their entirety.

In this situation, the financial assets are separated effectively into two distinct interests through the issuance of the beneficial interest and thus the interest subject to the forward contract has been detached. Transferor X should consider 70 percent of the loans as having been sold. A portion of the remaining 30 percent is sold and a portion retained based on the estimate of cash flows that will be remitted to Transferee Y before the Class A holders are repaid.

IAS 39.49 • PARTIAL DERECOGNITION WITH BASIS ALLOCATION ILLUSTRATED

EXAMPLE

Company A owns $1,000,000 face amount of loans that contractually yield 10% interest over their life. The carrying amount of these loans after considering the $20,000 allowance for loan losses is $980,000. Company A sells 90 percent of the principal, plus the right to receive interest income of 8% without recourse to an investor for $590,000 in cash. The transfer meets all the criteria for a sale. Company A retains the right to service these loans, and the servicing contract stipulates a 1% fee as compensation for performing the servicing. Company A also retains an interest-only strip for the portion of the interest coupon not sold (one percent). At the date of transfer, the fair value of the retained 10 percent of the loan is $100,000; the fair value of the servicing asset is $15,000; and the fair value of the interest-only strip is $35,000.

The following table demonstrates the allocation of this loan between the sold and retained interests:

<table>
<thead>
<tr>
<th>Interest</th>
<th>Fair value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount*</th>
<th>Sold Interest</th>
<th>Retained Interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$900,000</td>
<td>85.71%</td>
<td>$840,000</td>
<td>$840,000</td>
<td>-</td>
</tr>
<tr>
<td>Loans retained</td>
<td>$100,000</td>
<td>9.09%</td>
<td>93,333</td>
<td>93,333</td>
<td>$15,000</td>
</tr>
<tr>
<td>IO strip</td>
<td>$5,000</td>
<td>1.39%</td>
<td>31,667</td>
<td>31,667</td>
<td>3,333</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>$5,000</td>
<td>1.39%</td>
<td>14,000</td>
<td>14,000</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>$1,050,000</td>
<td>100.00%</td>
<td>$900,000</td>
<td>$840,000</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

* The allocated carrying amount is calculated as the interest’s percentage of total fair value times the aggregate carrying amount prior to the transfer ($980,000).

IAS 39.50 • SERVICING DESCRIBED

QUESTION

WHAT IS SERVICING?

Servicing refers to activities associated with the collection of cash flows from receivables or other financial assets after origination and the distribution of that cash to investors if the receivables are owned by other entities. Servicing may include the temporary investment and distribution to the financial asset owners of all or a portion of the cash collected. Servicing activities may also include monitoring delinquencies, advancing delinquent payments, restructuring receivables, and foreclosing on the collateral underlying the receivables when necessary. If the receivables are mortgage loans, servicing activities often include collecting and disbursing escrow payments for taxes and insurance. Servicing activities are inherent in all receivables; however, they do not need to be performed by the owner of the receivables. If the receivables are being serviced for another entity, the servicer generally receives a fee for performing these activities. This fee is usually a contractual amount received based on a fixed percentage of the outstanding receivables for the period. Servicers also, may receive additional compensation by retaining late charges, other ancillary fees, and the float, which is the net interest earned on funds held by the servicer before disbursement. The compensation received by the servicer is referred to as the benefits of servicing.
WHAT ARE SERVICING ASSETS AND LIABILITIES?

Servicing becomes a distinct asset or liability when it is contractually separated from the related receivables and thus becomes a servicing contract. The following are examples of servicing that are separated from the related receivables under a servicing contract:

- the owner of the receivables sells the servicing rights to another entity and retains the receivables;
- the owner of the receivables sells the receivables but retains the right to service those receivables; and
- receivables are exchanged for securities (backed by the receivables) that may be sold at a later date, and the securities do not include the right to service the underlying receivables.

Once the servicing has been separated from the related financial assets, it may represent an economic benefit (asset) to, or obligation (liability) of, the servicer. A servicing asset is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to have a positive fair value. A servicing liability is a contract to service financial assets under which the estimated future revenues from the stated servicing fees, late charges, and other ancillary revenues are expected to have a negative fair value. Intuitively, the servicing in this instance represents an obligation, because the servicer would have to pay another entity to assume the servicing contract or use its assets in the future to perform under the servicing contract.

Servicing liabilities initially have a negative fair value to the servicer. When the estimated future revenues will enable the servicer to performing the servicing but provide no additional benefits, the servicer has neither an asset nor a liability and the fair value of this servicing contract is zero. A servicing contract with a positive fair value is considered to be one that would not be unfavourable for a substitute servicer should one be required, and includes the profit that would be demanded in the marketplace. One approach in determining whether a servicing contract has a positive fair value is to use the servicing costs of an average servicer plus a reasonable profit margin if this information is available.

HOW IS A SERVICING FEE DISTINGUISHED FROM AN INTEREST-ONLY RECEIVABLE?

IAS 39.50 suggests that servicing assets are based on contractually specified fees. In the example in paragraph 50, retaining an interest in excess of the contractually specified servicing fee is an interest-only strip receivable. IAS 39.50 suggests that servicing assets are based on contractually specified fees. In the example in paragraph 50, retaining an interest in excess of the contractually specified servicing fee is an interest-only strip receivable.

In most revolving-period securitisations, a trust purchases short-term receivables (such as credit card or 90-day receivables) from the transferor and, concurrently, issues long-term beneficial interests (such as five-year certificates). The funds collected on the short-term receivables are used first to provide a return to the holders of the beneficial interests and then to purchase new receivables from the transferor. This procedure of purchasing new receivables with funds collected from previously transferred receivables continues until the liquidation period begins. Often the transferor is the servicer; therefore, the transferor will in effect use the funds it collected to purchase its own receivables on behalf of the trust.

A servicing asset retained in a sale or securitisation of financial assets should initially be recognised at its cost based on the allocated carrying amount determined using relative fair values at the date of the sale or securitisation. However, if the servicer obtains a servicing asset by purchase or a servicing liability by assumption (including servicing liabilities resulting from sales or securitisation of financial assets), the servicing contract initially should be recognised in the balance sheet at its fair value. When the servicing contract is purchased or assumed for cash, its fair value is presumptively the price paid or received. In addition, servicing assets should be reported separately from servicing liabilities in the balance sheet.

WHAT IS A REVOLVING PERIOD SECURITISATION AND HOW IS IT ACCOUNTED FOR?

In most revolving-period securitisations, a trust purchases short-term receivables (such as credit card or 90-day receivables) from the transferor and, concurrently, issues long-term beneficial interests (such as five-year certificates). The funds collected on the short-term receivables are used first to provide a return to the holders of the beneficial interests and then to purchase new receivables from the transferor. This procedure of purchasing new receivables with funds collected from previously transferred receivables continues until the liquidation period begins. Often the transferor is the servicer; therefore, the transferor will in effect use the funds it collected to purchase its own receivables on behalf of the trust.

If the securitisation meets the sales criteria, each transfer of receivables to the trust (the initial sale and each subsequent transfer using collected funds) is a separate sale of financial assets and should be accounted for as such. The gain or loss on each sale is limited to the gain or loss on only those receivables that exist and have been sold. Similarly, any servicing asset or liability and interest-only strip is limited to the servicing and excess interest on the receivables that exist and have been sold. Therefore, servicing on new receivables may not be included in the balance sheet until those receivables have been originated and sold to the trust.
The recording of a servicing asset or liability and/or interest-only strip for each new sale makes the accounting complex, because each servicing asset or liability and interest-only strip resulting from the separate sales should be tracked separately. Intuitively, the greater the number of sales that make up a pool of assets, the more complex the accounting will become.

The accounting for the initial sale in a revolving-period securitisation is very similar to the accounting for a standard securitisation. One primary difference is that the transferor may be required to recognise an asset or liability for the implicit forward contract if its fair value is other than zero. Usually, the transferor is required by agreement to sell, and the trust is required to purchase, new receivables using funds collected during the revolving period. This agreement is an implicit forward contract - that is, a component of the sales proceeds, and thus, should be recognised initially at fair value in the transferor’s statement of financial position. If the forward is entered into at market terms, its fair value is zero.

A transferor in a revolving-period securitisation may use a master trust for many securitisations. The transferor can achieve additional securitisations by transferring receivables to the existing trust in consideration for new securities and then selling those securities to investors. This transfer of new receivables to the trust is neither a sale nor a borrowing because the transfer only increases the transferor’s beneficial interests in the transferred assets. It is not until the transferor sells the beneficial interests to investors that the transferor can record a sale.

**IAS 39.50 - REVOLVING-PERIOD SECURITISATION: COMMITMENT TO FUTURE TRANSFERS**

**QUESTION**

**IF UNDER A REVOLVING-PERIOD SECURITISATION, A TRANSFEROR COMMITS TO SELL NON INTEREST-BEARING TRADE RECEIVABLES AT AN AMOUNT BELOW THEIR STATED VALUE TO COMPENSATE INVESTORS FOR THE TIME VALUE OF MONEY, IS A LOSS RECOGNISED AT THE COMMITMENT DATE?**

The fair value of the forward is based on the difference between the agreed-upon discount and a market discount. If the discount rate in the agreement equals the market rate, there is no loss on the forward. The loss to be incurred as a result of selling the receivables at a discount is for receivables that do not yet exist. Accordingly, the loss should not be recognised until the receivables are generated, which has the effect of matching the loss on the receivables to be sold with the revenue that created the receivables. The transferor should recognise the loss due to its commitment to sell non-interest-bearing receivables to the trust when the receivables are created and it is known that they will be transferred.

**IAS 39.50 - COMPONENTS OF SALES PROCEEDS**

**EXAMPLE**

Company A originates €1,000,000 of long-term loans that have a fixed interest rate of 10 percent. The loans have a carrying value of €960,000. Company A sells the loans to an investor and does not retain any interest in the loans. The transfer meets all the conditions to be accounted for as a sale. As compensation, the investor agrees to give Company A €75,000 in cash at the transfer date and a one-year, interest-bearing note for €300,000 (fair value equals €500,000). In addition, Company A agrees to provide full recourse to the investor (fair value of €30,000) and provide the servicing without compensation (fair value of €60,000). Finally, Company A agrees to provide the investor a variable rate on the receivables equal to LIBOR plus one percent. The fair value of a ‘receive fixed, pay variable’ interest rate swap on a notional amount of €1,000,000 that amortises similarly to the loans is a negative €10,000. Company A would recognise the sale as follows:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>€ 575,000</td>
<td></td>
</tr>
<tr>
<td>Note receivable</td>
<td>€ 500,000</td>
<td>€ 900,000</td>
</tr>
<tr>
<td>Loans, net</td>
<td></td>
<td>€ 50,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Servicing liability</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Pre-tax gain on sale</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**IAS 39.50 - SERVICING: A NON-FINANCIAL ASSET**

**COMPARISON WITH US GAAP**

Under US GAAP, servicing rights are treated specifically as non-financial assets or liabilities [FASB 140, paragraph 61]. US GAAP records servicing rights initially at fair value, but then amortises the basis over the related loan terms. Under IAS 38, although the benchmark treatment subsequent to initial recognition is to carry the asset at amortised cost, the allowed alternative treatment permits the recognition of servicing rights at fair value where, and only where this value can be determined by reference to an active market for the asset (IAS 38.64).

Transfers where the owner of receivables sells the servicing rights to another entity and retains the receivables are not subject to the derecognition criteria for financial instruments under US GAAP since servicing is regarded as a non-financial asset to which the derecognition provisions of FASB 140 do not apply. Under US GAAP, a reasonable estimate of fair value is considered sufficient where it is not practicable to determine fair value when allocating basis. IAS 39’s requirement of a reliable estimate represents a higher threshold in the determination of fair value though IAS 39 presumes that a reliable estimate of fair value can be obtained.
**IAS 39.51 · ASSET DERECOGNITION COUPLED WITH A NEW FINANCIAL ASSET OR LIABILITY**

**QUESTION**

**WHAT ARE NEW FINANCIAL ASSETS OBTAINED AND NEW LIABILITIES INCURRED IN CONNECTION WITH A TRANSFER?**

No further guidance is provided in IAS 39 as to what constitutes a new financial asset or liability, and judgment will be necessary to determine the extent to which the terms of the asset subsequent to the transfer differ from those prior to the transfer. Both form and substance must be assessed and the component parts of resultant assets and liabilities may need to be analysed carefully.

On completion of a transfer that meets the criteria for sale accounting, the entity recognises all assets obtained and liabilities incurred in its balance sheet.

**IAS 39.51 · PROCEEDS DESCRIBED**

**QUESTION**

**WHAT ARE PROCEEDS?**

The term ‘proceeds’ refers to those assets obtained, less any liabilities incurred, as consideration for the transfer. Retained interests are not proceeds.

Cash and other non-derivative assets received are easily identified as part of the sales proceeds. Common items that are obtained or incurred in sales of financial assets that should be included as part of the proceeds include:

- Holdbacks of cash sales proceeds that belong to the transferor but are held in escrow or held by the transferee. Holdbacks generally are used to enhance credit and ensure performance on guarantees of the transferor. This does not include initial cash deposits put up by the transferor, out of its own cash or debtor deposits, as a performance guarantee;
- Servicing liabilities (an obligation to service the financial assets for less than adequate compensation);
- Call options held on the transferred financial assets (for example, a call option on financial assets that are readily obtainable);
- Put options written on the transferred assets (for example, guarantees or recourse obligations);
- Forward commitments (for example, commitments to deliver additional receivables in a revolving-period securitisation), but only to the extent that they are off-market; and
- Swaps (for example, provisions that convert interest rates from fixed to variable or vice versa, or exchange currencies).

Sometimes, it may be difficult to determine whether a component in a sale is a retained interest or part of the sales proceeds. If the item is a liability incurred by the transferor, it is considered to be part of the proceeds since prior to the transfer of the financial assets, the transferor does not have an obligation to the transferee or any other party associated with the financial assets. The liability incurred only arises out of the transfer and, therefore, is considered new and not a retained interest. For this reason, credit recourse, a common component of transfers of financial assets, is by definition always part of the sales proceeds. In addition to recourse, there are many other types of obligations and guarantees that may be specified in a transfer of financial assets. The transferor should identify all such liabilities and record them at their fair value.

**IAS 39.51 · DERIVATIVES TRANSACTED IN A TRANSFER OF FINANCIAL ASSETS**

**QUESTION**

**IS A DERIVATIVE FINANCIAL INSTRUMENT ENTERED INTO IN CONNECTION WITH A TRANSFER CONSIDERED TO BE A NEW ASSET OR LIABILITY?**

If a derivative financial instrument is entered into concurrently with and as part of a transfer of financial assets and its cash flows are not inherent in the underlying assets being transferred, it is either an asset obtained or a liability incurred in a transfer and should be considered part of the sales proceeds.

**IAS 39.51 · PROCEEDS INDISTINGUISHABLE FROM RETAINED INTERESTS**

**QUESTION**

**HOW SHOULD A TRANSFEROR ACCOUNT FOR AN ASSET IT OBTAINS IN CONNECTION WITH A PARTIAL TRANSFER IF THE TRANSFEROR CANNOT CLEARLY DETERMINE WHETHER THE ASSET IS A PORTION OF THE ASSETS BEING SOLD OR A NEW ASSET?**

If a transferor cannot determine whether an asset is a retained interest or a new asset obtained in connection with a partial transfer, the asset should be treated as proceeds from the sale.

**IAS 39.51 · RETAINED INTERESTS VS. PROCEEDS: CONTINUING INVOLVEMENT**

**QUESTION**

**WHAT ARE SOME FORMS OF CONTINUING INVOLVEMENT WITH TRANSFERRED ASSETS THAT DO NOT REPRESENT RETAINED INTERESTS?**

Forms of continuing involvement with transferred assets that do not represent retained interests include liabilities incurred and derivatives resulting from the transfer. For example, recourse provisions, put options and guarantees of a specific return are considered to be new liabilities and not retained interests. Liabilities and derivatives that are not part of the original financing asset are not considered retained interests.
**IAS 39.54(a)** - ALLOCATION WHEN FAIR VALUE CANNOT BE DETERMINED RELIABLY

**EXAMPLE**

Company A owns $1,000,000 face amount of loans that contractually yield 10% interest over their life. The carrying amount of these loans after considering the $20,000 allowance for loan losses is $980,000. Company A sells 90 percent of the principal, plus the right to receive interest income of 8% without recourse to an investor for $900,000 in cash. The transfer meets all the criteria for a sale. Company A retains the right to service these loans, and the servicing contract stipulates a 1% fee as compensation for performing the servicing. Company A also retains an interest-only strip for the portion of the interest coupon not sold (one percent). At the date of transfer, the fair value of the retained 10 percent of the loan is $100,000; the fair value of the servicing asset is $15,000; and the fair value of the interest-only strip could not be measured reliably.

The following table demonstrates the allocation of this loan between the sold and retained interests:

<table>
<thead>
<tr>
<th>Interest</th>
<th>Fair value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
<th>Sold Interest</th>
<th>Retained Interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$900,000</td>
<td>88.67</td>
<td>$868,965</td>
<td>$868,965</td>
<td>-</td>
</tr>
<tr>
<td>Loans retained</td>
<td>100,000</td>
<td>9.85</td>
<td>96,552</td>
<td>$96,552</td>
<td></td>
</tr>
<tr>
<td>IO strip</td>
<td>0</td>
<td>0.00</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>15,000</td>
<td>1.48</td>
<td>14,883</td>
<td>14,883</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$1,015,000</td>
<td>100.00</td>
<td>$980,000</td>
<td>$868,965</td>
<td>$111,035</td>
</tr>
</tbody>
</table>

**IAS 39.56** - OFFSETTING GUARANTEE OBLIGATIONS AGAINST RETAINED INTERESTS

**QUESTION**

Can new guarantee obligations incurred in connection with a transfer of financial assets be offset against retained interests pledged as collateral under the guarantee?

No. Liabilities recognised as part of the proceeds (such as recourse obligations) generally may not be offset against assets, retained or newly obtained. They generally would not meet the requirements of IAS 32.33-41, for the right of set-off.

**IAS 39.57** - DERECOGNITION OF A FINANCIAL LIABILITY: EXPLICIT RELEASE BY CREDITOR

**QUESTION**

Does a debtor have to be explicitly released by the creditor for the debt to be extinguished?

Generally the debtor is explicitly released. However, in some situations, the debt can be discharged without an explicit release by the creditor. For example, if non-recourse debt is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller/debtor. In this instance, the seller/debtor may derecognise the non-recourse debt.

**IAS 39.61** - MODIFICATION OF TERMS

**QUESTION**

What is meant by modification of terms?

A modification of debt terms may include, among other things, any one or a combination of the following:

- reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt;
- extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk;
- reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement; and
- reduction (absolute or contingent) of accrued interest.

Cash flows can be affected by changes in principal amounts, interest rates, or maturity. They, also can be affected by fees exchanged between the debtor and creditor to effect changes in:

- recourse or non-recourse features;
- priority of the obligation;
- collateralised (including changes in collateral) or non-collateralised features;
- debt covenants and/or waivers;
- the guarantor (or elimination of the guarantor); and
- option features.
**IAS 39.38(c) - RETENTION OF RISKS AND REWARDS: PENALTY PROVISIONS**

**EXAMPLE**

Transferor X transfers receivables with a carrying value of $90 and a put option that expires in 10 days to Transferee Y. In the exchange, Transferee Y pays Transferor X $100, the fair value of the receivables. Under the terms of the put option, Transferee Y may put the receivables back to Transferor X for $101. However, if Transferee Y does not put the receivables back to Transferor X, Transferee Y must pay Transferor X an additional $50. The possibility of the fair value of the receivables increasing to $151 in 10 days is remote and, therefore, exercise of the option appears virtually assured at inception.

However, because at inception it appears virtually assured that the put option will be exercised, Transferor X has effectively maintained control over the receivables, and this transaction should be accounted for as a secured borrowing for $100.

**IAS 39.41(a) - TRANSFEREE OBTAINS CONTROL**

**QUESTION**

**HOW IS THE TRANSFER OF CONTROL ASSESSED FROM THE PERSPECTIVE OF THE TRANSFEREE?**

The condition in paragraph 41(a) encompasses the notion that an entity that has recorded an asset can use it in various ways to recover the future economic benefits in the financial asset. Thus, recovery by the transferee not only involves holding and collecting cash inflows according to the underlying original contractual terms inherent in those assets, but the transferee, also, must have the right to obtain the benefits through other alternatives, such as exchanging them either for other assets, including future goods and services, or in satisfaction of an obligation; or through an assignment to a third party. A transferee may be able to use a transferred asset in some of these ways but not others. A transferee that does not have all these alternatives available to it may control the transferred asset if the alternatives that are available allow the transferee to realise the full fair value of the economic benefits that comprise the asset. For example, if the transferee is prohibited from pledging the financial asset but may exchange it, sale treatment would not be precluded necessarily because the transferee could obtain the full fair value of the transferred asset through an exchange. Similarly, if the transferee is prohibited from exchanging the transferred asset, the asset may still be considered controlled by the transferee if it could realise the full economic value inherent in the cash flows of the asset by pledging it.

The assessment of control is more complex where the financial assets being transferred are not readily obtainable and are subject to put options, call options, or repurchase agreements. These features may constrain the transferee economically even though the transferee is not contractually precluded from selling or pledging the transferred assets and thus may permit the transferor to retain control over the transferred asset. In such a case, IAS 39.41(a) would be satisfied, indicating that the transferee has the ability to obtain the benefits of the asset and therefore that the transferor has lost control of the asset. However, since the transferor has a right to reacquire the transferred asset, in terms of IAS 39.38(a), the transferee is considered to have retained control and the asset, therefore, would not be derecognised. Where the position of either enterprise indicates that the transferor has retained control, IAS 39.37 requires that the transferor should not remove the asset from its balance sheet.

**IAS 39.41(a) - MINOR CONSTRAINTS**

**QUESTION**

**HOW ARE CONSTRAINTS ON A TRANSFEREE'S ABILITY TO SELL OR PLEDGE TRANSFERRED ASSETS IMPOSED BY A TRANSFEROR EVALUATED TO DETERMINE WHETHER THE TRANSFER QUALIFIES FOR DERECOGNITION?**

Constraints imposed by a transferor are evaluated based on their impact on the transferee. Many transferor-imposed or other conditions on a transferee’s contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, some transferor-imposed conditions may not be indicative of a failure to transfer control to a transferee. The following are examples of minor constraints that generally should not preclude sale treatment since they presumptively do not constrain a transferee from exercising its right to pledge or exchange approximately the full fair value of the transferred asset:

- a right of first refusal granted to transferors that allows reacquisition of transferred financial assets whenever a transferee solicits a bona fide offer of purchase from a third party;
- a stipulation contained in an agreement of sale that requires permission of the transferor to sell or pledge financial assets transferred, which, in the case of the transferor, is not to be withheld unreasonably; and
- qualifications prohibiting the transferee from subsequently selling or assigning transferred financial assets to competitors of the transferor and the transferee is able to sell or assign its beneficial interests to a number of third parties who do not compete with the transferor. [FASB 125, paragraph 25].

**IAS 39.41(a) - EXTERNAL CONSTRAINTS**

**QUESTION**

**HOW ARE EXTERNALLY IMPOSED CONSTRAINTS ON A TRANSFEREE'S ABILITY TO PLEDGE OR EXCHANGE TRANSFERRED ASSETS EVALUATED TO DETERMINE WHETHER THE TRANSFER QUALIFIES FOR DERECOGNITION?**

Judgement is exercised in determining whether external constraints preclude sale treatment. One of the factors that should be considered is whether the transferor surrenders all the control it has in the financial asset or whether the external constraint provides the transferor with the ability or an advantage to re-obtain the transferred asset (that is, the transferor obtains a benefit from the external constraint that results in the transferor retaining substantially all the risks and returns of ownership). In many cases, an external constraint will not preclude sale treatment, for example, a pre-existing restriction imposed by the issuer of, and embedded in, the assets to be transferred may require that transfers of the financial asset be to, or approved by, the original issuer of the financial assets. In this situation, the transferor does not obtain the ability to reacquire the assets.
IAS 39.41(a) - ELIMINATION OF CONSTRAINTS SUBSEQUENT TO THE TRANSFER

QUESTION

IF A RESTRICTION IMPOSED BY A TRANSFEROR IS DETERMINED TO PRECLUDE DERECOGNITION, WHAT IS THE ACCOUNTING CONSEQUENCE IF SUCH RESTRICTION IS SUBSEQUENTLY REMOVED OR LAPSES?

If a restriction that precludes derecognition is removed or lapses, derecognition would then be appropriate, providing all of the other conditions for derecognition are met.

IAS 39.41(a) - EXTERNAL CONSTRAINT MAY NOT PRECLUDE SALE TREATMENT

EXAMPLE

Entity X owns stock in entity B. Entity B desires to restrict the number of shareholders; thus, a condition contained in the shareholder agreement requires that holders of B’s stock cannot transfer such stock without the approval of B or the stock must be sold to B. X transfers the stock to Y, a buyer approved by B, for cash and has no other involvement with such stock.

The shareholder agreement precludes Y from selling the stock without the approval of B. The transfer should be accounted for as a sale (provided the transfer meets all other derecognition criteria) because X surrendered all control it had in the financial asset to Y and the external constraint does not involve X, provide X with a means for repurchasing the stock from Y, or permit X to obtain any other advantage with respect to the stock.

IAS 39.41(b) - SPECIAL PURPOSE ENTITIES

QUESTION

WHAT ARE SPECIAL PURPOSE ENTITIES (SPEs) AND WHY ARE THEY COMMONLY USED IN CONNECTION WITH SECURITISATION TRANSACTIONS?

SPEs, which may take the form of a corporation, trust, partnership, or unincorporated entity, are often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee, or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (in other words, they operate on so-called ‘autopilot’).

Structured transactions, such as securitisations and certain other asset-based financing arrangements, typically seek, as their primary economic objective, to legally isolate the assets from the party providing the assets (and from that party’s creditors) to avoid a credit exposure to the transferor. This isolation is often achieved through a special purpose entity. For many sellers of financial assets, structured arrangements that isolate the assets permit access to capital markets at more favourable prices than might otherwise be available since credit agencies and investors require a lower return from structures that avoid the consequences arising from bankruptcies. This ability is particularly important for those enterprises whose credit ratings may reflect the adverse effects of financial, operational or environmental risks not directly attributable to the assets being transferred. It does not, however, necessarily protect the sponsor from the requirement to consolidate the SPE for accounting purposes which may, through its impact on the sponsor’s financial ratios, negate certain of the benefits of isolating the SPE.

A special purpose entity may issue different types of beneficial interests, multiple classes of interests, and classes of interests with different maturities. Several forms of SPE are common, depending on the asset being securitised, the securities issued by the entity and the legal framework governing the entity’s operations. These include grantor trusts, owner trusts, revolving trusts, master trusts, special purpose corporations, and REMICS (real estate mortgage investment conduits).

Typically, the special purpose entity is prevented from selling, assigning, or pledging its direct interest in any financial asset it holds; however, the owners of the beneficial interests generally have the right to pledge or exchange their beneficial interests.
**IA 39.41(b) - TRANSFER TO SPECIAL PURPOSE ENTITY: IMPACT ON DERECOGNITION**

**QUESTION**

**HOW DOES THE TRANSFER TO A SPECIAL PURPOSE ENTITY AFFECT DERECOGNITION?**

When an enterprise transfers assets to an SPE, two tests of control need to be applied. The first test determines whether control over the contractual rights comprising the financial assets has been surrendered (in terms of the derecognition criteria in IAS 39) and therefore whether sale accounting is permitted. The second test determines whether the transferor retains sufficient control such that consolidation of the SPE is required in the transferor’s financial statements in terms of SIC 12. If consolidation is required, the sale becomes a borrowing transaction. This second test must be applied regardless of the results of the first test.

As a result of the application of these two tests, it is possible that instances could occur where, despite the criteria for derecognition being satisfied, the effects of sale accounting in that enterprise’s financial statements would be nullified because the transferor is required to consolidate the SPE.

The structure, terms, and conditions of the beneficial interest as well as the nature of the special purpose entity’s activities must be analysed carefully in applying the derecognition criteria when assets are transferred to an SPE. These factors are useful indicators of the extent to which control over the contractual rights comprising the transferred financial assets has been surrendered.

**IA 39.41(b) - QUALIFYING SPECIAL PURPOSE ENTITIES**

**COMPARISON WITH US GAAP**

Under US GAAP, an exception to the normal consolidation criteria is made for ‘qualifying special purpose entities’ (QSPE). If an SPE meets the conditions for being a QSPE, it is not consolidated and derecognition is permitted to the extent that the transferor receives consideration other than a beneficial interest in the QSPE. The holders of the beneficial interests in the QSPE must have the right, free of constraining conditions, to exchange or pledge those beneficial interests, thus indicating that the transferor has surrendered effective control. If an SPE fails to meet the criteria for a QSPE, derecognition may be permitted if derecognition criteria are met and there is sufficient third party equity capital invested in the SPE so as to avoid its consolidation with the transferor.

There is no QSPE exception to the consolidation criteria under IAS 39. However, a transaction between an SPE and a third party investor may qualify for derecognition and such transaction would not be affected by the consolidation of the SPE.
Transfers, particularly those involving derivatives, must be considered in terms of their control aspects. The concept of control, as developed in IAS 39, focuses on the ability of the transferee to obtain all or most of the rights to benefits comprising a financial asset (essentially the risks and returns of ownership). This condition usually is considered to be met if the transferee has the ability to exchange or pledge approximately the full fair value of the transferred asset (see paragraph 41). The wording of paragraph 41 requires the use of judgement in determining whether sale accounting is appropriate, having regard to the substance of the transaction rather than its legal form.

In many instances, derivatives are embedded in a transfer or securitisation structure or are not explicitly defined as derivatives. For example, the amortisation terms of a revolving credit card securitisation may call for the allocation of all principal cash flows to outside investors during the amortisation period, with any remainder going to the retained interest of the seller. This provision may be in the form of a call option, put option, or forward contract. Identifying the implicit derivative in this example requires a thorough understanding of the transfer structure, terms, and conditions. A further assessment is required in these circumstances to determine the applicability of the embedded derivative provisions in IAS 39 (see IAS 39.22).

Derivatives often are included in transfers of financial assets, either explicitly or implicitly. The identification and evaluation of derivatives that are included in a transfer of financial assets is crucial in applying the derecognition criteria because certain derivatives have control elements that may preclude sale treatment.

Derivatives commonly found in transfers of financial assets include put options, call options, forward or repurchase contracts, forward sales contracts, and swap agreements. Put options provide the transferee with the right to require the transferor to sell some or all of the financial assets that were sold, for example, to repurchase delinquent receivables. Call options provide the transferor with the right to repurchase some or all of the financial assets sold to the transferee. Forward or repurchase agreements require the transferor to sell and the transferee to buy some or all of the financial assets that were sold before their scheduled maturity. Forward sales contracts require the transferor to sell and the transferee to buy additional financial assets in the future. Swap agreements effectively change one or more cash flows of the underlying transferred assets (or debt issued by a special purpose entity). For example, an interest rate swap can convert a variable rate asset to a fixed rate.

Any derivative instrument that constrains a transferee from using a transferred asset in a manner that best realises the economic benefits encompassed in the asset should be carefully evaluated in the context of control. In most situations, it will be appropriate to evaluate derivatives based on their type or form. However, different types of derivatives can result in identical economic outcomes. There are a number of factors to consider when evaluating derivatives.

Derivatives can operate automatically or require exercise by one of the parties; they can be exercised freely or only after the occurrence of a future event. Such a future event may be certain of occurring, such as the passage of time, or may be conditional upon an event, such as a loan becoming delinquent. The certainty of occurrence varies with conditional events. Some conditional events may be probable of occurring, possible of occurring, or their occurrence may be considered remote. In some instances, it may not be possible to assess the likelihood of occurrence. The exercise price of a derivative can be fixed above, below, or equal to the market value of the financial assets at inception or it can be variable, equal to the market value at exercise date, or the result of a formula that is a function of market conditions or other future events. Derivatives can be combined to form different types of derivatives. Each of these factors impacts the degree of control retained by the transferor over the financial assets that have been transferred and the degree of control obtained by the transferee. Judgement is required in making these assessments.

There are many different terms that can be incorporated in a transaction that result in the transferor retaining control and/or economically constraining a transferee from actually selling the transferred assets, even if there is no legal constraint. A call option does not have to be in-the-money, and a put option does not have to be deep-in-the-money to constrain the transferee. A very short time period to the exercise date of a call option or put option, for example, may be sufficient to constrain a transferee when the assets transferred are not readily obtainable, even though a transferee has the legal right to sell the assets subject to the call or repurchase agreement.

**IAS 39.42 - LOAN PARTICIPATIONS AND SYNDICATIONS**

**QUESTION**

HOW ARE LOAN PARTICIPATIONS AND SYNDICATIONS EVALUATED IN DETERMINING WHETHER A PORTION OF A LOAN SHOULD BE DERECOGNISED?

Loan participations occur when groups of banks or other entities jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities. The transfer by the originating lender (transferor) may take the legal form of either an assignment or participation. The transfer is usually on a non-recourse basis, and the transferor continues to service the loan. The participating entity (transferee) may or may not, depending on the terms of the participation agreement, have the right to transfer its participation during the term of the loan.

If the loan participation agreement gives the transferee the right, free of constraint, to pledge or exchange approximately the full fair value of those participations and the other derecognition criteria are met, the transfer of the loan participation to the transferee must be accounted for as a sale. However, loan participations often have constraints on the transferee’s rights to pledge or exchange financial assets. A determination should be made regarding the significance of the constraint. Significant constraints preclude sale treatment, whereas minor constraints might not preclude necessarily sale treatment. The constraint is considered significant if the loan participation agreement constrains the transferee from pledging or exchanging approximately the full fair value of its participation. In this circumstance, the transferee has not obtained control over the loan and the transfer generally should be accounted for as a secured borrowing, assuming that the transferor has retained certain risks and returns of ownership.

A loan syndication is similar to a loan participation in that it is the formation of a group of lenders to jointly fund large loans. However, in a syndication under which several lenders each agree to lend to a single borrower, each lender originates a loan of a specific amount to the borrower and has the right to repayment from the borrower. Because each lender in the syndication originates its loan with the borrower and does not receive the loan in a transfer, the transaction is not subject to the transfer and derecognition principles of IAS 39. Each lender should account for the amounts it is owed by the borrower.

In some loan syndications, repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances where there is a lead lender that collects and distributes repayments, the lead lender is simply functioning as a servicer and should not recognise the aggregate loan as an asset.
HOW ARE CONDITIONAL EXCHANGE DERIVATIVES, FOR EXAMPLE A CONDITIONAL REPURCHASE AGREEMENT, EVALUATED IN DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECONCERNED?

Derivatives are conditional if they come into existence as a result of some event that may occur in the future, or if they come into existence as a result of information obtained in the future evidencing a condition that was not known to exist at the origination date (for example, a recourse provision). The mere passage of time is not a conditional event because the effectiveness of the derivative in the future is assured.

At the time the derivative becomes effective or is no longer conditional, the derivative may operate automatically and require repurchase of some or all of the transferred assets, or may permit one of the parties to require the other to purchase or sell the transferred assets. Repurchase or payment requirements that operate automatically and that do not always benefit one party at the expense of another or that are neutral to both parties are considered forward contracts rather than options.

Conditional repurchase requirements that operate automatically are conditional forward repurchase agreements. Those that provide one of the parties with the ability to buy or sell the transferred assets from or to the other party (respectively) can be considered to be conditional put options if the transferee may acquire the exercise right, or conditional call options if the transferor may acquire the exercise right.

Although IAS 39 does not specifically address the control implications of conditional derivatives, these are evaluated in terms of the derecognition criteria in the same manner as unconditional derivatives. In the circumstances listed below, conditional or contingent derivatives generally are not considered to be a significant factor in assessing whether the sale accounting criteria have been met:

- the transferred assets are readily obtainable;
- the occurrence of the condition or contingent event is considered to be remote; or
- the transferee will not be constrained by the derivative if it becomes effective provided that the transferor does not retain certain risks and returns of ownership.

When transferred assets are not readily obtainable and it is reasonably possible that the derivative will come into existence because the contingent event may occur, judgement is required to determine whether a transferee may be constrained. In making this assessment:

- conditional call options on assets that are not readily obtainable generally benefit the transferor and should preclude sale accounting, unless the contingent event protects the transferee, such as an event of recourse that provides the transferor with a choice of calling or repurchasing delinquent receivables or remitting the delinquent payments to the transferee;
- conditional put options generally benefit the transferee and will have no impact on sale accounting, unless there is some provision or term of the option that constrains the transferee;
- conditional forward repurchase agreements that protect the transferee generally will have no impact on sale accounting, unless there is a provision or term that constrains the transferee. A requirement to repurchase delinquent receivables does not constrain the transferee and generally should be evaluated as a put option held by the transferee; and
- conditional forward repurchase agreements that are not structured to benefit either party or that benefit the transferor should be assessed to determine the likelihood of the event occurring and whether it will constrain the transferee.

HOW ARE RECOURSE PROVISIONS EVALUATED FOR PURPOSES OF DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECONCERNED?

Recourse obligations may take several forms, including a call option held by the transferor, a forward contract requiring the transferee to sell and the transferor to buy any defaulted assets, or a put option held by the transferee. However, because a recourse obligation always benefits the transferee at the expense of the transferor, the repurchase requirement created by the recourse provision generally should be evaluated as a put option held by the transferee. As described above, these types of options generally do not preclude sale treatment unless the transferor substantially retains all of the risks of ownership.
IAS 39.42 • EVALUATION OF REPRESENTATIONS AND WARRANTIES

QUESTION

HOW ARE REPRESENTATIONS AND WARRANTIES EVALUATED IN DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECOGNITION?

Most transfer agreements include standard representations and warranties that typically address underwriting, title, transferability, and other standard provisions. Typically, a violation of a representation provides the transferor with the right to put ineligible assets back to the transferor. An option or forward that is conditional on representations and warranties will not preclude sale treatment, if the representations and warranties are deemed to be standard. Unique representations and warranties should be closely evaluated to determine whether they constitute retention of control by the transferor or a constraint on the transferee from exchanging the transferred assets.

IAS 39.42 • ACCELERATION PROVISIONS

QUESTION

HOW ARE ACCELERATION PROVISIONS THAT ARE CONTINGENT FORWARD REPURCHASE AGREEMENTS EVALUATED IN DETERMINING WHETHER A TRANSFER QUALIFIES FOR DERECOGNITION?

Certain transfer agreements include provisions that are contingent forward repurchase agreements, because they effectively accelerate the termination or maturity of all or a portion of the transferred assets. The acceleration is generally contingent upon a certain event, such as default rates, interest rates, credit ratings, changes in tax law, or other events. If it is remote that such events will occur, the transferee usually is not constrained from using the transferred assets. In these situations, the contingent derivative would not preclude sale treatment.

The acceleration event, however, may be certain to occur in the future or may be probable of occurring. For example, it could be based on the mere passage of time, on the level of the outstanding balances of the transferred assets, or some other factor that eventually will occur. Acceleration provisions that are probable or certain of occurring should be considered a forward repurchase agreement since they operate automatically, which suggests that the portion of the transferred assets subject to the acceleration provisions were not sold. In some instances, acceleration provisions are contingent on future events and benefit the transferee. Such provisions may be considered contingent put options, which should not preclude sale accounting in respect of the portion subject to the acceleration provisions. This argument is appropriate when the benefit protects the transferee from loss on specific loans, such as a repurchase provision on delinquent loans.

In some instances (for example with revolving period securitisations where a liquidation period is specified), securitisations have acceleration provisions whereby cash flows (principal repayments) are allocated to certain designated (senior) securities first. These allocations can result in the investors in the senior securities receiving a disproportionate distribution and are referred to as acceleration clauses, turbo-mechanisms, sequential pay classes, or pre-set percentages. This is often done both as a yield enhancement mechanism and to provide the senior classes with greater protection against credit risk. Although this is not seen as affecting the determination of whether or not sale accounting is permissible, any disproportionate allocations should be considered in determining the fair value of both the assets sold and the assets retained by the transferor.

Certain revolving period securitisations additionally contain ‘removal of accounts’ provisions entitling the transferor to withdraw certain individual accounts from a pool of receivables subject to certain conditions. The effect of these withdrawals is to reduce the seller’s interest and increase the investor’s relative interests in the remaining account balances. The removal of receivable balances can be considered a call option, which would prejudice sale treatment since it is indicative of the transferor retaining control over the assets. This should be evaluated in the light of the terms of the particular securitisation.

IAS 39.42 • BANKER’S ACCEPTANCES AND RELATED RISK PARTICIPATIONS

QUESTION

HOW ARE BANKER’S ACCEPTANCES AND RELATED RISK PARTICIPATIONS EVALUATED FOR PURPOSES OF DETERMINING WHETHER A TRANSFER QUALIFIES AS A SALE?

Banker’s acceptances provide a way for a bank to finance a customer’s purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer’s liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its acceptance of the liability to make payment on the draft on its due date. An accepted draft is a negotiable financial instrument.

When the bank accepts a draft, it has a receivable from the customer that is payable when the draft matures. The bank also has a liability to the vendor for the acceptance of the draft. The vendor can wait until the draft matures for the receipt of cash or it can sell the accepted draft at a discount either to the accepting bank or to another third party in order to receive the cash earlier than the maturity date of the draft.

A risk participation is a contract between the bank accepting the draft (accepting bank) and another third party (participating bank) in which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank for a portion of the receivable from the customer drawing the draft in the event that the customer defaults. The participating bank in effect guarantees the credit of the customer.

The transfer of the risk participation in the accepted draft from the accepting bank to the participating bank does not meet the derecognition criteria. The accepting bank should not derecognise any part of the receivable since it has not surrendered control over the benefits inherent in the receivable and is still entitled to receive payment from the customer that drew the draft. Instead, the accepting bank should recognise an asset for the guarantee purchased at the amount of the fee paid. The participating bank also should recognise a liability for the guarantee issued. In addition, the accepting bank that obtains a risk participation should not derecognise the liability for the banker’s acceptance because the accepting bank primarily is still liable to the holder of the banker’s acceptance.

[fasb 125, paragraph 79-80].
DOES FACTORING RECEIVABLES QUALIFY FOR DERECOGNITION UNDER IAS 39?

Factoring receivables usually consists of transferring receivables on a discounted basis to a bank without recourse. Factoring arrangements that meet the sales criteria should be accounted for in the same manner as a sale of receivables.

IMPACT OF A CONDITIONAL CALL OPTION

EXAMPLE

Transferor X sells mortgage loans with an expected life of 15 years to Transferee Y. The loans are not readily obtainable. Transferor X retains a call option that is not embedded in the loans and is not transferable. The call option permits Transferor X to call the loans if the 30-year US Treasury bond rate drops below 3%. In the past 30 years, the 30-year US Treasury bond rate has not dropped below 3%. It is considered remote that the call option will ever be exercisable. Does the call option preclude sale treatment? What if the call option were exercisable if rates dropped below 6%?

The call option is a contingent derivative and should be evaluated based on the likelihood of the contingent event occurring. The 3% option would not preclude sale treatment because the likelihood of the contingent event occurring is remote. Depending on the level of interest rates, the 6% option may preclude sale treatment. When the likelihood of the contingent event occurring is reasonably possible, judgement always should be used in evaluating contingent derivatives. Factors to consider consist primarily of the likelihood that a contingent event will occur and whether the transferee is constrained. In evaluating such a contingency, historical market conditions, expected volatility, and other factors should be considered. In instances where there is a remote likelihood that a contingent event will occur, the option should not affect the accounting for the transfer.

ACCELERATION PROVISION

EXAMPLE

Transferor X uses a special purpose entity, Y, to securitise financial assets that are not readily obtainable. The issued beneficial interests consist of two classes: Class A represents 80 percent of the total interests and is held by Transferee Y; Class B represents the remaining 20 percent and is held by Transferor X. The securitisation structure includes an acceleration provision in which the Class B beneficial interest holders do not receive any rewards as well as control and in this regard may be more restrictive than that under US GAAP. US GAAP does not consider risks and returns and is silent regarding transfers subject to put options and total return swaps whereas IAS 39 makes specific mention of these as instances where the transferor has not surrendered control.

FAIR VALUE REPURCHASE OPTION (CALL OPTIONS)

COMPARISON WITH US GAAP

US GAAP does not include the exception where the reacquisition price is fair value at the time of reacquisition.
IAS 39.42 • CLEAN-UP CALLS

**COMPARISON WITH US GAAP**

US GAAP provides a specific exception by permitting sale accounting in the case of ‘clean-up calls’ and ‘clean-ups’ structured as forwards. No such exception is provided under IAS 39. These features generally would preclude sale accounting under IAS 39 to the extent of the call. (Clean-up calls are options held by a servicer, who also may be the transferor, to purchase transferred financial assets when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome).

IAS 39.42 • REPURCHASE AGREEMENTS (FORWARDS)

**COMPARISON WITH US GAAP**

US GAAP follows a slightly different approach where the transferor is both entitled and obligated to repurchase or redeem an asset. Its starting point is based on specific, narrowly defined criteria that need to be satisfied for the agreement to be accounted for as a secured borrowing. IAS evaluates these transactions from the perspective of whether or not the transferee receives a lender’s return and whether or not the repurchase is to be effected at fair value. US GAAP does not specify the requirement that the terms of the transfer effectively provide the transferee with a lender’s return on the assets received in exchange for the transferred asset.

Additionally, US GAAP specifies that where a forward purchase contract can be satisfied with readily obtainable assets, further criteria must be met to treat it as a secured borrowing. These criteria require that the assets to be repurchased or redeemed must be substantially the same, the transferor must be able to repurchase or redeem the assets on substantially the agreed terms, even in the event of default by the transferee, the agreement to repurchase or redeem must be at a fixed or determinable price and the agreement must be entered into concurrently with the transfer [FASB 140, paragraph 47]. Further guidance is provided in SOP 90-3 as interpretation of the term ‘substantially the same’.

Under US GAAP, in order for the transferor to be able to redeem financial assets subject to a repurchase agreement on substantially the agreed terms, even in the event of default by the transferee, the transferor must at all times have obtained sufficient collateral to fund substantially all (90 percent or greater) of the purchase price of replacement securities from other parties in case the transferee defaults. The determination of whether this requirement has been met requires judgement, considering the contract provisions, and facts and circumstances at the transfer date.

IAS 39 neither specifically mentions any requirement in respect of whether or not the asset is readily obtainable where the transferor is entitled and obligated to repurchase or redeem the asset, nor sets out additional criteria to be satisfied over and above the agreement providing a lender’s return.

IAS 39.47 • DERECOGNITION OF PART OF A FINANCIAL ASSET: ESTIMATING FAIR VALUES OF COMPONENTS ON DERECOGNITION

**QUESTION**

**WHAT ARE THE KEY FACTORS TO CONSIDER IN ESTIMATING THE FAIR VALUE OF FINANCIAL COMPONENTS IDENTIFIED IN CONNECTION WITH A TRANSFER OF A PORTION OF FINANCIAL ASSETS?**

The fair value of an asset or liability is determined using the principles set out in paragraphs 95-102.

When valuation techniques are used, the determination of fair value should incorporate those assumptions that market participants would use in their estimates of value, future revenues, and future costs. This includes assumptions about the timing and amounts of cash flows, including contractual terms, interest rates, defaults, prepayments, and volatility. Estimates of expected future cash flows should be based on appropriate and supportable assumptions and projections that are readily determinable. Some of the adjustments for risks, such as defaults and prepayments, can be based on historical patterns and known trends. All available evidence should be considered, and the weight given to the evidence should be commensurate with the extent to which the evidence can be objectively verified. If the estimate of cash flows is a range, the best estimate of the future cash flows should be determined by considering the likelihood of the possible outcomes. In addition, the assumptions and methodologies used in estimating the fair value of similar instruments should be consistent.

The transferor should ensure that all possible cash flows are contemplated. For example, the expected cash flows of a recourse obligation should be based on all probable credit losses over the life of the transferred receivables and should consider reasonably possible losses. Adjustment of cash flows may be appropriate to consider losses where the probability may be reliably determined. This adjustment, however, is usually made through the discount rate.

Determining the market discount rate requires considerable judgement. Conceptually, if the timing and amounts of future cash flows could be determined absolutely, the discount rate would be the risk-free rate. However, an adjustment to the risk-free rate or risk premium is necessary to recognise that defaults, prepayments, and other adjustments cannot be estimated precisely.
There are a number of methods that can be used to determine the appropriate discount rate for each cash flow. For example, rates may be constructed by building each component, starting with the risk-free rate. The components would include factors for accepting risk (such as risk of credit losses and prepayments), unavoidable expenses (such as servicing), volatility (such as volatility relating to credit and prepayments), and liquidity considerations. Rates also can be obtained directly or developed from market interest rates of comparable instruments. Discount rates are developed by isolating the risk premium of the comparable instrument and adding it to the applicable risk-free rate. The risk premium can be isolated by computing the embedded spread to a risk-free rate or the implied option-adjusted spread.

While recognising the considerable subjectivity needed to estimate fair values of components, without objective evidence of values, it would be inappropriate to recognise a gain from allocating the basis between the various components such that the carrying value of the sum of the parts plus the recognised gain is greater than the fair value of the total asset without substantiating market transactions. It is often the case in instances in which the value of the parts exceeds the fair value of the whole that some aspect of the valuation is not being fully comprehended by the model. Is indicative either of a failure to recognise a financial asset or liability or of measurement errors in arriving at a reliable fair value.

**IAS 39.47 · CARRYING AMOUNT: COMPONENTS**

**QUESTION**

**WHAT IS THE CARRYING AMOUNT OF AN ASSET FOR PURPOSES OF ALLOCATING BASIS?**

While IAS 39 does not define the term ‘carrying amount’, this term is defined in various other pronouncements, including IAS 16.5, and IAS 38.7. In these Statements, the carrying amount is defined to encompass unamortised premiums or discounts, acquisition costs, and impairment amounts, such as an allowance for uncollectable amounts.

When only a portion of the financial assets is transferred, the allocation of any valuation allowances and impairment amounts to those assets transferred and retained generally should be done based on the relative fair values of the portion of the asset sold and the portion retained. For example, the percentage of the fair value of credit card loans transferred determined by dividing the fair value of the amount transferred by the total fair value of all credit card loans held at the time of the transfer is used to allocate a portion of the allowance for uncollectable amounts to the amount transferred.

**IAS 39.47 · CARRYING AMOUNT: ACCRUED INTEREST**

**QUESTION**

**IS ACCRUED INTEREST PART OF THE CARRYING AMOUNT OF THE TRANSFERRED ASSET?**

Accrued interest is a separate financial asset that may or may not be transferred in the same transaction. Accrued interest that is retained is not included in the carrying amount of the transferred asset because it is a separate financial asset and a present benefit that already has been recognised. If retained accrued interest were to be included in the carrying amount of the transferred assets, its basis could be reduced as a result of the allocation of the carrying amount based on fair values, and an additional gain would result when the interest was collected.
**IAS 39.47 • ALLOCATION OF THE CARRYING AMOUNT IN A SECURED BORROWING TRANSACTION**

**QUESTION**


No. The separation of financial assets is not permitted under IAS 39 unless they include derivative instruments that are required to be separated under IAS 39 or debt and equity components that are required to be separated under IAS 32. For example, a transferor may securitise receivables and the securities issued consist of senior and subordinated securities. The transfer of receivables represented by the senior securities fails to meet the criteria for a derecognition because the transferor retains a call option. In this situation, the carrying amount of the receivables should not be allocated to the senior securities, subordinated securities, and, if applicable, to any servicing asset retained. Rather, the asset should retain its original classification. Even though the transferred assets are retained in a different form, the carrying amount of the transferred assets is not allocated to the asset’s components to recognize this new form.

**IAS 39.47 • RETENTION OF ALL BENEFICIAL INTERESTS WITH INTENT TO SELL**

**QUESTION**

**IS BASIS ALLOCATION PERMITTED IF A TRANSFEROR INITIALLY RECEIVES ALL OF THE BENEFICIAL INTERESTS RESULTING FROM A SECURITISATION WITH THE INTENT TO TRANSFER THE BENEFICIAL INTERESTS TO UNRELATED THIRD PARTIES AT A LATER DATE?**

No. Basis allocation is not appropriate until beneficial interests are transferred to the unrelated third parties and that portion of the transferred assets qualifies for derecognition.

**IAS 39.47 • FORWARD AGREEMENT ON A PORTION OF THE TRANSFERRED ASSETS**

**EXAMPLE**

Transferor X uses a special purpose entity, Y, to securitise financial assets that are not readily obtainable. Assume that consolidation of the SPE is not required under SIC 12. The issued beneficial interests consist of two classes: Class A represents 70 percent of the total interests held by Transferee Y, Class B represents the remaining 30 percent. While both classes receive interest payments while the interests are outstanding, under this structure, the Class A holders receive all principal payments from the underlying assets until their interest is paid in its entirety, after which the Class B interests receive the remaining cash flows. Transferor X sells all the beneficial interest to Transferee Y. However, the Class B interests are subject to a forward commitment that requires Transferor X to repurchase these interests when the Class A interests have been paid in their entirety.

In this situation, the financial assets are separated effectively into two distinct interests through the issuance of the beneficial interest and thus the interest subject to the forward contract has been detached. Transferor X should consider 70 percent of the loans as having been sold. A portion of the remaining 30 percent is sold and a portion retained based on the estimate of cash flows that will be remitted to Transferee Y before the Class A holders are repaid.

**IAS 39.49 • PARTIAL DERECOGNITION WITH BASIS ALLOCATION ILLUSTRATED**

**EXAMPLE**

Company A owns $1,000,000 face amount of loans that contractually yield 10% interest over their life. The carrying amount of these loans after considering the $20,000 allowance for loan losses is $880,000. Company A sells 90 percent of the principal, plus the right to receive interest income of 8% without recourse to an investor for $500,000 in cash. The transfer meets all the criteria for a sale. Company A retains the right to service these loans, and the servicing contract stipulates a 1% fee as compensation for performing the servicing. Company A also retains an interest-only strip for the portion of the interest coupon not sold (one percent). At the date of transfer, the fair value of the retained 10 percent of the loan is $100,000; the fair value of the servicing asset is $15,000; and the fair value of the interest-only strip is $35,000.

The following table demonstrates the allocation of this loan between the sold and retained interests:

<table>
<thead>
<tr>
<th>Components</th>
<th>Interest in Retained</th>
<th>Interest in Sold</th>
<th>Carrying Amount</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
<th>Sold Interest</th>
<th>Retained Interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$900,000</td>
<td>85.71</td>
<td>$840,000</td>
<td>$840,000</td>
<td>$140,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans retained</td>
<td>100,000</td>
<td>9.53</td>
<td>93,333</td>
<td>93,333</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IO strip</td>
<td>35,000</td>
<td>3.33</td>
<td>12,667</td>
<td>12,667</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>15,000</td>
<td>1.43</td>
<td>14,000</td>
<td>14,000</td>
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<tr>
<td>Total</td>
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<td>100.00</td>
<td>$980,000</td>
<td>$840,000</td>
<td>$140,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* The allocated carrying amount is calculated as the interest’s percentage of total fair value times the aggregate carrying amount prior to the transfer ($880,000).

**IAS 39.50 • SERVICING DESCRIBED**

**QUESTION**

**WHAT IS SERVICING?**

Servicing refers to activities associated with the collection of cash flows from receivables or other financial assets after origination and the distribution of that cash to investors if the receivables are owned by other entities. Servicing may include the temporary investment and distribution to the financial asset owners of all or a portion of the cash collected. Servicing activities may also include monitoring delinquencies, advancing delinquent payments, restructuring receivables, and foreclosing on the collateral underlying the receivables when necessary. If the receivables are mortgage loans, servicing activities often include collecting and disbursing escrow payments for taxes and insurance. Servicing activities are inherent in all receivables; however, they do not need to be performed by the owner of the receivables. If the receivables are being serviced for another entity, the servicer generally receives a fee for performing these activities. This fee is usually a contractual amount received based on a fixed percentage of the outstanding receivables for the period. Servicers also, may receive additional compensation by retaining late charges, other ancillary fees, and the float, which is the net interest earned on funds held by the servicer before disbursement. The compensation received by the servicer is referred to as the benefits of servicing.
**IAS 39.50 • SERVICING ASSETS AND LIABILITIES**

**QUESTION**

What are servicing assets and liabilities?

Servicing becomes a distinct asset or liability when it is contractually separated from the related receivables and thus becomes a servicing contract. The following are examples of servicing that are separated from the related receivables under a servicing contract:

- the owner of the receivables sells the servicing rights to another entity and retains the receivables;
- the owner of the receivables sells the receivables but retains the right to service those receivables; and
- receivables are exchanged for securities (backed by the receivables) that may be sold at a later date, and the securities do not include the right to service the underlying receivables.

Once the servicing has been separated from the related financial assets, it may represent an economic benefit (asset) to, or obligation (liability) of, the servicer. A servicing asset is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to have a positive fair value. A servicing liability is a contract to service financial assets under which the estimated future revenues from the stated servicing fees, late charges, and other ancillary revenues are expected to have a negative fair value. Intuitively, the servicing in this instance represents an obligation, because the servicer would have to pay another entity to assume the servicing contract or use its assets toward the future to perform under the servicing contract.

Servicing liabilities initially have a negative fair value to the servicer. When the estimated future revenues will enable the servicer to performing the servicing but provide no additional benefits, the servicer has neither an asset nor a liability and the fair value of this servicing contract is zero. A servicing contract with a positive fair value is considered to be one that would not be unfavourable for a substitute servicer should one be required, and includes the profit that would be demanded in the marketplace. One approach in determining whether a servicing contract has a positive fair value is to use the servicing costs of an average servicer plus a reasonable profit margin if this information is available.

**IAS 39.50 • SERVICING FEE VS. INTEREST-ONLY RECEIVABLE**

**QUESTION**

How is a servicing fee distinguished from an interest-only receivable?

IAS 39.50 suggests that servicing assets are based on contractually specified fees. In the example in paragraph 50, retaining an interest in excess of the contractually specified servicing fee is an interest-only strip receivable. Servicing fees represent all amounts per the contract that are due to the servicer in exchange for servicing the financial assets and that no longer would be received by a servicer if the beneficial owners of the serviced assets, or their trustees or agents, were to exercise their authority under the contract to shift the servicing to another servicer.

**IAS 39.50 • SERVICING: INITIAL RECOGNITION**

**QUESTION**

How is a servicing asset initially recognized?

A servicer may obtain a servicing contract by either (1) undertaking it in conjunction with selling or securitising the financial assets being serviced or (2) purchasing or assuming it separately. A servicing contract asset retained by the transferor of financial assets is a retained interest. However, if the servicing contract is a liability, it is a new interest. As discussed below, servicing assets and liabilities that are the result of a transfer of financial assets are recognised on the transfer date, not an earlier date such as when the owner of the financial assets has a definitive plan to sell them. Servicing contracts that are purchased and are not held by the transferor of the loans are also considered new interests on the date of purchase.

A servicing asset retained in a sale or securitisation of financial assets should initially be recognised at its cost based on the allocated carrying amount determined using relative fair values at the date of the sale or securitisation. However, if the servicer obtains a servicing asset by purchase or a servicing liability by assumption (including servicing liabilities resulting from sales or securitisation of financial assets), the servicing contract initially should be recognised in the balance sheet at its fair value. When the servicing contract is purchased or assumed for cash, its fair value is presumptively the price paid or received. If the purchase price exceeds the fair value of the servicing contract, the excess should be recognised as other comprehensive income. A servicing asset or liability is measured at fair value, except for servicing that is a retained interest in a loan or securitisation of financial assets, which is measured at amortised cost.

**IAS 39.50 • REVOLVING-PERIOD SECURITISATIONS**

**QUESTION**

What is a revolving-period securitisation and how is it accounted for?

In most revolving-period securitisations, a trust purchases short-term receivables (such as credit card or 90-day receivables) from the transferor and, concurrently, issues long-term beneficial interests (such as five-year certificates). The funds collected on the short-term receivables are used first to provide a return to the holders of the beneficial interests and then to purchase new receivables from the transferor. This procedure of purchasing new receivables with funds collected from previously transferred receivables continues until the liquidation period begins (funds collected from the receivables held by the trust will be used to redeem the securities). Often the transferor is the servicer; therefore, the transferor will in effect use the funds it collected to purchase its own receivables on behalf of the trust.

If the securitisation meets the sales criteria, each transfer of receivables to the trust (the initial sale and each subsequent transfer using collected funds) is a separate sale of financial assets and should be accounted for as such. The gain or loss on each sale is limited to the gain or loss on only those receivables that exist and have been sold. Similarly, any servicing asset or liability and interest-only strip is limited to the servicing and excess interest on the receivables that exist and have been sold. Therefore, servicing on new receivables may not be included in the balance sheet until those receivables have been originated and sold to the trust.
The recording of a servicing asset or liability and/or interest-only strip for each new sale makes the accounting complex, because each servicing asset or liability and interest-only strip resulting from the separate sales should be tracked separately. Intuitively, the greater the number of sales that make up a pool of assets, the more complex the accounting will become.

The accounting for the initial sale in a revolving-period securitisation is very similar to the accounting for a standard securitisation. One primary difference is that the transferor may be required to recognise an asset or liability for the implicit forward contract if its fair value is other than zero. Usually, the transferor is required by agreement to sell, and the trust is required to purchase, new receivables using funds collected during the revolving period. This agreement is an implicit forward contract - that is, a component of the sales proceeds, and thus, should be recognised initially at fair value in the transferor’s statement of financial position. If the forward is entered into at market terms, its fair value is zero.

A transferor in a revolving-period securitisation may use a master trust for many securitisations. The transferor can achieve additional securitisations by transferring receivables to the existing trust in consideration for new securities and then selling those securities to investors. This transfer of new receivables to the trust is neither a sale nor a borrowing because the transfer only increases the transferor’s beneficial interests in the transferred assets. It is not until the transferor sells the beneficial interests to investors that the transferor can record a sale.

**IAS 39.50 - REVOLVING-PERIOD SECURITISATION: COMMITMENT TO FUTURE TRANSFERS**

**QUESTION**

**IF UNDER A REVOLVING-PERIOD SECURITISATION, A TRANSFEROR COMBITS TO SELL NON INTEREST-BEARING TRADE RECEIVABLES AT AN AMOUNT BELOW THEIR STATED VALUE TO COMPENSATE INVESTORS FOR THE TIME VALUE OF MONEY, IS A LOSS RECOGNISED AT THE COMMITMENT DATE?**

The fair value of the forward is based on the difference between the agreed-upon discount and a market discount. If the discount rate in the agreement equals the market rate, there is no loss on the forward. The loss to be incurred as a result of selling the receivables at a discount is for receivables that do not yet exist. Accordingly, the loss should not be recognised until the receivables are generated, which has the effect of matching the loss on the receivables to be sold with the revenue that created the receivables. The transferor should recognise the loss due to its commitment to sell non-interest-bearing receivables to the trust when the receivables are created and it is known that they will be transferred.

**IAS 39.50 - COMPONENTS OF SALES PROCEEDS**

**EXAMPLE**

Company A originates €1,000,000 of long-term loans that have a fixed interest rate of 10 percent. The loans have a carrying value of €960,000. Company A sells the loans to an investor and does not retain any interest in the loans. The transfer meets all the conditions to be accounted for as a sale. As compensation, the investor agrees to give Company A €75,000 in cash at the transfer date and a one-year, interest-bearing note for €500,000 (fair value equals €500,000). In addition, Company A agrees to provide full recourse to the investor (fair value of €30,000) and provide the servicing without compensation (fair value of €10,000). Finally, Company A agrees to provide the investor a variable rate on the receivables equal to LIBOR plus one percent. The fair value of a ‘receive fixed, pay variable’ interest rate swap on a notional amount of €1,000,000 that amortises similarly to the loans is a negative €10,000. Company A would recognise the sale as follows:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>€ 575,000</td>
<td></td>
</tr>
<tr>
<td>Note receivable</td>
<td>€ 500,000</td>
<td></td>
</tr>
<tr>
<td>Loans, net</td>
<td></td>
<td>€ 960,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Servicing liability</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Pre-tax gain on sale</td>
<td>25,000</td>
<td></td>
</tr>
</tbody>
</table>

**IAS 39.50 - SERVICING: A NON-FINANCIAL ASSET**

**COMPARISON WITH US GAAP**

Under US GAAP, servicing rights are treated specifically as non-financial assets or liabilities (FASB 140, paragraph 61). US GAAP records servicing rights initially at fair value, but then amortises the basis over the related loan terms. Under IAS 38, although the benchmark treatment subsequent to initial recognition is to carry the asset at amortised cost, the allowed alternative treatment permits the recognition of servicing rights at fair value where, and only where this value can be determined by reference to an active market for the asset (IAS 38.64).

Transfers where the owner of receivables sells the servicing rights to another entity and retains the receivables are not subject to the derecognition criteria for financial instruments under US GAAP since servicing is regarded as a non-financial asset to which the derecognition provisions of FASB 140 do not apply. Under US GAAP, a reasonable estimate of fair value is considered sufficient where it is not practicable to determine fair value when allocating basis. IAS 39’s requirement of a reliable estimate represents a higher threshold in the determination of fair value though IAS 39 presumes that a reliable estimate of fair value can be obtained.
IAS 39.51: ASSET DERECOGNITION COUPLED WITH A NEW FINANCIAL ASSET OR LIABILITY

QUESTION
WHAT ARE NEW FINANCIAL ASSETS OBTAINED AND NEW LIABILITIES INCURRED IN CONNECTION WITH A TRANSFER?
No further guidance is provided in IAS 39 as to what constitutes a new financial asset or liability, and judgement will be necessary to determine the extent to which the terms of the asset subsequent to the transfer differ from those prior to the transfer. Both form and substance must be assessed and the component parts of resultant assets and liabilities may need to be analysed carefully.

On completion of a transfer that meets the criteria for sale accounting, the entity recognises all assets obtained and liabilities incurred in its balance sheet.

IAS 39.51: PROCEEDS DESCRIBED

QUESTION
WHAT ARE PROCEEDS?
The term ‘proceeds’ refers to those assets obtained, less any liabilities incurred, as consideration for the transfer. Retained interests are not proceeds.
Cash and other non-derivative assets received are easily identified as part of the sales proceeds. Common items that are obtained or incurred in sales of financial assets that should be included as part of the proceeds include:
- holdbacks of cash sales proceeds that belong to the transferor but are held in escrow or held by the transferee. Holdbacks generally are used to enhance credit and ensure performance on guarantees of the transferor. This does not include initial cash deposits put up by the transferor, out of its own cash or debtor deposits, as a performance guarantee;
- servicing liabilities (an obligation to service the financial assets for less than adequate compensation);
- call options held on the transferred financial assets (for example, a call option on financial assets that are readily obtainable);
- put options written on the transferred assets (for example, guarantees or recourse obligations);
- forward commitments (for example, commitments to deliver additional receivables in a revolving-period securitisation), but only to the extent that they are off-market; and
- swaps (for example, provisions that convert interest rates from fixed to variable or vice versa, or exchange currencies).

Sometimes, it may be difficult to determine whether a component in a sale is a retained interest or part of the sales proceeds. If the item is a liability incurred by the transferor, it is considered to be part of the proceeds since prior to the transfer of the financial assets, the transferor does not have an obligation to the transferee or any other party associated with the financial assets. The liability incurred only arises out of the transfer and, therefore, is considered new and not a retained interest. For this reason, credit recourse, a common component of transfers of financial assets, is by definition always part of the sales proceeds. In addition to recourse, there are many other types of obligations and guarantees that may be specified in a transfer of financial assets. The transferor should identify all such liabilities and record them at their fair value.

IAS 39.51: DERIVATIVES TRANSACTED IN A TRANSFER OF FINANCIAL ASSETS

QUESTION
IS A DERIVATIVE FINANCIAL INSTRUMENT ENTERED INTO IN CONNECTION WITH A TRANSFER CONSIDERED TO BE A NEW ASSET OR LIABILITY?
If a derivative financial instrument is entered into concurrently with and as part of a transfer of financial assets and its cash flows are not inherent in the underlying assets being transferred, it is either an asset obtained or a liability incurred in a transfer and should be considered part of the sales proceeds.

IAS 39.51: PROCEEDS INDISTINGUISHABLE FROM RETAINED INTERESTS

QUESTION
HOW SHOULD A TRANSFEROR ACCOUNT FOR AN ASSET IT OBTAINS IN CONNECTION WITH A PARTIAL TRANSFER IF THE TRANSFEROR CANNOT CLEARLY DETERMINE WHETHER THE ASSET IS A PORTION OF THE ASSETS BEING SOLD OR A NEW ASSET?
If a transferor cannot determine whether an asset is a retained interest or a new asset obtained in connection with a partial transfer, the asset should be treated as proceeds from the sale.

IAS 39.51: RETAINED INTERESTS VS. PROCEEDS: CONTINUING INVOLVEMENT

QUESTION
WHAT ARE SOME FORMS OF CONTINUING INVOLVEMENT WITH TRANSFERRED ASSETS THAT DO NOT REPRESENT RETAINED INTERESTS?
Forms of continuing involvement with transferred assets that do not represent retained interests include liabilities incurred and derivatives resulting from the transfer. For example, recourse provisions, put options and guarantees of a specific return are considered to be new liabilities and not retained interests. Liabilities and derivatives that are not part of the original financing asset are not considered retained interests.
**IAS 39.54(a) - ALLOCATION WHEN FAIR VALUE CANNOT BE DETERMINED RELIABLY**

**EXAMPLE**

Company A owns $1,000,000 face amount of loans that contractually yield 10% interest over their life. The carrying amount of these loans after considering the $20,000 allowance for loan losses is $980,000. Company A sells 90 percent of the principal, plus the right to receive interest income of 8% without recourse to an investor for $900,000 in cash. The transfer meets all the criteria for a sale. Company A retains the right to service these loans, and the servicing contract stipulates a 1% fee as compensation for performing the servicing. Company A also retains an interest-only strip for the portion of the interest coupon not sold (one percent). At the date of transfer, the fair value of the retained 10 percent of the loan is $100,000; the fair value of the servicing asset is $15,000; and the fair value of the interest-only strip could not be measured reliably.

The following table demonstrates the allocation of this loan between the sold and retained interests:

<table>
<thead>
<tr>
<th>Interest</th>
<th>Fair value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
<th>Sold Interest</th>
<th>Retained Interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$900,000</td>
<td>88.67</td>
<td>$868,965</td>
<td>$868,965</td>
<td></td>
</tr>
<tr>
<td>Loans retained</td>
<td>100,000</td>
<td>9.85</td>
<td>96,552</td>
<td></td>
<td>$96,552</td>
</tr>
<tr>
<td>IO strip</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>15,000</td>
<td>1.48</td>
<td>14,883</td>
<td></td>
<td>14,883</td>
</tr>
<tr>
<td>Total</td>
<td>$1,015,000</td>
<td>100.00</td>
<td>$980,000</td>
<td>$868,965</td>
<td>$111,035</td>
</tr>
</tbody>
</table>

**IAS 39.61 - MODIFICATION OF TERMS**

**QUESTION**

**WHAT IS MEANT BY MODIFICATION OF TERMS?**

A modification of debt terms may include, among other things, any one or a combination of the following:

- reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt;
- extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk;
- reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement; and
- reduction (absolute or contingent) of accrued interest.

Cash flows can be affected by changes in principal amounts, interest rates, or maturity. They, also can be affected by fees exchanged between the debtor and creditor to effect changes in:

- recourse or non-recourse features;
- priority of the obligation;
- collateralised (including changes in collateral) or non-collateralised features;
- debt covenants and/or waivers;
- the guarantor (or elimination of the guarantor); and
- option features.

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IAS 32 and IAS 39: Summaries, Guidance, Examples, and US GAAP Comparisons
IASS.61 - APPLICATION OF THE PRESENT VALUE 10 PERCENT RULE

QUESTION

IF A MODIFICATION IS CONSIDERED TO BE AN EXTINGUISHMENT, HOW IS THE GAIN OR LOSS CALCULATED?

The modified debt is considered to be new debt and it is recorded at fair value adjusted for fees paid relating to the modification. Any difference between the carrying amount of the new debt and the carrying amount of the old debt is recognised in net profit or loss.

IASS.61 - COSTS OR FEES ON EXTINGUISHMENT/MODIFICATION

QUESTION

ARE FEES PAID TO THIRD PARTIES IN CONNECTION WITH A MODIFICATION ACCOUNTED FOR DIFFERENTLY FROM FEES PAID TO A CREDITOR?

IAS 39 does not distinguish between costs or fees exchanged between the debtor and creditor and those paid to third parties (such as legal fees). Fees are often used as a mechanism to amend the terms of the loan and are therefore often closely linked to adjustments in the interest rate charged on liabilities, rather than being true fees in nature. If the fees paid to third parties are related directly to the modification, they are accounted for as part of the gain or loss if the modification is an extinguishment, or as an adjustment to the carrying amount if the modification is not an extinguishment.

IASS.61 - DEBT MODIFICATION WITH PARTIAL EXTINGUISHMENT

QUESTION

HOW IS A MODIFICATION OF TERMS ACCOUNTED FOR WHEN IT IS ACCOMPANIED BY A PARTIAL EXTINGUISHMENT OF THE DEBT?

IAS 39 is not explicit in the treatment of instances where extinguishment of part of a financial liability occurs simultaneously with a modification of the terms of the remaining debt. Paragraph 65 requires the allocation of basis on relative fair values between the extinguished and the retained portions in determining the gain or loss on extinguishment and the adjusted carrying amount. Paragraph 61 requires full extinguishment if the modified terms exceed a ten percent threshold. The test in paragraph 62 to determine whether the modification is accounted for as an extinguishment is based on a comparison of cash flows under the new terms with the cash flows under the original terms. Such cash flows would encompass payments to reduce the debt, the test in paragraph 61 should be applied first to determine whether the entire transaction is an extinguishment. If the transaction is not considered to be an extinguishment under paragraph 61, the reduction in the outstanding principal as a result of a partial payment should be accounted for using the guidance in paragraph 63.

COMPARISON WITH US GAAP

The treatment of costs or fees under US GAAP is identical to that under IAS 39 in the case of fees exchanged between the debtor and creditor. However, under IAS 39 fees paid to third parties are recognised as part of the extinguishment even if new debt is issued in connection with the transactions.

Under US GAAP, when new debt is issued, fees paid to a third party associated with an extinguishment of the original debt are considered to be related to the new debt instrument and are amortised over the term of the new instrument using the effective interest rate method. Where the exchange or modification is not accounted for as an extinguishment, these fees are expensed as incurred. [EITF 96-10]

IAS 39 does not provide guidance on making the calculation of the 10 percent limitation.

US GAAP provides the following guidance in calculating the present value of the cash flows to determine whether or not a substantial modification has occurred:

- the cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument, plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification;
- if the original debt instrument and/or the new debt instrument have a floating interest rate, the variable rate in effect at the date of the exchange or modification is to be used to calculate the cash flows of the variable-rate instrument;
- if either the new debt instrument or the original debt instrument is callable or puttable, separate cash flow analyses are to be performed assuming exercise and non-exercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met;
- if the debt instruments contain contingent payment terms or unusual interest rate terms, judgement should be used to determine the appropriate cash flows;
- the discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument. It would not be considered appropriate to use the current market rate applied to the new debt as the discount rate; and
- if within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, the debt terms that existed a year ago should be used to determine whether the current exchange or modification substantially is different. [EITF 96-10].
**IAS 39.68 - MEASUREMENT: SUBSEQUENT CHANGES TO CLASSIFICATIONS**

**QUESTION**

**ARE SUBSEQUENT CHANGES TO THE CLASSIFICATION OR FINANCIAL ASSETS PERMITTED?**

Yes, in certain circumstances. The criteria for changes in classification between the various categories of financial assets and liabilities are set out below:

| Held-for-Trading | Because the designation of a financial asset as held for trading is based on the objective for initially acquiring it, an enterprise should not reclassify its financial assets that are being remeasured to fair value out of the trading category while they are held. (IAS 39.107) An enterprise should reclassify a financial asset into the trading category only if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification. (see IAS 39.107 and paragraph 21) Although paragraph 107 states that reclassifications should not be made from the held-for-trading category to another category, paragraph 92 permits the use of a different basis of valuation in the event that there is a change in intent or ability such that it becomes appropriate to carry at amortised cost an asset that was formerly carried at fair value. Paragraph 92 is not restricted specifically to available-for-sale assets. We believe that this was not intended to represent an exception to paragraph 107 and therefore that transfers out of the held-for-trading category are not permitted. |
| Held-to-Maturity (HTM) | Except in limited circumstances (due to either a change in intent or ability to hold the asset to maturity), IAS 39 does not permit reclassification out of the held-to-maturity category. Sales out of the held-to-maturity category that are considered to taint an enterprise’s intent result in the enterprise being required to reclassify all instruments in this category as either available-for-sale or held-for-trading. (see IAS 39.83) |
| Originated Loans and Receivables | Loans and receivables originated by the enterprise are not included in held-to-maturity investments but, rather, are classified separately under IAS 39. (IAS 39.10) This is not addressed specifically in IAS 39 but paragraph 10 indicates that originated loans and receivables may only be classified as either held for trading (where there is the intent to sell them in the short term) or in the separate, originated loans category. They, therefore, may not be classified as available-for-sale or held-to-maturity. |

**Available-for-Sale (AFS)**

Reclassifications into the held for trading category are required where there is evidence of a recent actual pattern of short-term profit taking. (see held-for-trading above)

IAS 39.92 permits available-for-sale instruments to be reclassified as held-to-maturity where the enterprise can demonstrate it has both the intent and ability to hold such instruments to maturity (or alternatively where the two-year ‘tainting’ period for held-to-maturity instruments has passed).

Instruments may only be reclassified into the available-for-sale category from either the held-to-maturity or originated loans categories since transfers out of the held for trading category are prohibited by IAS 39.107.

**Fair Value Instruments Where Fair Value Cannot Be Reliably Determined**

Changes in classification in respect of this category are based solely on whether fair value is reliably determinable. Once this becomes reliably determinable, these instruments are treated as either available-for-sale or as held-for-trading, as appropriate. If fair value is no longer reliably determinable, the relevant instruments are reported separately.
IAS 39.68 - SUMMARY OF MEASUREMENT AND RECOGNITION REQUIREMENTS BY CATEGORY

EXAMPLE

A summary of the measurement and recognition requirements, subsequent to initial recognition, for each category of financial asset or liability, is provided below.

HELD-TO-MATURITY INVESTMENTS (FINANCIAL ASSETS)

<table>
<thead>
<tr>
<th>Basis of Subsequent Measurement</th>
<th>Amortised cost. (see IAS 39, paragraphs 69, 71, and 84)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remeasurement Gains/ Losses</td>
<td>Remeasurement gain/ loss consists of the amortisation amount (determined using the effective interest rate method) which is reflected in net profit or loss for the period. (see IAS 39, paragraphs 108, 73, and 10)</td>
</tr>
<tr>
<td></td>
<td>Difference between the asset's carrying amount and the present value of expected future cash flows discounted at the original effective interest rate (the estimated recoverable amount) is recognised in net profit or loss for the period. The carrying amount is reduced to its estimated recoverable amount either directly or through an allowance account. (see IAS 39.111)</td>
</tr>
<tr>
<td>Impairment</td>
<td>Subsequent reversals of impairment losses are adjusted against net profit or loss and either directly against the carrying amount of the asset or the allowance account as appropriate. These may not exceed the equivalent amortised cost carrying amount had impairment not occurred. (see IAS 39.114)</td>
</tr>
<tr>
<td>Changes in Classification</td>
<td>If HTM designation is no longer appropriate, the financial asset should be remeasured at fair value. Gains or losses are then recognised based on whether it is subsequently classified as held-for-trading or available-for-sale. (see IAS 39, paragraphs 83, 84, and 90)</td>
</tr>
</tbody>
</table>

AVAILABLE-FOR-SALE FINANCIAL ASSETS

<table>
<thead>
<tr>
<th>Basis of Subsequent Measurement</th>
<th>Fair value. (see IAS 39.69)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remeasurement Gains/ Losses</td>
<td>Depending on the enterprise’s upfront election in respect of all assets of this class, this is either:</td>
</tr>
<tr>
<td></td>
<td>I Included in net profit or loss in the period it occurs; or</td>
</tr>
<tr>
<td></td>
<td>I Recognised directly in equity until the asset is disposed of at which time the cumulative gain or loss previously recognised in equity is included in net profit or loss for the period. (see IAS 39.123(b))</td>
</tr>
<tr>
<td>Impairment</td>
<td>If a loss on remeasurement to fair value is recognised directly in equity, and it can objectively be determined that the asset is impaired, the cumulative net loss previously recognised directly in equity for that asset is recognised in net profit or loss for the period even though the asset is not derecognised. (see IAS 39.117)</td>
</tr>
<tr>
<td></td>
<td>The amount of the loss to be removed from equity is the excess of the acquisition cost (net of any principal repayment and amortisation) over the current fair value (for equity instruments) or recoverable amount (for debt instruments), less any impairment loss on that asset previously recognised in net profit or loss. (see IAS 39.118)</td>
</tr>
<tr>
<td></td>
<td>The recoverable amount is calculated using the current market rate of interest for a similar financial asset. (see IAS 39.118)</td>
</tr>
<tr>
<td></td>
<td>A subsequent decrease in impairment loss is recognized in net profit or loss by reversing the previous loss to the extent of the recovery. (IAS 39.114)</td>
</tr>
<tr>
<td>Changes in Classification</td>
<td>If it is classified subsequently as held-to-maturity, the treatment is the same as the treatment for changes in classification of the held-for-trading category. (see below)</td>
</tr>
<tr>
<td></td>
<td>A change in classification from available-for-sale to held-for-trading only has an impact in instances where gains or losses on remeasurement were previously recognised directly in equity in accordance with the enterprise’s policy.</td>
</tr>
<tr>
<td></td>
<td>Interpretation: In this case, previously recognised gains or losses should be kept in equity until the instrument is disposed of when the full amount is recognised in net profit or loss. (See IGC Q&amp;A 127-1, Reclassification from Available-for-Sale to Trading)</td>
</tr>
</tbody>
</table>
### Loans and Receivables Originated by the Enterprise and Not Held-for-Trading (Financial Assets)

**Basis of Subsequent Measurement**
- Amortised cost unless the asset does not have a fixed maturity in which case it is measured at cost. (see IAS 39, paragraphs 69 and 73)

**Remeasurement Gains/Losses**
- Not applicable since assets are carried at cost.
- For assets carried at amortised cost, the amortisation amount (determined using the effective interest rate method) is reflected in net profit or loss for the period. (see IAS 39, paragraphs 108, 73, and 10)

**Impairment**
- The treatment is the same as that for held-to-maturity investments.

**Changes in Classification**
- Not addressed specifically but we believe that originated loans and receivables may only be reclassified into the held for trading category (see IAS 39.10). Such a change would result in measurement at fair value with changes in fair value recognised in net profit or loss in the period in which they occur.

### Financial Assets and Liabilities Held-for-Trading (Including Derivatives)

**Basis of Subsequent Measurement**
- Fair value. (see IAS 39.69)
- Remeasurement Gains/Losses.

**Remeasurement Gains/Losses**
- Recognised in net profit or loss in the period in which it arises. (see IAS 39.103(a))

**Impairment**
- Not applicable since the full loss already is recognised in net profit or loss. However, if the impairment occurs subsequent to the balance sheet date, recognition may be required subject to the provisions of IAS 10.

**Changes in Classification**
- This is not permitted in terms of IAS 39.107.

### Financial Assets or Liabilities Carried at Fair Value Where Fair Value Cannot Be Reliably Determined

**Basis of Subsequent Measurement**
- Cost or Amortised Cost depending on whether the instrument has a specified maturity. (see IAS 39, paragraphs 69 and 73)

**Remeasurement Gains/Losses**
- Not applicable unless fair value becomes reliably measurable in which case it is remeasured to fair value with the difference between its carrying amount and fair value recognised according to the classification of the instrument below.
- In respect of assets carried at amortised cost, the amortisation amount (determined using the effective interest rate method) is reflected in net profit or loss for the period. (see IAS 39, paragraphs 108, 73, and 10)

**Impairment**
- Use the same procedure as for held-to-maturity investments, with the exception that the review is based on an analysis of expected cash inflows. The impairment loss is then determined based on the difference between the asset’s carrying amount and the present value of expected future cash flows discounted at the current market interest rate for a similar financial asset (rather than using the original effective interest rate). (see IAS 39.115)

**Changes in Classification**
- Remeasured to fair value once a reliable measure of fair value becomes available. Gains or losses are then recognised based on whether it is subsequently classified as held-for-trading or available-for-sale and, in the case of available-for-sale, on the company’s policy for recognising changes in either equity or net profit or loss. (see IAS 39.91)
- In the rare circumstances that this is permitted under IAS 39.92, if it is subsequently classified as held-to-maturity, the fair value carrying amount becomes its new amortised cost. Amortisation is based on the difference between the maturity amount and the new carrying value. Previous gains/loss recognised directly in equity are amortised over the remaining life of the held-to-maturity investment or, if the instrument does not have a fixed maturity, are kept in equity until the instrument is disposed of when the full amount is recognised in net profit/loss. (see IAS 39.92)
FINANCIAL LIABILITIES (EXCEPT HELD-FOR-TRADING AND DERIVATIVE LIABILITIES)

<table>
<thead>
<tr>
<th>Basis of Subsequent Measurement</th>
<th>Amortised cost. (see IAS 39, paragraphs 69 and 73)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remeasurement Gains/Losses</td>
<td>The amortisation amount (determined using the effective interest rate method) is reflected in net profit or loss for the period. (see IAS 39, paragraphs 108, 73, and 10)</td>
</tr>
<tr>
<td>Impairment</td>
<td>Use the same procedure as for held-to-maturity investments.</td>
</tr>
<tr>
<td>Changes in Classification</td>
<td>Not specifically addressed under IAS 39; however, we believe that if these liabilities are subsequently classified as held-for-trading, they would be recognised at fair value with changes in fair value recognised in earnings.</td>
</tr>
</tbody>
</table>

HEDGES

<table>
<thead>
<tr>
<th>Basis of Subsequent Measurement</th>
<th>Fair value.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remeasurement Gains/Losses</td>
<td>Fair value hedges: the gain/loss in respect of both the hedging instrument and hedged item are recognised in net profit or loss in the period in which it arises (regardless of the classification of the underlying item) and the carrying amount of the hedged item is adjusted accordingly. (see IAS 39, paragraphs 153 - 157) Cash flow hedges: the gain/loss on the hedging instrument is recognised directly in equity to the extent the hedge is effective. The ineffective portion (as defined) is recognised immediately in net profit or loss if the hedging instrument is a derivative, or directly in equity if it is the enterprise’s policy and the hedging instrument is not a derivative. (see IAS 39.158-163)</td>
</tr>
<tr>
<td>Impairment</td>
<td>Not specifically addressed, however, this would be taken into account in determining the fair value of the hedging instrument, and therefore, would already affect hedge effectiveness.</td>
</tr>
<tr>
<td>Changes in Classification</td>
<td>Changes in treatment are based on the failure of a hedge’s effectiveness in offsetting changes in fair value or cash flows of the hedged item.</td>
</tr>
</tbody>
</table>
IAS 39.77 - TRANSACTION COSTS: CONSIDERATION IN SUBSEQUENT MEASUREMENT

QUESTION

HOW ARE TRANSACTION COSTS ACCOUNTED FOR IN THE SUBSEQUENT MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES THAT ARE NOT HELD-FOR-TRADING?

For instruments that are held-to-maturity, financial liabilities that are neither derivatives nor held-for-trading and for originated loans and receivables that are not held-for-trading, transaction costs will be amortised over the life of the instrument rather than being expensed as incurred. For available-for-sale instruments held by an enterprise that has elected, pursuant to IAS 39.103(b)(ii), to recognise all changes in fair value directly in equity, these costs are amortised from equity into the income statement using the effective interest method over the life of the instrument. If, however, the instrument does not have a fixed maturity, the costs are recognised in net profit or loss only at the time of sale.

IAS 39.77 - TRANSACTION COSTS SUBSEQUENT TO INITIAL MEASUREMENT

COMPARISON WITH US GAAP

US GAAP is silent about transaction costs subsequent to initial recognition and, therefore, does not either prohibit their deduction, or require these to be excluded from the determination of fair value. Enterprises following IAS 39 may therefore reflect higher fair values than US GAAP entities because those following US GAAP may choose to deduct anticipated transaction costs relating to sales in arriving at a fair value.

IAS 39.83 - SUBSEQUENT MEASUREMENT OF FINANCIAL ASSETS: IMPACT OF SALES ON REMAINING HTM INVESTMENTS

EXAMPLE

Assume Enterprise X has a portfolio of held-to-maturity (HTM) financial assets comprising both municipal and corporate bonds.

A sale or transfer of a single corporate bond that does not meet the specific exceptions in paragraph 86 of IAS 39 causes a taint of all remaining municipal and corporate bonds. These securities would be transferred into the available-for-sale or held-for-trading categories as appropriate.

IAS 39.83 - IMPACT OF SALES AFTER THE BALANCE SHEET DATE ON REMAINING HTM INVESTMENTS

EXAMPLE

Enterprise X, with a 31 December year-end, has a portfolio of financial assets classified as held-to-maturity (HTM). Early in January 20X2, prior to the issuance of the 20X1 financial statements, Enterprise X sells a portion of the financial assets held, and the factors motivating the sale do not qualify under the exceptions provided in paragraph 83 of IAS 39.

The entire HTM securities portfolio is required to be reclassified as either available-for-sale or held-for-trading in the balance sheet as at 31 December 20X1, since the actions in January call into question the enterprise’s assertion of intent at year-end.

IAS 39.83 - HELD-TO-MATURITY: ASSET-LIABILITY RISK MANAGEMENT CONSIDERATIONS

EXAMPLE

Enterprise X has a portfolio of debt securities and wishes to classify the investments as held-to-maturity (HTM). The investment policy will allow management to transfer every HTM security to the available-for-sale category at a specific predetermined date (for example, 24 months prior to each security’s stated maturity); the policy is designed to permit X the flexibility to sell debt securities and thereby manage the duration of the portfolio. Enterprise X’s policy would preclude classifying its debt securities as HTM because it does not have the positive intent and ability to hold those securities to maturity, and the remaining period to maturity is not sufficiently close to maturity to meet the exception in IAS 39.83(a).

IAS 39.83(c) - HELD-TO-MATURITY: NON-RECURRING AND ISOLATED

QUESTION

WHEN IS AN EVENT CONSIDERED TO BE NON-RECURRING AND ISOLATED?

An event that is isolated, non-recurring and unusual for the reporting enterprise that could not have been reasonably anticipated seems to comprehend situations that, by definition, would either not be known to the enterprise and has not occurred in the past or is not considered probable of occurring. Having met these conditions, in order to qualify for the exception, the event also, must be beyond the control of the enterprise.

IAS 39.85 - HELD-TO-MATURITY: EXTREMELY REMOTE EVENT

QUESTION

WHAT IS AN ‘EXTREMELY REMOTE’ EVENT?

The phrase ‘extremely remote’ is not defined specifically, but the example suggests that occurrence of the event is rare and outside of the control of the enterprise and that it also threatens the viability of the enterprise. Very few events would likely meet this criterion.

IAS 39.85 - HELD-TO-MATURITY: CATASTROPHIC INSURANCE POLICY LOSSES

QUESTION

ARE CATASTROPHIC POLICY LOSSES OF AN INSURANCE COMPANY CONSIDERED TO BE A DISASTER SCENARIO?

No. Catastrophic losses or high levels of policy surrenders generally are not considered a disaster scenario. Such losses are ‘reasonably possible’ of occurring in the insurance industry. They also, are not considered to be non-recurring or isolated and would not meet the exception under IAS 39.83(c). As a result, the sale of investments classified as held-to-maturity in order to meet excessive levels of claim obligations or because of policyholder withdrawals would taint the enterprise’s held-to-maturity classification.
**IAS 39.86 - HELD-TO-MATURITY: SALES CONTEMPLATED IN RESPONSE TO PERMITTED CONDITIONS**

**QUESTION**

**IF AN ENTERPRISE PLANS TO SELL A SECURITY FROM THE HELD-TO-MATURITY CATEGORY IN RESPONSE TO ONE OF THE CONDITIONS PERMITTED IN PARAGRAPH 86, IS IT PERMITTED TO CLASSIFY THE INSTRUMENT IN HELD-TO-MATURITY?**

Yes. There is no requirement in IAS 39 for the security to be reclassified to the available-for-sale or held-for-trading categories if an enterprise intends to sell in response to one of the permitted conditions.

**IAS 39.86(a) - HELD-TO-MATURITY: SIGNIFICANT DETERIORATION IN CREDIT**

**QUESTION**

**WHAT FACTORS ARE INDICATIVE OF A SIGNIFICANT DETERIORATION IN CREDIT?**

Although judgement is required, the following factors should be considered in determining whether a significant deterioration in the issuer’s creditworthiness has occurred as envisaged in paragraph 86:

- **The deterioration in the issuer’s creditworthiness should have occurred after the security was acquired.** Low credit ratings or creditworthiness concerns existing at acquisition would generally not provide a basis for a subsequent sale from the held-to-maturity category.

- **There should be evidence of actual deterioration of the issuer’s creditworthiness.** A downgraded by a rating agency provides objective evidence of credit deterioration. An expectation of deterioration should be supported by objective evidence. Some of the concrete financial measures that may provide objective evidence are:
  - cash flows from operations (declines in cash flows, available cash flows, or liquidity);
  - broker/analyst reports on the issuer;
  - adverse performance compared to projections;
  - sustained decline in earnings or other key measures; and
  - violation of covenants or other evidence that the issuer is in peril of violating covenants.

- **In many situations, an effective measure of a significant deterioration is a significant increase in the yield on the debt of an entity when compared to the change in the yield of a risk-free security of a similar maturity.** An increase in yield relative to a risk-free rate may be indicative of the market’s evaluation of the total mix of information including the risk associated with holding the issuer’s debt.

- **Guidance related to impairment, also, may be useful in assessing a significant decline in the issuer’s creditworthiness (see IAS 39.110).** Information, such as the current and near-term projected financial condition and performance of the issuer, the issuer’s dividend payment and earnings performance, the general market conditions and prospects of the region and industry in which the issuer operates, and specific adverse news or events affecting the issuer, also, may be used as general guidelines.

**IAS 39.86(a) - HELD-TO-MATURITY: EVIDENCE OF CREDIT DETERIORATION BASED ON GENERAL INDUSTRY FACTORS**

**QUESTION**

**DO GENERAL MARKET OR INDUSTRY FACTORS PROVIDE A BASIS FOR CONCLUDING THAT A SIGNIFICANT CREDIT DETERIORATION HAS OCCURRED?**

General market or industry prospects or events should have a direct or demonstrable effect on a specific issuer to provide evidence of a decline in creditworthiness for that issuer. For instance, widespread difficulties experienced by others in the industry (for example, due to over-leveraging or weak assets), but which are not expected to affect the issuer more adversely than its peers, would not be relevant. In contrast, the development of severe competition, adverse tax or regulatory developments, or declining markets may have a direct bearing on the creditworthiness of specific issuers.

**IAS 39.86(a) - HELD-TO-MATURITY: IMPACT OF A ONE-LEVEL CREDIT DOWNGRADE**

**QUESTION**

**IS A DOWNGRADE OF ONE LEVEL IN CREDIT A SIGNIFICANT DETERIORATION?**

A security that is downgraded one level generally would not meet the significant deterioration criteria. A decline in credit rating of two grades or more would, we believe, constitute a significant deterioration.

**IAS 39.86(a) - HELD-TO-MATURITY: SALE BASED ON ANTICIPATED CREDIT DOWNGRADE**

**QUESTION**

**IS A SALE OUT OF HELD-TO-MATURITY PERMITTED IF A SIGNIFICANT DOWNGRADE IN CREDIT IS ANTICIPATED?**

To meet this exemption, a sale should be in response to an actual deterioration rather than in advance of a deterioration in creditworthiness and should not be based on mere speculation or in response to industry statistics. The deterioration should be supported by evidence about the issuer’s creditworthiness through the enterprise need not await the formal notification of an actual downgrading in the issuer’s published credit rating or inclusion on a credit watch list.

**IAS 39.86(a) - HELD-TO-MATURITY: APPLICABILITY FOR HIGH-RISK DEBT**

**QUESTION**

**CAN AN ENTERPRISE CLASSIFY A HIGH-RISK DEBT SECURITY AS HELD-TO-MATURITY IF IT EXPECTS THAT AT SOME FUTURE DATE THERE WILL BE A SIGNIFICANT CREDIT DETERIORATION AND IT WOULD SELL IN RESPONSE TO SUCH DOWNGRADE?**

Yes, provided the enterprise has both the ability and intent to hold to maturity considering the poor credit quality that exists at the acquisition date. However, for high-risk debt securities and debt securities that are in default, it may be difficult, absent a bankruptcy, to substantiate that a subsequent significant credit deterioration occurred.
IAS 39.86(a) - HELD-TO-MATURITY: EXCHANGE OF DEBT SECURITIES PURSUANT TO BANKRUPTCY

QUESTION

WOULD AN EXCHANGE OF DEBT SECURITIES CLASSIFIED AS HELD-TO-MATURITY PURSUANT TO A BANKRUPTCY QUALIFY AS A PERMITTED SALE OUT OF HELD-TO-MATURITY?

Generally, yes. Bankruptcy is the ultimate form of credit deterioration. However, this condition is not met if the investor anticipated the bankruptcy at the acquisition date and was able to control the outcome.

IAS 39.86(a) - SALES OUT OF HTM DUE TO FAILURE OF REINSURERS

EXAMPLE

An insurance enterprise sells financial assets that have been classified as held-to-maturity (HTM) due to cash needs arising from the failure of one of its principal reinsurers.

A sale from the HTM portfolio for this reason would be inconsistent with the positive intent and ability to hold the security to maturity. This situation is not analogous to significant deterioration in an issuer’s creditworthiness, because the deterioration does not relate specifically to the issuer of the security sold but to the enterprise’s reinsurer. The failure of an insurance enterprise’s principal reinsurer, also, would not be considered an event that is ‘extremely remote’ or isolated, non-recurring, and unusual, given the environment in which an insurance enterprise operates.

IAS 39.86(a) - HELD-TO-MATURITY: BANKRUPTCY AND RESTRUCTURING

EXAMPLE

Assume N, a life insurance enterprise, purchased debt in a private placement offering. At acquisition, N classified the debt as held-to-maturity. The issuer, a private company, is currently in bankruptcy proceedings and is restructuring its debt. The issuer is contemplating swapping its debt to N in exchange for new debt and stock. N has no control over the outcome of the issuer’s restructuring arrangements.

Prior to the issuer’s determination of the final restructuring arrangements, N can continue to classify the debt security as held-to-maturity (HTM). The HTM classification is acceptable because the issuer’s termination of the original debt is not under N’s control. The restructuring is analogous to the issuer’s call option described in IAS 39.81. In some circumstances it may not be possible to hold a security to its original stated maturity, such as when the security is called by the issuer prior to maturity. The issuer’s exercise of the call option effectively accelerates the security’s maturity and is not to be viewed as being inconsistent with the held-to-maturity classification. Under these circumstances, the maturity date is accelerated to the date the issuer pays off or swaps the debt. Accordingly, we believe N’s classification as held-to-maturity is appropriate. N should determine whether impairment has occurred in terms of IAS 39, paragraphs 109-115, and if so, write down the financial instrument to its net recoverable amount.

Prior to the issuer’s determination of the final restructuring arrangements, N may transfer the debt security from the held-to-maturity (HTM) to the available-for-sale category without tainting its HTM portfolio. This conclusion is based on the guidance contained in paragraph 86(a), which concludes that a transfer resulting from evidence of a significant deterioration in the issuer’s creditworthiness will not call into question an enterprise’s intent to hold other financial assets to maturity in the future.

IAS 39.86(b) - HELD-TO-MATURITY: SALES IN RESPONSE TO ANTICIPATED TAX LAW CHANGES

QUESTION

ARE SALES OUT OF HELD-TO-MATURITY IN ANTICIPATION OF FUTURE TAX LAW CHANGES THAT HAVE NOT BECOME LAW, PERMITTED?

No. To qualify for the exception the tax change has to be law. Also precluded are reclassifications resulting from tax law changes that impact the marginal tax rate applicable to interest income on HTM debt securities.

IAS 39.86(b) - HELD-TO-MATURITY: ANTICIPATED CHANGE IN TAX LAW AFFECTING TAX-EXEMPT STATUS

EXAMPLE

Assume Enterprise X, a company operating in Canada, has a portfolio of financial assets classified as held-to-maturity (HTM), which contains a Malaysian bond issue. Also, assume that at the date that Enterprise X purchased the security, a tax treaty existed between the Canadian tax jurisdiction and Malaysia. This treaty allowed the use of Canadian foreign tax credits to reduce the onerous tax consequences that, otherwise, would result from inclusion of interest on the Malaysian security in taxable income in both tax jurisdictions (assuming Enterprise X, also, is taxed on the income in Malaysia).

Enterprise X cannot reclassify the security from its HTM category in anticipation of the treaty’s expiration without calling into question the intent to hold other financial assets to maturity. If the treaty does expire, however, reclassification is permitted, and no taint will occur in respect of any remaining HTM securities.

IAS 39.86(c) - HELD-TO-MATURITY: LIMITATION ON EXCEPTION RELATING TO BUSINESS COMBINATIONS/DISPOSITIONS

QUESTION

MAY AN ENTERPRISE SELL OUT OF HELD-TO-MATURITY WHENEVER THERE IS A MAJOR BUSINESS ACQUISITION OR DISPOSITION?

No, by referring to consequential rather than anticipated changes arising from a business combination or disposal, a sale is permitted only to maintain existing interest rate risk or credit risk positions. An enterprise may reassign the classification of held-to-maturity (HTM) securities concurrently with or shortly after a major business combination and not call into question its intent to hold other securities to maturity in the future. Following a major purchase acquisition, some of the acquiring enterprise’s HTM investments may need to be transferred or sold because of the nature of the liabilities assumed - even though all of the acquired financial instruments are classified anew following such a business combination. As time passes, it becomes increasingly difficult to demonstrate that the business combination, and not other events or circumstances, necessitated the transfer or sale of HTM securities.
**IAS 39.87 • HELD-TO-MATURITY: FACTORS AFFECTING ABILITY**

**QUESTION**

**WHAT FACTORS AFFECT ABILITY TO HOLD TO MATURITY?**

For financial assets classified as held-to-maturity (HTM), management should consider whether the enterprise has both the financial ability as well as the regulatory ability to obviate the need to dispose of HTM securities prior to maturity. An enterprise’s financial ability takes into account factors such as its funding position and its ability to maintain any over-collateralisation requirements. An enterprise’s regulatory ability takes into account factors such as its regulatory capital requirements, its liquidity position (including specified holdings of liquid assets), its loans-to-one-borrower ratio, growth prospects and financing related requirements and its investment authority (and permitted asset mix).

**IAS 39.87 • HELD-TO-MATURITY: REGULATORY CONSIDERATIONS • HIGH-RISK SECURITIES**

**QUESTION**

**CAN A REGULATED ENTITY CLASSIFY SECURITIES AS HELD-TO-MATURITY IF ITS REGULATORS MAY REQUIRE THE ENTITY TO DISPOSE OF THE SECURITIES?**

No. Even though the entity may have the intent to hold the securities to maturity, it does not have the ability. Certain financial institution regulators have designated specific financial instruments - such as certain collateralised mortgage obligations (CMOs) or other, similar stripped securities (for instance, interest-only and principal-only securities) - as high-risk securities. The regulators may require a regulated entity to sell such securities as a result of changes in interest rates. If a financial instrument is subject to such regulatory provisions, classification as held-to-maturity may not be appropriate since management would not be able to demonstrate the ability to hold to maturity as a result of the regulator being able to require the sale of the security under its existing policy.

**IAS 39.87 • HELD-TO-MATURITY: REGULATORY CONSIDERATIONS • LIQUIDITY**

**QUESTION**

**CAN AN ENTERPRISE DESIGNATE FOR REGULATORY PURPOSES A PORTION OF ITS HELD-TO-MATURITY PORTFOLIO TO BE USED FOR LIQUIDITY PURPOSES?**

No, such a representation contradicts the enterprise’s stated intent to held-to-maturity. One objective of financial reporting is that the assumptions used in preparing financial statements are consistent. It would be inconsistent under IAS 39 for an insurance company or other regulated enterprise to classify financial assets as held-to-maturity and, also, indicate to regulators that those investments could be sold to meet liquidity needs in a defined interest rate scenario whose likelihood of occurrence is reasonably possible but not probable.

**IAS 39.88 • TRANSFERS OUT OF HTM DUE TO FORECLOSURES**

**QUESTION**

**IS THE FORECLOSURE OF COLLATERAL AS A RESULT OF DEBT COVENANTS VIOLATIONS CONSIDERED A TRANSFER OUT OF HELD-TO-MATURITY AND DOES IT CAUSE A TAINT?**

As a remedy to protect the investor from the issuer’s violation of a debt covenant, a contractual right of foreclosure that was negotiated at arm’s-length at the issuance date would not preclude an investor classifying an investment as held-to-maturity (HTM). Similarly, the exercise of such a right or foreclosure on the violation of a substantial covenant would not taint an investor’s remaining HTM portfolio. However, this conclusion does not apply to a refinancing evidenced by any continuing debtor/creditor relationship.

**IAS 39.88 • INTER-COMPANY SALES OUT OF HTM**

**QUESTION**

**ARE INTER-COMPANY SALES OF HELD-TO-MATURITY INVESTMENTS PERMITTED?**

In consolidated financial statements, inter-company sales generally would not taint the held-to-maturity portfolio from a group perspective, as long as the business purpose of the transfer and the investment policies of the buyer are consistent with a positive intent and ability to hold to maturity. The impact on each entity’s stand-alone financial statements should be assessed separately.

**IAS 39.88 • SALES OUT OF HTM IN CONNECTION WITH A RESTRUCTURING AND CHANGE IN MANAGEMENT**

**QUESTION**

**IF THERE IS A CHANGE IN SENIOR MANAGEMENT IN CONNECTION WITH A RESTRUCTURING OF THE ENTERPRISE, IS A SALE OUT OF HELD-TO-MATURITY PERMITTED IF THE NEW MANAGEMENT EXECUTES SUCH SALES IN RESPONSE TO RESTRUCTURING STRATEGIES?**

No. A sale as a result of a change in management does not meet one of the exceptions under paragraphs 83 and 86 of IAS 39. Even if the enterprise undergoes a significant restructuring that is initiated by the board of directors and is independent of management, such sale out of held-to-maturity is not permitted.

**IAS 39.88 • VIOLATION OF DEBT COVENANTS**

**EXAMPLE**

Enterprise M, an insurance company, has a portfolio of private placement debt securities classified as held-to-maturity. The securities contain normal debt covenants that, in the event of default or non-compliance, permit M to exercise an embedded put option to sell the securities back to the issuer (initiate foreclosure). Trigger events for such covenants may include a change in control of the issuer and financial and operating covenants that may or may not have resulted in an actual credit deterioration.
Enterprise M may classify this financial asset as held-to-maturity (HTM). If, in a subsequent period, the issuer violates a substantial debt covenant, Enterprise M may exercise its right to sell the security back to the issuer without tainting its remaining HTM portfolio.

**IAS 39.88 - SALES IN RESPONSE TO UNSOLICITED OFFERS**

**EXAMPLE**

Enterprise A, an insurance company, initially classified 100 percent of its property liability fixed income portfolio as available-for-sale, 50 percent of its life fixed income securities portfolio as held-to-maturity (HTM), and 50 percent as available-for-sale. Enterprise A considered various factors in making these classifications, including its investment philosophy, security characteristics, liquidity needs, and asset-liability management strategy.

In a subsequent year, Enterprise A began receiving unsolicited tender offers from borrowers with respect to its fixed income portfolio (including its held-to-maturity portfolio) which was prompted by a very volatile interest rate environment. Enterprise A's analysis of these tender offers indicated that generally it would have been economically advantageous to accept them. In addition, Enterprise A was being approached with increased frequency by borrowers who desired to renegotiate the terms of certain previously issued securities which, in some cases were favourable to Enterprise A. These renegotiations were for reasons other than deterioration in creditworthiness. Enterprise A accepted certain tender offers involving the exchange of debt securities classified as HTM as these exchanges were on economically favourable terms.

As a consequence of the tender exchanges, Enterprise A is required to transfer 100 percent of previously classified held-to-maturity securities to available-for-sale because it can no longer assert it has the positive intent to hold all of these securities to maturity. The sale of a security in response to a tender offer typically is motivated not by a need for cash, but instead by the investor’s desire for additional possible profit - a motive inconsistent with the held-to-maturity classification. Further, none of the exceptions identified in paragraphs 83 and 84 of IAS 39 are met.

**IAS 39.89 - SALES SUBSEQUENT TO SIGNIFICANT CREDIT DETERIORATION**

**QUESTION**

**IF AN ENTERPRISE DOES NOT SELL IMMEDIATELY A DEBT INSTRUMENT IN RESPONSE TO A SIGNIFICANT CREDIT DETERIORATION, IS A SALE AT A FUTURE DATE PERMITTED?**

No. However, it would be permitted if the debt instrument was reclassified to the available-for-sale category when the credit deterioration occurred. An enterprise is required to make an ongoing assessment of its ability and intent to hold an instrument to its maturity. By not reclassifying the instrument out of held-to-maturity when the credit deterioration occurred, the enterprise effectively reconfirmed its intent to hold the instrument to its maturity.

**IAS 39.90 - ERROR CONSIDERATION FROM TRANSFERS OUT OF HTM**

**QUESTION**

**DOES A SALE OR TRANSFER OF A SECURITIES CLASSIFIED AS HELD-TO-MATURITY FOR REASONS OTHER THAN THOSE PERMITTED UNDER PARAGRAPH 86 OF IAS 39 INDICATE THAT THE PREVIOUS FINANCIAL STATEMENTS WERE ISSUED IN ERROR?**

Generally, because the accounting for securities is based primarily on a representation of intent by management, the sale or transfer of a security classified as held-to-maturity does not represent an error of previously issued financial statements, provided there was no evidence that existed at the time the financial statements were issued demonstrating that the entity did not have the positive intent and ability to hold the security to maturity. Such sale or transfer may call into question the enterprise’s intent to hold other debt securities to maturity in the future.

An example of evidence that would contradict management’s stated intention might be the existence of an investment policy that indicates investment objectives to manage the investment portfolio to meet liquidity needs for asset-liability management purposes, for specific tax positions, or for other objectives that would be inconsistent with the notion of holding securities to maturity. Another example of evidence that might be viewed as contradictory to management’s positive intent to hold certain securities to maturity is a history of selling held-to-maturity securities for reasons not specifically permitted in paragraph 86 of IAS 39.

**IAS 39.93 - TRADING LIABILITIES**

**COMPARISON WITH US GAAP**

US GAAP does not provide a ‘trading’ classification for liabilities. Under US GAAP, liabilities are carried at amortised cost, with the only exception being for derivative financial liabilities recorded a fair value.

**IAS 39.94 - SUBSEQUENT MEASUREMENT OF COMPONENTS OF COMPOUND INSTRUMENTS**

**QUESTION**

**HOW ARE COMPONENTS FROM COMPOUND INSTRUMENTS THAT INCLUDE A LIABILITY COMPONENT AND AN EQUITY COMPONENT SUBSEQUENTLY MEASURED?**

These components are required to be separated at inception. Subsequent to initial recognition, the liability component of a compound instrument should be recognised in the issuer’s accounting records in accordance with the provisions of IAS 39 to which they relate. A liability is carried at amortised cost, unless the liability is considered to be a derivative, in which case it would be a trading liability carried at fair value. Use of amortised cost results in the liability component being accreted to the redemption amount over the life of the instrument (using the effective yield method). The equity instrument is not remeasured subsequent to initial recognition since it falls outside the scope of IAS 39. If the equity component is a conversion option, upon exercise, equity would be increased in an amount equal to the carrying amount of the liability.
IAS 39.95 - FAIR VALUE MEASUREMENT: COST CONSIDERATIONS

QUESTION

TO WHAT EXTENT ARE COST CONSIDERATIONS TAKEN INTO ACCOUNT IN MAKING ESTIMATES OF FAIR VALUE?

It is possible that in situations where valuation techniques require sophisticated assumptions or comprehensive data sets to arrive at reliable estimates of fair value, enterprises, particularly smaller ones, will be forced to incur significant additional costs. In this case, provided that the criteria in paragraph 95 are satisfied, it may be more appropriate to use simplified assumptions (subject to adequate disclosure) to provide a reliable estimate of fair value at a reasonable cost. Sensitivity analysis could be performed to determine that the range of possible outcomes to changes in key variables is within tolerable limits so as not to produce estimates that are not reliable.

IAS 39.98 - INSTANTANEOUS TRANSACTION GAINS

QUESTION

CAN AN ENTITY ACQUIRE A FINANCIAL INSTRUMENT IN A PRIVATE TRANSACTION AND RECOGNIZE AN IMMEDIATE GAIN BASED ON ITS OWN ESTIMATE OF FAIR VALUE?

A transaction between a willing buyer and seller establishes its fair value. Accordingly there should be no instant profit. If market quotations are not available, a model should be developed to produce a zero profit at inception. Such model should be applied consistently to estimate subsequent values with adjustments for any subsequent changes in available market factors that affect value.

IAS 39.99 - MID-MARKET

QUESTION

WHAT IS MEANT BY THE TERM ‘MID-MARKET’?

IAS 39 does not define mid-market prices further but this is interpreted to mean the mid (or average) of both the bid and ask prices rather than the average of the bid prices or the average of the ask prices.

IAS 39.99 - SELECTING THE APPROPRIATE FAIR VALUE FROM DIFFERENT SOURCES

QUESTION

WHEN FAIR VALUE QUOTATIONS ARE AVAILABLE FROM DIFFERENT SOURCES, WHICH ONE SHOULD BE USED?

Market quotations ordinarily can be obtained from several different sources such as quoted prices on a financial exchange, prices from market makers who are willing to quote and trade at their own prices (sometimes referred to as a dealer market), or from independent brokers (sometimes referred to as brokered markets). Valuations may also be obtained from appraisers, from specialists firms that offer pricing services or from database services (such as BloombergTM). Where market quotations can be obtained from several different markets or different sources, the price in the most active market or from the most active source generally will be the best indicator of fair value. Market quotations that are obtained from any source other than the exchange market (typically described as the over-the-counter or OTC market), however, generally are not as precise or as reliable as the exchange market quotations. In addition, different price quotes might be obtained from different participants in the same non-exchange market. Since these can vary widely between participants, enterprises that place reliance on independent quotations should obtain more than one quotation to ensure that the fair value estimate is appropriate.

IAS 39.100 - CONSIDERATIONS WHEN USING MODELS TO ESTIMATE FAIR VALUE

QUESTION

WHAT ARE SOME OF THE KEY FACTORS TO BE CONSIDERED IN USING MODELS TO ESTIMATE FAIR VALUE?

A number of decisions must be made when using models to estimate fair value. These decisions involve the selection of methods, formulas, and assumptions (including the probability distributions of key variables and the required data sets). Each of these decisions requires judgement, and these decisions will vary depending on the characteristics of the particular instrument. Although the models used to estimate the value of financial instruments will differ depending on the type of instrument being valued, many market valuation techniques are founded on arbitrage arguments, which are based on the premise that a risk-free profit cannot occur in the marketplace. If risk-free arbitrage profits cannot occur, the theoretical value of a financial instrument must be equal to the value of an equivalent alternative investment.
There is no equivalent requirement under IAS 39.

Under US GAAP, the fair value of an equity security that is traded only in a foreign market is not considered to be comparable to one of the U.S. markets. Under IAS 39, an enterprise should determine whether fair value can be readily determined. Accordingly, if the net assets that underlie the unquoted equity instrument have readily determinable fair values, they are not used and the unquoted equity instrument is carried at cost. Under IAS 39, unquoted equity instruments can overcome the presumption that fair values can be reliably determined. If fair value of an unquoted equity instrument can be determined reliably, that instrument is carried at its fair value.

Under US GAAP, the fair value of an equity security that is traded only in a foreign market is not considered to be readily determinable and, therefore, is carried at cost unless the breadth and scope of that foreign market is comparable to one of the U.S. markets. There is no equivalent requirement under IAS 39.
US GAAP does not permit an adjustment for blockage when a company has a significant investment in a particular security and believes that an attempt to sell the entire investment at one time significantly would affect the security’s market price. If a quoted market price is available for an instrument, the fair value to be used is the product of the number of trading units of the instrument times its market price. [FASB 115, paragraph 137]

Although an adjustment for blockage is permitted under IAS 39.100, IGC Q&A 100-1 makes it clear that this would be difficult to do reliably in the absence of firm contracts of sale and hence the circumstances in which this would be applied are expected to be extremely rare.

Enterprises have different bookkeeping methods for available-for-sale (AFS) securities. Generally, a debit to cash (or trade date receivable) is recorded for the sales proceeds and a credit is recorded to remove the security at its fair value (or sales price). The amount recorded in equity, representing the unrealised gain or loss at the date of sale, is reversed into earnings and the deferred tax accounts are adjusted. Some adjustment to this procedure will be necessary for enterprises that have not yet recorded the security’s change in value up to the point of sale (perhaps because fair value changes are recorded at the end of each interim period) or when write-downs for impairment have been recognised.

Enterprise X has an investment in Y, an equity security, that was acquired in 19X8 with a cost of €1,000 that is classified as AFS. X’s effective tax rate is 40 percent, and the enterprise is not taxed on a marked-to-market basis. At the close of 19X8, X’s investment in Y shares had a fair value of €1,100; thus, X increased the carrying amount of the AFS securities by €100 and recorded a gain, net of related deferred income tax expense, of €60 (€100 - [€100 x 40%]) in the separate component of shareholders’ equity; additionally, a deferred tax liability of €40 was recorded at the end of 19X8. If X sells its shares in Y for €1,100 in 19X9, the gain reported previously in stockholders’ equity is reversed and the deferred tax accounts are adjusted as shown in the following journal entry.
**IAS 39.107 - SALE OF SECURITIES HELD-FOR-TRADING**

**EXAMPLE**

Enterprise X has an investment in an equity security, Y, that was acquired late in 20X1 with a cost of £1,000 and which was classified as held-for-trading. Enterprise X’s effective tax rate is 40% and the enterprise is not taxed on a mark-to-market (fair value) basis. At the close of 20X1, X’s investment in Y shares had a fair value of £1,100; thus, X increased the carrying amount of the trading security by £100, recording a gain in income of £100. Enterprise X also recognised deferred tax expense (and a deferred tax liability) of £40 (£100 x 40%) in 20X1. If X sells its shares in Y for £1,100 early in 20X2, no gain or loss would be recognised and the following journal entry would be made:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>£1,100</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Current tax expense</td>
<td>40</td>
<td></td>
</tr>
</tbody>
</table>

To record the sale of trading securities carried at fair value in 20X2.

**IAS 39.111 - IMPAIRMENT OF FINANCIAL ASSETS CARRIED AT AMORTISED COST: ASSESSING PROBABILITY OF IMPAIRMENT**

**QUESTION**

How is the probability test, that the enterprise will be able to collect all amounts due according to the contractual terms of the agreements, applied when payments are contractually delinquent?

Specific guidance is not provided for assessing probability, and considerable judgement is required. The wording implies, however, that this envisages situations where the likelihood of impairment is beyond a mere possibility. If the impairment is expected to be temporary and, therefore, is not expected to impact negatively on the ability to collect all amounts due, an impairment loss normally would not be recognised.

**IAS 39.111 - IMPAIRMENT: PAST DUE STATUS AND FREQUENT LATE PAYMENTS**

**QUESTION**

Does objective evidence of impairment exist that requires measurement of the recoverable amount when a debtor is frequently past due in making contractual payments?

Ordinarily the failure of a debtor to pay when due provides objective evidence of impairment that requires measurement. However, a single delinquent payment or even a pattern of missing payment dates but making such payments within a short period of time after their due date does not by itself indicate that the recoverable amount must be measured. There may be other factors, however, that provide additional evidence that an impairment exists and those factors combined with the past due status may provide such objective evidence.

**IAS 39.111 - OBJECTIVE EVIDENCE OF IMPAIRMENT**

**EXAMPLE**

Company B has receivables arising from sales to Company X. Company B’s normal credit terms specify that payment must be made within 30 days of invoice date. Company X receivables are currently aged at 90 days. However, Company X is the largest producer in the industry and wields significant buying power over its suppliers. As part of its financing strategy, Company X usually settles amounts due to suppliers within 60 to 90 days. In addition, it has no history of defaulting on payments.

Company B would not perform an impairment test since it is probable that it will be able to collect all amounts due. Although these sales fall outside Company B’s normal credit terms, the short-term nature of the receivable is not considered to result in a carrying amount that exceeds the net recoverable amount, and there is no past history of default. If, however, after a more substantial period of time, for example 120 days, Company B still had not received payment from Company X, absent other factors, there exists objective evidence of impairment that would require Company B to conduct an impairment assessment of these receivables.

**IAS 39.111 - IDENTIFYING AND RECOGNISING IMPAIRMENT**

**EXAMPLE**

Enterprise K purchases bonds that are classified as held-to-maturity and has a financial year ending on 30 September. During the 20X1 and 20X2 financial years, in accordance with its investment strategy of seeking a high-level of income without risking the principal, Enterprise K invested a total of €13.7 million in high yielding emerging market debt from countries with an investment grade rating. At 30 September 20X1, the fair value of Enterprise K’s investment had increased by €35,000. During the 20X2 financial year, the global fixed-income markets were impacted negatively by an emerging markets crisis, which increased significantly credit spreads for these countries’ debt and therefore resulted in sharply higher interest rates. As a result, after conducting impairment testing, K had a €1.5 million notional unrealised loss on the investments at 30 September 20X2. The unrealised holding losses in the investments amounted to €1.1 million at 30 September 20X3, after a slight recovery in the markets (as evidenced by a €400,000 net increase in the value of the investments between the 20X2 and 20X3 financial years).
K analysed the decline in fair value at 30 September 20X2 and 20X3. K expected the fixed-income markets to continue to improve during fiscal year 20X4. K also concluded that it was still probable that it would collect all amounts due based on the contractual terms.

Although the value of the investments improved significantly during the first quarter of the 20X4 financial year (K’s unrealised holding losses had further declined to €800,000 by December 20X3), the fixed-income markets began to deteriorate shortly thereafter following an economic crisis in China. As a result, the fair value of the investments began to decline significantly and K’s unrealised holding losses increased to €1.8 million by 30 September 20X4.

As a result of the continued decline in fair value and based on market analysis, K now concluded that it was no longer probable that all amounts would be collected when due and therefore recognised an impairment loss in the fourth quarter of the 20X4 financial year. Although the fair value of the bonds showed signs of recovery at the end of the 20X3 financial year and in the first few months of the 20X4 financial year, the following factors indicated a strong probability that K would not be able to collect all amounts due:

- Consensus forecasts by leading international investment banks indicated that a large number of emerging market countries were expected to default on their sovereign debt with little prospect of renegotiation or recovery of principal in the short to medium term;
- Liquidity in the markets for certain of these countries’ debt had disappeared and it was no longer possible to sell bonds except at significant discounts to fair value;
- The fair value of the investments had declined each month from January 20X4 until year-end. The fair value of the investments showed no signs of recovery during that period;
- The fair value of the investments has not been above the £13.7 million amortised cost since the 20X1 financial year; and
- The investments’ historically poor performance suggests that the adequacy of its performance in the future is uncertain.

Accordingly, the carrying amounts of the investments were written down to their net recoverable amount. The amount of the write-down was recorded in net profit or loss for the fourth quarter of the 20X4 financial year. The charge to earnings in the fourth quarter of fiscal year 20X4 is appropriate given the length of time that has passed (nine months) since the investments showed any signs of recovery.

**IAS 39.111 - IMPAIRMENT TESTING IS BASED ON OTHER-THAN-TEMPORARY**

**COMPARISON WITH US GAAP**

Impairment testing under US GAAP for available-for-sale and held-to-maturity securities is based on circumstances where the impairment is considered to be ‘other than temporary’ and, therefore, involves an assessment of the probability of the impairment being reversed. Although impairment under IAS 39 also is based on the probability that a loss has occurred, it does not include the requirement that the impairment is other than temporary. Unlike US GAAP, IAS 39 would recognise a reversal of an impairment loss in a subsequent period.

**IAS 39.114 - IMPAIRMENT LOSSES ADJUST THE BASIS OF THE ASSET**

**COMPARISON WITH US GAAP**

Under US GAAP, if an impairment loss is recognised, it is a basis adjustment of the asset. Any subsequent recovery is not permitted to be recognised until the asset is sold or when it matures.

IAS 39 impairment guidelines permit reversing previous impairment-related write-downs through earnings.

**IAS 39.122 - FOREIGN CURRENCY INSTRUMENTS THAT QUALIFY AS HEDGING INSTRUMENTS**

**COMPARISON WITH US GAAP**

<table>
<thead>
<tr>
<th>Hedging Instruments that Can Qualify for Hedge Accounting</th>
<th>IAS 39</th>
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<tbody>
<tr>
<td>Derivatives</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Non-Derivatives</td>
<td>Yes</td>
<td>No (1)</td>
</tr>
<tr>
<td>Related Party Derivatives</td>
<td>Yes (not explicit) (2)</td>
<td>Yes (not explicit) (2), (3)</td>
</tr>
</tbody>
</table>

(1) Non-derivatives can, however, be used to hedge unrecognised firm commitments and a net investment in a foreign operation.
(2) A related party derivative can qualify as a hedging instrument in the consolidated financial statements if it is offset by a derivative with an independent third party.
(3) Hedge accounting is permitted for foreign currency exposures relating to unrecognised firm commitments and forecasted transactions involving the same foreign currency that are combined centrally through the use of internal derivatives and netted, and the net exposure offset with a third party derivative if certain conditions are met relating to the maturity of the instruments, and tracking and maintaining the external derivative positions.

**IAS 39.123 - HEDGING INSTRUMENTS: AN ENTITY’S OWN EQUITY INSTRUMENTS**

**QUESTION**

**WHY IS AN ENTITY’S OWN EQUITY INSTRUMENT NOT PERMITTED TO BE DESIGNATED AS A HEDGING INSTRUMENT IN A HEDGING RELATIONSHIP?**

An entity’s own equity instruments are not accounted for as a derivative and, accordingly, changes in value are not recognised. Only derivative instruments and foreign currency assets and liabilities qualify as hedging instruments.
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**COMPARISON WITH US GAAP**

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IAS 39.123 - HEDGING INSTRUMENTS: MANDATORILY REDEEMABLE PREFERRED SHARES

QUESTION

IS THE FAIR VALUE EXPOSURE ON MANDATORILY REDEEMABLE PREFERRED SHARES A RISK THAT CAN BE HEDGED FOR ACCOUNTING PURPOSES UNDER IAS 39?

Yes, provided that the mandatorily redeemable preferred shares are accounted for as debt. The limitation on hedging an enterprise’s own equity securities is based on their classification as debt or equity, not on their form. In the case of mandatorily redeemable preferred shares, since IAS 32 regards these as debt instruments, the dividend on these shares is, by nature, interest. The distinction between debt and equity is based on whether the enterprise is obligated to make the payment, thus dictating whether it is recorded through earnings. Hedging dividends on mandatorily redeemable preferred shares and on other ‘equity’ instruments that, by nature, are obligation of the enterprise is permitted because those instruments are considered to be debt instruments.

IAS 39.123 - HEDGE OF DETACHABLE SHARE WARRANTS NOT PERMITTED

EXAMPLE

Company S has issued debt with detachable share warrants. The warrants were assigned a fair value and are recorded in shareholders’ equity. The price of Company S’s common stock has improved significantly in the market in the current year, and S believes that the warrants will be in the money within the next three months. The exercise of the warrants will have a dilution effect for Company S’s shareholders and, therefore, Company S would like to hedge the fair value exposure associated with the warrants. S purchases call options on its own shares as a hedge of the written call options (warrants) that it issued.

The options are considered equity instruments. Accordingly, the warrants do not qualify as hedged items under IAS 39 because the exchange or settlement of the warrants will not affect net profit or loss.

IAS 39.123 - HEDGING WITH INSTRUMENTS INDEXED TO AN ENTITY’S OWN STOCK

QUESTION

IS A CALL OPTION ISSUED BY AN ENTERPRISE THAT IS INDEXED TO ITS STOCK AND THAT REQUIRES SETTLEMENT IN CASH ELIGIBLE TO BE TREATED AS A HEDGED INSTRUMENT?

Yes. Such an instrument is not an equity instrument because it may obligate the entity to settle on a net-cash basis. However, it is a derivative instrument that is required to be treated as a trading instrument and carried at fair value. To hedge this instrument, the enterprise must enter into an offsetting equity-linked instrument, and it too must be a derivative instrument. If it were classified as equity, a change in value would not be recognised in net profit or loss.

IAS 39.124 - HEDGING: COMBINATION OF OPTIONS INDEXED TO DIFFERENT INTEREST RATES

QUESTION

IF A COMBINATION OF INTEREST RATE OPTIONS IS USED IN A HEDGING RELATIONSHIP, CAN THE COMBINATION QUALIFY AS A HEDGE IF THE PAYOFF OF EACH OPTION COMPONENT IS BASED ON DIFFERENT INTEREST RATES, FOR EXAMPLE, A WRITTEN FLOOR BASED ON THREE-MONTH TREASURY RATES AND A PURCHASED CAP BASED ON THREE-MONTH LIBOR?

No, Treasury rates and LIBOR rates are not considered to be the same underlying even though both are interest rates. To qualify for hedge accounting the combination must be based on the same underlying.

IAS 39.124 - HEDGING: COMBINATION OF OPTIONS WITH VARYING TERMS

QUESTION

HOW IS A COMBINATION OF OPTIONS EVALUATED IF EITHER THE STRIKE PRICES OR THE NOTIONAL AMOUNTS, OF EITHER THE WRITTEN OR THE PURCHASED OPTION COMPONENTS WITHIN A COMBINATION OF OPTIONS, DO NOT REMAIN CONSTANT OVER THE LIFE OF THE RESPECTIVE COMPONENT?

No specific guidance is provided in IAS 39. However, since the variations in strike prices or notional amounts over the life of the contracts provide a basis for changing risk profiles of the instrument, the evaluation must consider the effect of those changes. If either the strike prices or the notional amounts, of either the written or the purchased option components within a combination of options, do not remain constant over the life of the respective component, the assessment of whether this represents a net written option should be evaluated with respect to each date that either the strike prices or the notional amounts change within the contractual term from inception to maturity. Even though the assessment is made on the date that a combination of options is designated as a hedging instrument, it must consider the receipt of a net premium (in cash or as a favourable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change. [DIG Issue E-5]

IAS 39.124 - HEDGING: COMBINATION OF OPTIONS - SEPARATING OUT THE WRITTEN OPTION COMPONENT

QUESTION

IF A COMPOUND DERIVATIVE CONTAINS AN EMBEDDED WRITTEN OPTION, CAN THE WRITTEN OPTION COMPONENT BE SEPARATED AND ACCOUNTED FOR AS A HEDGE OF A PURCHASED OPTION?

No. The embedded option may not be split out from the derivative to enable the residual component to be designated as a hedging instrument. The splitting out of a derivative is permitted only if it is embedded in a hybrid instrument where the host component is not a derivative. (See paragraphs 22 and 144 of IAS 39)
IAS 39.124 - HEDGING: COMBINATION OF OPTIONS - ASSESSING EXISTENCE OF A NET WRITTEN OPTION

EXAMPLE

Consider the following two scenarios:

<table>
<thead>
<tr>
<th></th>
<th>Scenario #1</th>
<th>Scenario #2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Purchased Cap</td>
<td>Written Floor</td>
</tr>
<tr>
<td>Trade Date</td>
<td>04/01/00</td>
<td>04/01/00</td>
</tr>
<tr>
<td>Effective Date</td>
<td>04/01/00</td>
<td>04/01/00</td>
</tr>
<tr>
<td>Maturity Date</td>
<td>31/12/04</td>
<td>31/12/04</td>
</tr>
<tr>
<td>Notional Amount</td>
<td>$100 million</td>
<td>$100 million</td>
</tr>
<tr>
<td>Underlying</td>
<td>LIBOR</td>
<td>LIBOR</td>
</tr>
<tr>
<td>Strike</td>
<td>6.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Premium Paid (Received)</td>
<td>$2.25 million</td>
<td>($1.15 million)</td>
</tr>
</tbody>
</table>

Based on the FASB Derivative Implementation Group guidance discussed above, the following conclusions may be made:

The combination option in Scenario #1 may be designated as a hedging instrument because:

- no net premium is received;
- the components of the combination of options are based on the same underlying (LIBOR);
- the components of the combination of options have the same maturity date (31/12/04); and
- the notional amount of the written option component is not greater than the notional amount of the purchased option component (that is, notional amounts are identical).

This combination option is, therefore, considered to be a net-purchased option.

The combination option in Scenario #2 may not be designated as a hedging instrument because:

- a net premium of $1.5 million was received;
- the components of the combination of options are not based on the same underlying (LIBOR for the purchased option and the Prime rate for the written option); and
- the notional amount of the written option component is greater than the notional amount of the purchased option component ($75 million notional amount for purchased option and $100 million for written option).

This combination option is, therefore, considered to be a net-written option.

IAS 39.124 - HEDGING WITH A DERIVATIVE WITH AN EMBEDDED WRITTEN OPTION COMPONENT

EXAMPLE

Company A enters into a pay-variable, receive-fixed interest rate swap that has an early termination feature that permits the counterparty to terminate the swap prior to its maturity at a specified price. The termination feature is an embedded written option that would require the entire derivative instrument to be viewed as a written option because the potential loss on the swap is greater than the potential gain.

Company A may not split out the embedded written option from the swap and designate the swap component as a hedge.

Note that in the above example, if the termination feature merely specified that the counterparty could terminate the transaction at the market price (an ‘early termination’ or ‘break’ clause), this would not represent a written option because there is no value attached to it. Since the option merely enables the parties to terminate the derivative contract at market, there is no exposure to gain or loss.

IAS 39.127 - HEDGED ITEM: HEDGING INTERCOMPANY TRANSACTIONS

QUESTION

DO INTERCOMPANY TRANSACTIONS QUALIFY AS HEDGED ITEMS IN THE CONSOLIDATED FINANCIAL STATEMENTS OF THE ENTERPRISE?

Generally no. Intercompany transactions typically do not expose the entity to a risk that affects net profit or loss.

IAS 39.127 - HEDGING INTERCOMPANY FOREIGN CURRENCY TRANSACTIONS

QUESTION

DO INTERCOMPANY FOREIGN CURRENCY TRANSACTIONS QUALIFY AS HEDGED ITEMS IN THE CONSOLIDATED FINANCIAL STATEMENTS?

Yes, provided that they expose the enterprise to a risk that affects net profit or loss. This condition generally is met if the hedged transaction is denominated in a currency other than that unit’s measurement currency since the transaction produces a foreign currency transaction gain or loss that is recognised in the financial statements and not eliminated in consolidation.

IAS 39.127 - HEDGING UNRECOGNISED ASSETS

QUESTION

CAN AN UNRECOGNISED ASSET QUALIFY AS A HEDGED ITEM?

No. Paragraph 27 of IAS 39 specifies that recognised assets and liabilities qualify as hedged items.
IAS 39.127 - HEDGING THE DOWNSIDE RISK IN AN EQUITY SECURITY

**EXAMPLE**

Company XYZ owns 1,000 shares of Company ABC’s publicly traded common stock and has classified the securities as available-for-sale. At 1 January 2000, these shares are trading at A$50 per share and Company XYZ has an unrealised gain of A$25,000 recognised directly in equity. XYZ would like to lock in the unrealised gain and purchases a put option on Company ABC’s common stock from Counterparty A for A$9,000. The purchased put option allows XYZ to put its 1,000 shares to Counterparty A at A$50 per share on 31 December 2002. The purchased put option may be appropriately designated as a hedge of the exposure to the decline in the fair value of the investment in ABC.

IAS 39.127 - HEDGING UNRECOGNISED ASSETS: CORE DEPOSIT INTANGIBLES OF BANKS

**EXAMPLE**

Bank C has significant core deposit relationships. Management views these relationships as a significant intangible asset. However, no intangible asset for the deposit relationships has been recognised because the deposits have been internally generated by Bank C. Bank C would like to hedge the fair value exposure related to changes in fair value of its deposit intangible. Because the intangible asset is unrecorded, it is an unrecognised asset and, therefore, cannot be designated as a hedged item. However, if Bank C had paid a premium to purchase the core deposits, that premium could be designated as a hedged item with the hedged risk being the changes in the overall fair value of the core deposits. To qualify for hedge accounting, however, the other qualifying criteria of IAS 39 would also have to be met.

IAS 39.127 - HEDGING FOREIGN CURRENCY RECEIVABLES

**EXAMPLE**

Company Z produces, distributes, and sells software products throughout the world. Z’s functional currency is the Japanese Yen. Company Z sells its products in the local currency of its customers. Company Z is subject to foreign currency risks on receivables denominated in local currencies other than the Japanese Yen. Company Z has entered into a foreign forward exchange contract (a derivative) to hedge existing accounts receivable denominated in different local currencies.

The hedged items (accounts receivable) are remeasured at fair value (that is, the cash flows are converted to the measurement currency using forward exchange rates and discounted to arrive at fair value using market interest rates of the measurement currency) with the changes in the carrying amount reported currently in earnings. In this example, the receivables can be hedged and the hedging relationship accounted for as a fair value hedge whereby the changes in the fair value of the hedging instrument are recognised in earnings.

IAS 39.127 - HELD-TO-MATURITY INVESTMENTS

**COMPARISON TO US GAAP**

Under US GAAP, the risk of changes in foreign currency exchange rates may not be hedged if the hedged item is classified as held-to-maturity. However, US GAAP permits hedge accounting for the change in the fair value of a prepayment option component embedded in the held-to-maturity instrument.

IAS 39 permits the foreign currency exposures to be hedged for an instrument classified as held-to-maturity but it does not provide an exception to permit hedge accounting for prepayment risk in a held-to-maturity instrument. Both IAS 39 and US GAAP permit the credit risk in a held-to-maturity instrument to be designated as a hedged item.

IAS 39.127 - INSTRUMENTS REMEASURED AT FAIR VALUE

**COMPARISON WITH US GAAP**

Under US GAAP, a forecasted transaction cannot qualify as a hedged item where the forecasted transaction results in the acquisition of an asset or a liability being incurred that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. If the forecasted transaction relates to a recognised asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. [FASB 133, paragraph 29(d)]

However, FASB 138, paragraph 40, permits hedge accounting for foreign currency expenses if certain conditions are met, even though, the foreign currency component is remeasured with the change in spot rates reported in earnings.

IAS 39 does not specifically prohibit hedge accounting for forecasted transactions that will be remeasured with changes in fair value reported in net profit or loss.
IAS 39.127 - HEDGING INTERCOMPANY TRANSACTIONS

COMPARISON WITH US GAAP

Under US GAAP, hedge accounting for hedges of forecasted intercompany foreign currency transactions is permitted if all of the following criteria are met:

I the operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary). Another operating unit with the same functional currency as the operating unit that has the foreign currency exposure also could be a party to the hedging instrument;

I the hedged transaction is denominated in a currency other than that unit’s functional currency;

I all of the criteria for a cash flow hedge are met, except for the requirement that the forecasted transaction be with a party external to the reporting entity; and

I if the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

IAS 39 does not specify criteria necessary to hedge intercompany transactions. However, in addition to the specific hedge accounting provisions, the enterprise must determine that the intercompany transaction exposed it to risk.

IAS 39.127 - FOREIGN CURRENCY HEDGED ITEMS COMPARED

COMPARISON WITH US GAAP

<table>
<thead>
<tr>
<th>Foreign Currency Risk in Foreign-Currency-Denominated Transactions and Balances That Can Qualify for Hedge Accounting</th>
<th>IAS 39</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading securities</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Held-to-maturity investments</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Unrecognised firm commitments</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Available-for-sale security</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Related party receivables and payables</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm commitment to purchase a business</td>
<td>Yes</td>
<td>Yes (Limited)</td>
</tr>
<tr>
<td>Forecasted transactions</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Forecasted related party transactions</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Net investment in a foreign operation</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Assets, liabilities, and transactions remeasured at spot</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

IAS 39.128 - HEDGING AN INSTRUMENT SUBJECT TO PREPAYMENT

QUESTION

IF AN INSTRUMENT TO BE HEDGED CONTAINS AN EMBEDDED PREPAYMENT OPTION, MUST THAT OPTION BE CONSIDERED IN DESIGNATING A HEDGING RELATIONSHIP OF MARKET INTEREST RATE RISK ON THE DEBT TO BE ABLE TO DEMONSTRATE HIGH CORRELATION?

It depends on whether the entire instrument is designated as the hedged item or just the fixed term. If the entire instrument is designated as being hedged, the effect of an embedded derivative must be considered in designating a hedge of an individual risk. If the entire asset or liability is designated as being hedged, the hedging instrument to be effective would have to contain an option that coincides with the prepayment option on the debt allowing the entity to terminate the hedge. However, the hedging relationship could be designated for just the fixed portion of the term of the instrument, that is, for the period, if any, before the prepay option can be exercised. A portion can be designated as being hedged provided effectiveness can be measured.

IAS 39.128 - HEDGE OF A PORTION: CREDIT RISK

EXAMPLE

Company F purchased £2,500,000 in BBB rated corporate bonds on 1 March. The securities will be classified as available-for-sale. Company F realises that if the issuer’s credit standing is downgraded, the fair value of the fixed-rate bonds will decrease. On 1 March, Company F also enters into a credit swap to hedge the fair value exposure associated with changes in the issuer’s credit rating. The terms of the swap call for Company F to pay a fixed amount and receive or pay a variable amount based on changes in the credit fair value of the bonds.

The portion of the risk of the bonds related to credit exposure qualifies as a hedged item and the credit swap appropriately may be designated as the hedging instrument.

IAS 39.128 - HEDGING SELECTED CASH FLOWS

EXAMPLE

Company R is replacing maturing debt with a new NZ$100 million 10-year fixed-rate borrowing. Company R believes that interest rates will be volatile for the next three years and will decline in years 4 to 10. Company R issued the new debt on 4 January 2000, with a fixed rate of 8.25%. Interest on the debt is payable annually beginning 31 December 2000. At the same time that Company R issued the debt, it entered into a forward starting interest rate swap and designated it as a hedge of fair value exposure due to interest rates on the last seven years of the debt.

The forward starting interest rate swap may appropriately be designated as a hedge of the fair value in years 4 to 10 of the 10-year debt. The change in fair value is based on the changes in the yield curve in years 4 to 10.
**IAS 39.128 - HEDGING MULTIPLE RISKS WITH DIFFERENT DERIVATIVES**

**EXAMPLE**

Company M’s functional currency is the Israeli Shekel. On 1 April, Company M entered into a firm commitment to invest in fixed-rate debt to be issued by Company D with delivery of the bond on 1 May. The price of the corporate debt is set at €270,000. Company M would like to hedge its fair value exposure related to interest rate risk and foreign exchange risk. M enters into a forward contract on 3 February to purchase €270,000 on May 1 and designates this contract as the hedge of the foreign exchange risk. M also enters into a forward starting interest rate swap that calls for M to pay a fixed amount and receive a variable amount. The swap is designated as a hedge of the interest rate risk.

Subject to the other criteria being satisfied, both of these derivative transactions would qualify for hedge accounting.

**IAS 39.128 - HEDGING THE FOREIGN CURRENCY EXPOSURE IN AN AFS EQUITY SECURITY**

**EXAMPLE**

ABC is a US-based manufacturing company. ABC owns shares in Company X, a publicly traded stock; the security is classified as available-for-sale. Company X is listed only on the London Stock Exchange. Dividends are paid in pound sterling and the share price is quoted in pound sterling.

Because this instrument is not traded on a US dollar-denominated exchange, it creates a foreign currency exposure and can qualify as a hedged item. If Company X’s shares are also traded on the NYSE, they would not be eligible for hedge accounting since there would not be a foreign currency exposure.

**IAS 39.128 - PARTIAL-TERM HEDGES**

**COMPARISON WITH US GAAP**

Under US GAAP, partial-term hedge transactions of fair value exposures do not qualify for hedge accounting because only specified portions of risk (credit, interest rate, prepayment) are permitted to be hedged.

Partial term fair value hedges are permitted under IAS 39 provided that effectiveness can be demonstrated and the other qualifying requirements are met.

**IAS 39.128 - HEDGING CREDIT AND INTEREST RATE RISK**

**COMPARISON WITH US GAAP**

FASB 138 redefined the FASB 133 definition of interest rate risk under US GAAP. FASB 133 defined interest rate risk as the changes attributable to changes in interest rates and changes in prevailing spreads over market interest rates. This resulted in credit spread risk being a source of ineffectiveness that was either included in current income or could result in the hedge failing to qualify for hedge accounting. Under FASB 138, changes in prevailing spreads over market interest rates and specific events affecting the creditworthiness of a particular debt issuer are now classified as credit risk. Interest rate risk has been redefined as arising from changes in a benchmark interest rate (which is limited in the USA to the interest rate on direct treasury obligations of the US Government or the LIBOR swap rate). This amendment significantly has expanded the extent to which both interest rate risk and credit risk now qualify for hedge accounting.

IAS 39 does not restrict the designation of portions of risk as long as the risk being hedged can be measured reliably.

**IAS 39.129 - HEDGING THE COPPER COMPONENT IN BRONZE**

**EXAMPLE**

Company B purchases bronze for its inventory of raw materials used in manufacturing its products. Company B enters into a forward contract indexed to copper and designates it as a hedge of the copper component in forecasted purchases of bronze.

The hedge does not qualify for hedge accounting because the exposure to changes in the price of copper is only a portion of the exposure to changes in price of bronze. For non-financial assets or liabilities, the risk being hedged is foreign currency risks or all of the risks of the asset or liability.

**IAS 39.129 - NON-FINANCIAL ASSETS, COMPONENTS, OR INGREDIENTS**

**COMPARISON WITH US GAAP**

US GAAP provides an exception to its requirement for hedging non-financial assets in their entirety and permits a portion of the risk to be hedged for recognised loan servicing rights and non-financial firm commitments with financial components. For hedges of non-financial assets or liabilities, the designated risk being hedged must be the risk of changes in the fair value or cash flows of the entire hedged asset or liability or foreign currency risk.

These exceptions are not provided for under IAS 39.
interest payments dates of the currency swap match those of the debt and effectively converts the fixed-rate 7,320,644 and receives ¥100,000,000. The maturity date and the semi-annual € receive 7% prime interest rate swap. The pay and receive legs of the swap match the interest receipt dates on the loans and the debt. The swap can qualify as a hedge of the LIBOR-based indexed loans and the prime-based debt.

WHAT ARE SOME TYPES OF MULTIPLE RISKS THAT CAN BE HEDGED WITH A SINGLE INSTRUMENT?
A single derivative appropriately constructed could be designated as hedging multiple foreign currency exposures from different instruments, multiple interest-rate risks, and aggregated forecasted purchase and sales transactions with different parties, and various components of different instruments.

WHAT IS A CIRCUS?
A CIRCUS is a combined interest rate and currency swap. It frequently is used as a hedge of foreign-currency-denominated debt instruments. Enterprises commonly issue debt in cross-border financing transactions and swap the debt obligation, including principal and interest, back to the local functional currency and change the debt from fixed to variable or vice versa.

WHAT ARE SOME TYPES OF MULTIPLE RISKS THAT CAN BE HEDGED WITH A SINGLE INSTRUMENT?

EXAMPLE
Financial Institution B has a $1 billion portfolio of 10-year variable-rate loans. The loans are indexed to various indices including LIBOR. Financial Institution B, also, has prime-based debt. B enters into an interest rate swap to hedge the cash flow exposure related to the future interest payments. The swap is a $1 billion, 10-year pay LIBOR, receive 7% prime interest rate swap. The pay and receive legs of the swap match the interest receipt dates on the loans and the debt.

HOW DOES AN ENTITY DETERMINE THAT THE CHANGES IN FAIR VALUE ATTRIBUTABLE TO THE HEDGED RISK OF THE GROUP?

Although IAS 39 does not provide specific guidance as to what is approximately proportional, US GAAP provides useful guidance in this regard. US GAAP strictly interprets the term ‘proportionately’; nevertheless, this term does not mean ‘identically’. A group of assets would not be considered to respond proportionately to a change in interest rates if a 100 basis point increase in interest rates is expected to result in percentage decreases in the fair values of the individual items ranging from 7% to 15%. However, percentage decreases within a range of 9% to 11% could be considered proportionate if that change in interest rates reduced the fair value of the portfolio by 10%. [FASB 133, paragraph 444]

Additionally, this provision should be considered in view of the overall limitation on effectiveness. IAS 39 specifies that a hedge is effective if it is in the range of 50 percent to 125 percent. If all items in the portfolio were individually within the range of 80 percent to 125 percent of the change in the value of the hedging instrument, each would qualify for hedge accounting regardless of how closely they moved in proportion to each other. The approximately proportional test becomes significant when, on average, effectiveness is at the limits (close to 80 percent or 125 percent). In these circumstances, some of the items in the portfolio may be outside of the range of 80 percent to 125 percent, yet on average, the portfolio is within the limits. For example, if the average effectiveness is 80 percent (representing the hedge gain or loss divided by the average portfolio gain or loss), an individual item that is 50 percent of the portfolio average would by itself have an effectiveness of 72.7 percent (80 percent/110 percent). Although IAS 39 does not provide specific guidance, a movement more than 10 percent from the average portfolio when the average is close to the minimum acceptable limits suggests that the hedged item should not be part of the portfolio.

HOW DOES AN ENTITY DETERMINE THAT THE CHANGES IN FAIR VALUE ATTRIBUTABLE TO THE HEDGED RISK WILL BE PROPORTIONAL FOR ALL ITEMS IN THE PORTFOLIO?
At inception, an entity should perform a sensitivity analysis of all individual items to be included in a portfolio that will be designated as a hedged item. The sensitivity analysis should use a broad range of expected changes and should be applied to all items individually. The entity must continue this analysis process over the term of the hedge to determine that no changes have occurred that would cause the individual items to respond differently compared to the initial expectations or to fall outside the acceptable range.

Individual items that respond to changes outside the 90 to 110 percent range when the average effectiveness of the portfolio is at the minimum acceptable limit, but that are not material to the portfolio, should not result in the entire portfolio becoming ineffective. In the event that ineffectiveness is determined for individual items that are, in aggregate, not material, that amount should be marked to market through earnings.
If some items within a pool respond within the range of 90 to 110 percent while others do not, we believe that judgement will be required to determine if the portfolio qualifies as a hedged item. For example, if in a pool of 2,000 loans, 20 (one percent) of the loans do not respond within 90 to 110 percent, the portfolio, as a whole, may continue to qualify as a hedged item. In the same pool, if 100 (10 percent) of the loans do not respond within 90 to 110 percent, the portfolio would not qualify as a hedged item because the individual items within the portfolio did not respond proportionately to the total change in fair value of the hedged portfolio. An entity could then achieve the required range of change for individual items and in aggregate through further subdivision of the items in the portfolio.

**IAS 39.132 - PORTFOLIO HEDGING: DIFFERENT CREDIT RATINGS AND MATURITIES**

**QUESTION**

Can investments in debt instruments that have different credit ratings and different maturities be combined and hedged as a portfolio?

Yes. However, to comply with the requirement that all items in the portfolio share the same risk exposure for which they are designated and that changes in their fair values are expected to be proportional to the overall change in the fair value attributable to the hedged risk of the group, only portions of the risks related to these instruments can be designated as being hedged. For example, the risk-free interest rate component that is shared by these instruments can qualify as being hedged, and only a portion of their terms that is common to all instruments in the portfolio can qualify as being hedged.

If the entity wanted to designate the entire risk of each instrument in the portfolio as being hedged, it would have to segregate the loans into portfolios in which each item in the portfolio is similar. This can be done by classifying according to any predominant risk characteristic, including date or origination or geographic location.

An entity may choose to consider some of the following characteristics, as appropriate, in the case of loans:

- loan type;
- loan size;
- nature and location of collateral;
- interest rate type (fixed or variable) and the coupon interest rate (if fixed);
- scheduled maturity, prepayment history of the loans; and
- expected prepayment performance in varying interest rate scenarios.

**IAS 39.132 - PORTFOLIO HEDGES: SEPARATING THE INEFFECTIVE PORTION**

**EXAMPLE**

Bank D has a portfolio of motor vehicle loans that it wishes to designate as a hedged item. All of the loans in the portfolio have an 8% fixed rate and a maturity of 48-60 months. Bank D wants to hedge the fair value interest rate risk on the motor vehicle loans. Bank D performs a sensitivity analysis on the portfolio and concludes that the individual items in the portfolio respond proportionately to overall changes in the portfolio (within a range of 90-110 percent).

The portfolio may qualify as a hedged item because each item is expected to respond to changes in interest rates within a narrow range.

**IAS 39.133 - HEDGING NET PURCHASES AND SALES**

**QUESTION**

Can a forecasted purchase and a forecasted sale be combined and only the net exposure of the two transactions be designated as being hedged?

No. The net position does not qualify for hedge accounting. However, by designating a portion of the exposure of the gross position that is equal to the net exposure of the combined position as a hedge, hedge accounting can be achieved.
IAS 39.134 - RELATED PARTY HEDGING TRANSACTIONS

QUESTION

WHY DO RELATED PARTY DERIVATIVE TRANSACTIONS NOT QUALIFY AS HEDGING INSTRUMENTS?

Related party derivative transactions do not qualify as hedging instruments because they do not affect the enterprise’s net profit or loss in consolidation.

IAS 39.134 - RELATED PARTIES: ENTITIES NOT CONSOLIDATED

QUESTION

ARE DERIVATIVES ENTERED INTO WITH ENTITIES ACCOUNTED FOR UNDER THE EQUITY METHOD OR UNDER PROPORTIONATE CONSOLIDATION CONSIDERED TO BE THIRD PARTY DERIVATIVES?

No. Although the IGC defines inter-company derivatives within the specific context of members or divisions within a consolidated group, the same principles would apply to derivatives transacted on behalf of affiliates other than subsidiaries (that is, those accounted for under the equity method or under proportionate consolidation). If a transaction between entities is required to be eliminated in the consolidated financial statements, it is considered not to be a third party derivative.

IAS 39.134 - QUALIFYING HEDGE USING INTERCOMPANY FOREIGN EXCHANGE CONTRACTS

EXAMPLE

Company B enters into forward foreign currency exchange contracts with its subsidiaries. The subsidiaries designate those contracts as hedges of their respective foreign currency exposures. Company B enters into external forward foreign exchange contracts to offset the exposures created by the internal contracts with its subsidiaries.

The forward foreign exchange contracts qualify as a hedging instrument at the subsidiary levels and the effects of the hedging transactions are not required to be eliminated in the consolidated financial statements of Company B because the intercompany derivatives are validated by the offsetting third party contracts.

IAS 39.137(a) - HEDGE ACCOUNTING: SOURCES OF FAIR VALUE EXPOSURE

QUESTION

WHAT ARE SOME SOURCES OF FAIR VALUE EXPOSURE?

Fair value exposures arise from existing assets or liabilities, including firm commitments. Fixed-rate financial assets and liabilities, for example, have a fair value exposure to changes in market rates of interest and changes in credit quality. Non-financial assets and liabilities, on the other hand, have a fair value exposure to changes in the market price of a particular item or commodity. Some assets and liabilities have fair value exposures arising from more than one type of risk. [FASB 133, paragraphs 333 and 354]

IAS 39.137(a) - HEDGE ACCOUNTING: FIRM COMMITMENTS

COMPARISON WITH US GAAP

Under US GAAP, hedges of firm commitments are accounted for as fair value hedges. Hedges of foreign currency risk in foreign-currency-denominated firm commitments can accounted for as fair value hedges or cash flow hedges.

IAS 39 requires hedges of firm commitments to be accounted for as cash flow hedges.

IAS 39.137 - HEDGE ACCOUNTING: EXPOSURES AND TYPES OF HEDGES

EXAMPLE

The following table provides examples of assets, liabilities and future transactions, the earnings exposures including exposures of their components, and the type of hedge accounting that can be used when a hedging relationship is established.

<table>
<thead>
<tr>
<th>Exposures and Types of Hedges</th>
<th>Fixed-Rate Assets and Liabilities</th>
<th>Variable-Rate Assets and Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examples:</td>
<td>Fixed-rate loans and receivables</td>
<td>Variable-rate loans and receivables</td>
</tr>
<tr>
<td></td>
<td>Investments in debt securities</td>
<td>Variable-rate debt securities</td>
</tr>
<tr>
<td></td>
<td>Fixed-rate debt of the enterprise</td>
<td>Variable-rate debt of the enterprise</td>
</tr>
<tr>
<td></td>
<td>Fixed-rate deposit liabilities</td>
<td>Variable-rate deposit liabilities</td>
</tr>
<tr>
<td>Exposure</td>
<td>Hedge Accounting</td>
<td>Hedge Accounting</td>
</tr>
<tr>
<td>Overall fair value</td>
<td>FV (Fair Value)</td>
<td>Overall fair value</td>
</tr>
<tr>
<td>Interest rates</td>
<td>FV</td>
<td>Interest rates</td>
</tr>
<tr>
<td>Credit of the issuer</td>
<td>FV or CF</td>
<td>Credit of the issuer</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>FV or CF</td>
<td>Foreign currency</td>
</tr>
<tr>
<td>Termination options</td>
<td>FV</td>
<td>Termination options</td>
</tr>
</tbody>
</table>

Firm Commitments to Purchase or Sell Financial Instruments

Examples: Commitment to purchase fixed-rate debt

Fixed-rate loan commitments

Exposure | Hedge Accounting |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall fair value</td>
<td>CF (Cash Flow)</td>
</tr>
<tr>
<td>Interest rates</td>
<td>CF</td>
</tr>
<tr>
<td>Credit</td>
<td>CF</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>CF</td>
</tr>
</tbody>
</table>

Forecasted Purchases and Sales of Financial Instruments

Examples: Forecasted purchase of fixed-rate debt

Forecasted loan originations

Exposure | Hedge Accounting |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall fair value</td>
<td>CF (Cash Flow)</td>
</tr>
<tr>
<td>Interest rates</td>
<td>CF</td>
</tr>
<tr>
<td>Credit</td>
<td>CF</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>CF</td>
</tr>
</tbody>
</table>

Table continued on next page
IAS 39 recognises that firm commitments create a fair value exposure. However, it requires that hedges of firm commitments be accounted for as cash flow hedges (see IAS 39.137(c)).

**IAS 39.139 - CASH FLOW HEDGE OF AN ANTICIPATED FIXED-RATE DEBT ISSUANCE**

**EXAMPLE**

R intends to issue $200 million seven-year bonds in six months. R wants to obtain the current interest rate of 8% and hedges the forecasted issuance of the bonds. The hedge consists of selling (shorting) $186 million worth of futures on seven-year treasury bonds to hedge the $200 million anticipated issuance of bonds.

The hedge is as a cash flow hedge because the interest payments on the debt are exposed to changes in interest rates until the debt is issued.

**IAS 39.139 - CASH FLOW HEDGE OF A FOREIGN CURRENCY PURCHASE WITH CASH DEPOSITS**

**EXAMPLE**

Company B can use the cash deposits as a cash flow value hedge of the firm commitment under IAS 39. Company B would also be able to use a derivative instrument to hedge its Euro-denominated firm commitment to purchase equipment. Under IAS 39 hedges of all unrecognised firm commitments are accounted for as cash flow hedges, regardless of whether the commitment creates a fair value exposure.

**IAS 39.140 - HEDGING: FIRM COMMITMENT VS. FORECASTED TRANSACTIONS**

**QUESTION**

IF A HEDGE OF A FIRM COMMITMENT IS ACCOUNTED FOR AS A CASH FLOW HEDGE, WHY IS IT NECESSARY TO DISTINGUISH BETWEEN FIRM COMMITMENTS AND FORECASTED TRANSACTIONS?

Although hedges of both firm commitments and forecasted transactions are accounted for as cash flow hedges, the exposures are different. Firm commitments create an exposure to changes in fair value, forecasted transactions create an exposure to cash flows. As a result, the type of hedging instrument needed to offset the exposure differs.

**IAS 39.140 - HEDGE OF A FIRM COMMITMENT: FORWARD CONTRACT TO BUY INVENTORY**

**EXAMPLE**

Company E is a discount grocery chain with over 400 stores in the USA and which enters into forward contracts to purchase various inventory items for its stores. On 1 June 2000, Company E enters into a forward contract to purchase 300,000 bushels of wheat for a fixed price of $1.40 per bushel on 1 August 2000. Company E will use the wheat in its bakery operations. If Company E was to fail to take delivery of the wheat, it would both be required to pay for any decrease in the value of the wheat and would be subject to legal remedies.

This transaction is a firm commitment because it specifies all significant terms of the transaction, including quantity, fixed price, and timing. The forward contract is not accounted for as a derivative because Company E intends to take delivery and the purchase is considered to be normal given the operations of E. Under IAS 39, E could hedge the fair value exposure of the firm commitment relating to the change in the price of wheat between 1 June 2000, and 1 August 2000, by entering into a forward contract that qualifies as a derivative to sell wheat for a fixed price on 1 August.

**IAS 39.140 - HEDGE OF A FIRM COMMITMENT: MORTGAGE LOAN COMMITMENTS**

**EXAMPLE**

In possession of the necessary approvals, Bank M issues interest rate lock commitment letters for mortgage loans to prospective borrowers. Each commitment letter details the principal to be borrowed, related fees, and the fixed interest rate. The commitment letter has a stated maturity date, typically 60 to 90 days. The borrower is not required to accept and finalise the mortgage loan and there is no penalty if the borrower does not make use of the offered facility. Bank M can estimate the number of commitments that it projects will be finalised. Bank M would like to hedge the projected fair value exposure related to its fixed-rate loan commitments.
Loan commitments are option contracts that are binding on one party but not on the other and, thus, a loan commitment is not considered to be a firm commitment since a sufficiently large disincentive for non-performance does not exist which would make the commitment legally enforceable. This may be hedged, for example, as a cash flow hedge by purchasing options provided that the company can demonstrate hedge effectiveness.

IAS 39.140 - HEDGING: FORECASTED TRANSACTIONS AND FIRM COMMITMENTS

EXAMPLE

The following table illustrates some examples of forecasted transactions and, also, illustrates the difference between a forecasted transaction and a firm commitment.

<table>
<thead>
<tr>
<th>Forecasted Transaction</th>
<th>Firm Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity forecasts the purchase of 100,000 bushels of corn to be used in its manufacturing process in October. The forecasted transaction was identified in May.</td>
<td>An entity has signed a legally binding purchase agreement to take delivery of 100,000 bushels of corn on 30 September 20X1 for $2 per bushel.</td>
</tr>
<tr>
<td>Treasury forecasts the sale of an available-for-sale debt instrument to a fellow subsidiary at the end of the fourth quarter.</td>
<td>Treasury signs a legally binding agreement with a third party to sell a specific available-for-sale debt instrument for par on 30 December 20X1.</td>
</tr>
<tr>
<td>Treasury forecasts the purchase of a £25 million bond on 23 March 20X1 from an investment banker.</td>
<td>Treasury enters into a legally binding purchase agreement with a banker to take delivery of a £25 million bond for par on 23 March 20X1.</td>
</tr>
</tbody>
</table>

IAS 39.142(a) - FORMAL DOCUMENTATION OF THE HEDGING RELATIONSHIP

QUESTION

WHY IS IT NECESSARY TO HAVE DESIGNATION AND DOCUMENTATION REQUIREMENTS FOR HEDGE ACCOUNTING?

The concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result. Identifying the nature of the risk being hedged and using a hedging derivative consistent with an entity’s established policy for risk management are essential components of risk management and are necessary to add verifiability to the hedge accounting model. [FASB 133, paragraph 58] Accordingly, an entity’s failure to establish written risk management policies and designation at the inception of a hedge will invalidate hedge accounting.

IAS 39.142(a) - RETROSPECTIVE DOCUMENTATION

QUESTION

IS HEDGE ACCOUNTING PERMITTED IF A HEDGING RELATIONSHIP IS DOCUMENTED RETROSPECTIVELY?

Under the transition provisions of IAS 39.172(b), in the financial year in which IAS 39 is initially applied, hedge accounting is no longer permitted for previously designated hedges that do not meet the hedge criteria under IAS 39. The hedge accounting provisions are not applied retrospectively. In the event that ongoing hedging transactions were entered into prior to the implementation of IAS 39 but were not previously designated and documented as such, subsequent documentation of the hedging relationship, prior to the start of the accounting period, is necessary to qualify in the future.

IAS 39.142(a) - DESIGNATION AND DOCUMENTATION OF HEDGING ACTIVITIES

EXAMPLE

Company XYZ has €500 million in short-term (30-day) commercial paper (CP) borrowings. XYZ wants to hedge the interest rate risk on the forecasted rollover of the CP for a five-year period. On 1/1/X0, XYZ enters into a five-year pay 7% fixed, receive 30-day CP interest rate swap. The hedging strategy is consistent with XYZ’s written risk management policy that specifically permits the use of swaps to hedge interest rate risk on forecasted rollovers of CP borrowings. The policy permits such hedging strategies for periods of up to seven years.

XYZ prepares the following written documentation formally designating the hedging relationship at the date the hedge is initiated:

XYZ Company Hedging Files
Date: 1/1/X0
On 1/1/X0, XYZ Company entered into a pay 7% fixed, receive 30-day CP interest rate swap. The swap is designated as a cash flow hedge of the interest rate risk on the forecasted rollover of the bottom £100 million layer of 30-day CP borrowings. The hedge will be assessed for effectiveness using the shortcut method* (i.e., assumption of no ineffectiveness) because all of the critical terms of the hedged item (bottom layer of CP) and the hedging instrument match.

* See the discussion of the ‘shortcut method’ and the comparison of IAS 39 and US GAAP at IAS 39.151 later in this book.

XYZ specified that the swap was designated against the bottom layer of the CP borrowings. XYZ could have designated the swap on a proportionate basis. However, XYZ must specify which portion (layer) is being hedged when the entire asset, liability, firm commitment, or forecasted transaction is not being hedged.
IAS 39.142(b) - FORMING AN EXPECTATION OF HIGH EFFECTIVENESS

QUESTION

HOW DOES AN ENTERPRISE ESTABLISH THAT A HEDGE IS EXPECTED TO BE HIGHLY EFFECTIVE IN ACHIEVING OFFSET?

Effectiveness, which is assessed both prospectively based on historical relationships that are expected to continue in the future and retrospectively to determine that actual results continue to validate that expectation. IAS 39 does not specify how this assessment is made. However, ratio and regression analysis typically are used, sometimes, in combination to make these assessments.

IAS 39.142(c) - ASSESSING HIGH PROBABILITY OF A FORECASTED TRANSACTION OCCURRING

QUESTION

HOW IS THE ASSESSMENT MADE THAT A FORECASTED TRANSACTION IS ‘HIGHLY PROBABLE OF OCCURRING’?

Probability is assessed based on observable facts and the attendant circumstances. In assessing the likelihood that a transaction will occur, consideration should be given to the following:

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

In addition, both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable.

For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract.
Because the hedging instrument and the hedged item have the same basis and are on the same number of shares, increases in the intrinsic value of the option are expected to be fully effective in offsetting decreases in the fair value of the investment. In this example, the entire £9,000 is time value because the option was purchased at-the-money. Changes in time value are recognized directly in earnings. Effectiveness of the hedge is assessed based on the intrinsic value rather than the fair value of the option. To the extent that the fair value of the option changes due to other variables such as volatility and the risk free rate, Company X calculates the fair value of the option and then deducts the intrinsic value to arrive at the time-value component that is recognized in earnings. In other words, the time value component reflects the effect of all variables on the option’s price other than the intrinsic value. Based on Company X’s designation of effectiveness, all of these other components represent ineffectiveness of the hedge and are therefore recognized directly in earnings.

In some circumstances, it may be possible to demonstrate effectiveness within the designated range even where there is a difference between the basis of the hedging instrument and the hedged item. For example, it may be demonstrated that there is a significant (and increasing) degree of correlation between the Euro and the currencies of certain Scandinavian countries due to regional proximity and similar economic policies and fundamentals. A further example might be a variable rate debt instrument with an embedded pre-payment option that is hedged by a vanilla (standard) swap. In this instance, it might be possible that the fair value of the prepayment option is so insignificant relative to the fair value of the host contract that even though this feature is not replicated in the swap, that it does not impact negatively on hedge effectiveness. Provided that effectiveness can be clearly and rigorously demonstrated in these instances, the use of hedge accounting may be permitted. Generally, however, this would not be a good hedge.

**IA 39.144 · SEPARATING OUT MINIMUM VALUE**

**COMPARISON WITH US GAAP**

US GAAP permits the measurement of the effectiveness of a hedge with an option contract based on the option’s minimum value. An option’s minimum value is defined as its intrinsic value plus the effect of discounting. If effectiveness is measured in this manner, the change in the volatility value of the contract is excluded in the determination of effectiveness. [FASB 133, paragraph 63(b)]

It appears that the use of an option’s minimum value is not permitted under IAS 39 because IAS 39.142(d) requires measurement of the fair value of the hedged item and the hedging instrument in assessing hedge effectiveness.

US GAAP also permits the time value of purchased option that qualifies for hedge accounting to be recognized in other comprehensive income (equity) and to assume perfect effectiveness if certain conditions are met. (DIG Issue G20)

There is no such provision in IAS 39.

**IA 39.144 · SPLITTING OUT A FOREIGN CURRENCY COMPONENT OF A DERIVATIVE: TRANSITION COMPARISON WITH US GAAP**

Although US GAAP prohibits separating a compound derivative into component parts and designating any such component as the hedging instrument, it provides an exception to this rule and permits the foreign currency component of a compound derivative to be separated at the date of initial application of FASB 133 by the transition provisions. [FASB 133, paragraph 18]

There is no equivalent transition provision in IAS 39.

**IA 39.145 · HEDGING: PROPORTION VS. PORTION**

**QUESTION**

**WHAT IS THE DISTINCTION BETWEEN A PROPORTION AND A PORTION FOR PURPOSES OF DESIGNATING A PART OF A DERIVATIVE AS A HEDGING INSTRUMENT?**

A proportion refers to a percentage of the entire derivative financial instrument whereby any gains and losses on the entire derivative financial instrument relate to the separate pieces as a percentage of their notional amounts. A portion refers to any part of a derivative financial instrument, for example, the first three years of the five-year life of an interest rate swap, or the risk-free interest rate component in a A-rated bond. Gains and losses on the entire derivative instrument relate to the separate components based on their specific terms and characteristics and, accordingly, are not proportional to the notional amounts of the pieces.

**IA 39.145 · PROPORTIONS: HEDGING WITH A COMPONENT PART OF A DERIVATIVE**

**QUESTION**

**CAN AN ENTERPRISE SEPARATE A COMPOUND DERIVATIVE INTO COMPONENT PARTS AND DESIGNATE CERTAIN COMPONENTS AS HEDGING INSTRUMENTS?**

An entity is prohibited from separating a compound derivative into components representing different risks and from designating specific components as the hedging instruments. IAS 39 does not permit the bifurcation of derivative instruments.

**IA 39.145 · PROPORTIONS: HEDGING WITH A PERCENTAGE OF A DERIVATIVE**

**EXAMPLE**

Company X enters into a R200 million five-year pay-variable, receive-fixed interest rate swap to hedge R100 million in five-year fixed-rate debt. Company X designates 50 percent of the swap as a fair value hedge of the debt. Fifty percent of the swap may be designated as a hedge because it is a proportion of the entire derivative.
IAS 39.145 - PROPORTIONS: DESIGNATING A SPECIFIC TIME PERIOD OF A DERIVATIVE

**EXAMPLE**

Company X enters into a £100 million 10-year pay-variable, receive-fixed interest rate swap to hedge £100 million in five-year fixed-rate debt. Company X designates the first five years of the swap as a fair value hedge of the debt.

The swap does not qualify for hedge accounting because Company X designated only a portion of the time period in which the swap is outstanding as the hedging instrument. Designating specific cash flows of the swap, in this example the first five years, rather than a proportion, is not permitted under IAS 39.

IAS 39.146 - METHODS FOR ASSESSING HEDGE EFFECTIVENESS

**QUESTION**

**HOW ARE RATIO AND REGRESSION ANALYSIS USED IN ASSESSING HEDGE EFFECTIVENESS?**

The common definition of highly effective seems to imply some form of ratio analysis, which is a comparison of hedging gains and losses to the corresponding losses and gains on the hedged item. Ratio analysis is a point-in-time measure. It is relatively simple to compute and seems to be well suited for measuring the effectiveness of short-term hedges and for measuring the level of actual offset.

Statistical measurement techniques, such as regression analysis, are more complex. They require appropriate interpretation and understanding of the statistical inferences. Regression analysis seems to be best suited for measuring the strength of empirical relationships, assessing probability of offset, and establishing hedge ratios based on such historical relationships.

The use of regression analysis to measure effectiveness is more complex than the use of ratio analysis, because valid conclusions cannot be made solely on the basis of a single regression statistic, such as $r^2$ (also known as goodness-of-fit). The statistical level of effectiveness means little without an understanding of the regression formula and other statistical results. The constant and slope of the regression formula and standard errors of the regression should be interpreted and understood to arrive at appropriate conclusions. Assuming a constant of zero, the slope of the regression equation is equivalent to the ratio of effectiveness and, therefore, also, should lie within the range of 0.8 to 1.25 (corresponding to a ratio of 80 to 125 percent). In the absence of anything to the contrary, a correlation coefficient ($r^2$) lying between the values of 0.8 to 1 typically is representative of a highly effective offsetting relationship between the hedged item and the hedging instrument.

A regression analysis generally can be performed to determine whether there is a probability of achieving offset. Such analysis is essential for indirect hedges, whereby the commodity or index underlying the futures or options contract is not the same commodity or index as the item being hedged (for example, oil as a hedge of petrol). After the hedge has commenced, a ratio analysis can be performed on a cumulative basis to ensure that substantial offset has occurred and should be used to measure ineffectiveness.

IAS 39.146 - HEDGE EFFECTIVENESS OUTSIDE 80 TO 125 PERCENT RANGE

**QUESTION**

**IF EFFECTIVENESS IS OUTSIDE THE RANGE OF 80 TO 125 PERCENT AT ANY MEASUREMENT PERIOD, IS HEDGE ACCOUNTING PRECLUDED FOR FUTURE PERIODS?**

The enterprise’s risk management policy should address hedge failures (where effectiveness falls outside the 80 to 125 percent range) as well as instances in which hedge failure is considered to result in hedge accounting being precluded. Continuation of hedge accounting in those instances only would be appropriate if a strong historical relationship exists and there is an expectation that the hedge will be highly effective in future periods.

Alternatively, the enterprise may change its expectation and redesignate the hedge accordingly (for example, by changing the hedge ratio, the designated hedged item or even the hedging instrument used). In such instances, hedge accounting is appropriate prospectively, only after the new hedging relationship is established and documented. Hedge failures that do not preclude qualification for continued use of hedge accounting should be unusual and infrequent.

IAS 39.146 - COMPARISON OF REGRESSION AND RATIO ANALYSIS

**EXAMPLE**

Bank A owns a €100 million portfolio of 10-year BBB corporate bonds. The bonds are eligible to be hedged as a portfolio because each item in the portfolio shares the same risk. On 1 January 2000, Bank A executes a fair value hedge of the interest rate risk on the bond portfolio using a Euro-bond indexed derivative. To establish a basis for hedge accounting at inception, Bank A computed a historical regression analysis on the monthly results for the previous six months and assessed offset on a monthly and cumulative basis as summarised below:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>(700,000) €</td>
<td>300,000 €</td>
<td>(433.33%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>February</td>
<td>1,600,000 €</td>
<td>(1,500,000) €</td>
<td>0.970</td>
<td>1.11</td>
<td>(106.67)</td>
</tr>
<tr>
<td>March</td>
<td>(2,050,000) €</td>
<td>2,200,000 €</td>
<td>0.980</td>
<td>0.99</td>
<td>(93.18)</td>
</tr>
<tr>
<td>April</td>
<td>1,100,000 €</td>
<td>(1,020,000) €</td>
<td>0.988</td>
<td>1.00</td>
<td>(107.84)</td>
</tr>
<tr>
<td>May</td>
<td>3,900,000 €</td>
<td>(3,980,000) €</td>
<td>0.993</td>
<td>0.99</td>
<td>(97.99)</td>
</tr>
<tr>
<td>June</td>
<td>(12,350,000) €</td>
<td>11,900,000 €</td>
<td>1.00</td>
<td>1.03</td>
<td>(103.78)</td>
</tr>
</tbody>
</table>

* Constant set to zero
30 observations are needed to obtain valid statistical information. (2) Note that only six observations were used for illustrative purposes to compute the regression statistics. Ordinarily, close to that the method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified.

Jan Constant set to zero

IAS 39 does not provide specific guidance about how effectiveness tests should be performed. However, it requires that the method chosen be documented at the inception of the hedging relationship. Also, it requires that the assessment of effectiveness must be based on the objective of management’s risk management strategy and that the method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified.

HOW SHOULD HEDGE EFFECTIVENESS TESTS BE PERFORMED?

In the example above, the hedge relationship on a cumulative basis through December was effective using a ratio test. Using a regression test measured on a period basis with the constant set to zero, the hedge was highly effective because the r² was greater than 0.8 and the slope was within the range of 0.8 to 1.25. If the hedge was evaluated using period-to-period changes, the hedging relationship had periods of ineffectiveness in August and September using a ratio test and was always effective using a regression test. An entity’s risk management policy should address when a failure to establish a hedging relationship, using either ratio or regression, would preclude hedge accounting.

Even though on a ratio basis the hedge failed the 80 to 125 percent test in two months, the entity may conclude that hedge accounting was appropriate based on the strength of historical period-to-period offset. This assessment only would be appropriate if the entity’s risk management policy specifically addresses hedge failures and indicates when such failures preclude hedge accounting.

Note, however, that the measurement and recognition of the ineffective portion, which is computed on a monthly basis in the above example, is based on the degree of offset. Hence, for example, in July, €90,000 is recognised in net profit or loss (€75,000 on the hedging instrument plus €15,000 on the hedged item). Although hedge accounting is permitted for the full period, the full extent of ineffectiveness is recognised in the income statement for each month and thus for the months in which the effectiveness ratio fell outside the acceptable range, a relatively higher amount is recognised in net profit or loss as ineffectiveness of the hedge.

IA 39.147 PERFORMING HEDGE EFFECTIVENESS TESTS

QUESTION

HOW SHOULD HEDGE EFFECTIVENESS TESTS BE PERFORMED?

In the above example, the hedge relationship on a cumulative basis through December was effective using a ratio test.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>July</td>
<td>€ 8,573,000</td>
<td>€ (7,885,000)</td>
<td>1.00</td>
<td>1.05 (108.75%)</td>
</tr>
<tr>
<td>August</td>
<td>€ 423,000</td>
<td>(200,000)</td>
<td>0.98</td>
<td>1.04 (58.56)</td>
</tr>
<tr>
<td>September</td>
<td>€ 750,000</td>
<td>(350,000)</td>
<td>0.99</td>
<td>1.05 (214.29)</td>
</tr>
<tr>
<td>October</td>
<td>(1,000,000)</td>
<td>800,000</td>
<td>0.99</td>
<td>1.05 (135.00)</td>
</tr>
<tr>
<td>November</td>
<td>€ 2,500,000</td>
<td>(2,300,000)</td>
<td>0.99</td>
<td>1.05 (108.70)</td>
</tr>
<tr>
<td>December (a)</td>
<td>(2,773,000)</td>
<td>2,775,000</td>
<td>0.99</td>
<td>1.05 (100.00)</td>
</tr>
</tbody>
</table>

(1) Constant set to zero
(2) Note that only six observations were used for illustrative purposes to compute the regression statistics. Ordinarily, close to 30 observations are needed to obtain valid statistical information.

Based on the historical regression analysis, Bank A has a basis for concluding that the hedge is expected to be effective in offsetting changes in fair value. The ratio on a cumulative basis from January to June was within the acceptable 80 to 125 percent range. Although there were two observations where the cumulative ratio was outside the acceptable 80 to 125 percent range, based on the per-period ratio results and the strong statistical (regression) results, Bank A could conclude that the hedge was expected to be effective at providing offset. On a per-period basis, the ratio was within the acceptable 80 to 125 percent range in all periods after the initial period. The regression statistics, with the constant set to zero, were well within the acceptable range of 0.80 to 1.25 for slope, while the range of 0.8 to 1.0 for r² also is considered highly effective. The regression statistics were computed using month-end data points for January through June.

The actual cumulative and current period changes in fair value of the interest rate risk on the bond portfolio and the Euro-bond indexed derivative, from the date the hedge was initiated on 1 July, are summarised below. The r² and slope values were computed using the monthly observations from January to December.
IAS 39.147 - SEPARATING THE FOREIGN CURRENCY COMPONENT FROM AN AFS INSTRUMENT

QUESTION

IF A MARKETABLE EQUITY SECURITY ISSUED BY A FOREIGN ENTITY IS CLASSIFIED AS AVAILABLE-FOR-SALE AND EXPOSES THE ENTITY TO FOREIGN EXCHANGE RISK THAT IS HEDGED BY THE ENTITY, HOW IS THE FOREIGN CURRENCY COMPONENT SEPARATED FROM THE FAIR VALUE OF THE ENTIRE INSTRUMENT?

No specific guidance is provided in IAS 39 to determine the components of the change in fair value of a foreign-currency-denominated available-for-sale security. However, the fair value on the exchange in which the instrument is traded in the issuer’s domestic market provides a basis for determining the fair value of the instrument that is unrelated to the exchange difference and the currency that creates the exposure.

There are at least three methods that could be used based on the following fact pattern:

A Euro functional currency entity purchases a foreign-denominated debt security on 10 January 2000 for $100 and classifies it as AFS. The enterprise recognizes changes in the fair value of AFS securities directly in equity in terms of its policy. On 10 January 2000, the Euro/$ exchange rate is €1=$1; thus, the historical cost basis of the security in Euros is €100. At 31 January 2000, the market value of the AFS debt security is $120 and the exchange rate is €0.8=$1. Therefore, the Euro market value of the security is €96.

Method 1: FX Effect Based on Original Investment

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical cost in Euro based on current exchange rates ($100 x €0.8)</td>
<td>80</td>
</tr>
<tr>
<td>Historical cost in Euro based on historical exchange rates ($100 x €1)</td>
<td>100</td>
</tr>
<tr>
<td>Impact of exchange rates on historical cost amount</td>
<td>20</td>
</tr>
<tr>
<td>Current fair value of security in Euro based on current exchange rates ($120 x €0.8)</td>
<td>96</td>
</tr>
<tr>
<td>Historical cost in Euro based on current exchange rates ($100 x €0.8)</td>
<td>80</td>
</tr>
<tr>
<td>Change in market value of security based on current exchange rates</td>
<td>16</td>
</tr>
<tr>
<td>Net Impact</td>
<td>4</td>
</tr>
</tbody>
</table>

Market Value of Security

Current market value in $ x change in the exchange rate: € 24 Loss

Historical exchange rate x change in market value: 20 Gain

Net impact € 4 Loss

Method 2: FX Effect Measured Against Current FC

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price change ($120 x $100) x [€/$/1 + €/€0.8 + 2]</td>
<td>18 Gain</td>
</tr>
<tr>
<td>Impact of exchange rates</td>
<td>22 Loss</td>
</tr>
<tr>
<td>Net impact</td>
<td>4 Loss</td>
</tr>
</tbody>
</table>

Method 3: Average Rate Approach

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact of exchange rates</td>
<td>24 Loss</td>
</tr>
<tr>
<td>Net impact</td>
<td>4 Loss</td>
</tr>
</tbody>
</table>

IAS 39.148 - CAUSES OF HEDGE INEFFECTIVENESS

QUESTION

WHAT ARE SOME CAUSES OF INEFFECTIVENESS?

Differences result from using a hedging instrument with risk attributes that are similar but not exactly identical to the item being hedged. For commodities, basis differences between a hedging instrument and the hedged item or hedged transaction are due to differences in markets and locations in which similar items are exchanged. For interest sensitive items, basis differences result from differences in interest indices, for example LIBOR vs. Treasury rates, and in terms, for example three-month LIBOR vs. six-month LIBOR, and from credit differences. Also, it results from using in a hedging instrument an underlying that is highly correlated to the risk being hedged, for example using a highly correlated currency in a hedging instrument that is not the currency creating the exposure, perhaps because of greater liquidity of the currency.
IAS 39.148 - MINIMIZING HEDGE INEFFECTIVENESS

QUESTION

HOW CAN INEFFECTIVENESS IN A HEDGING RELATIONSHIP BE MINIMIZED?

Ineffectiveness is minimized when basis differences are minimized. However, since IAS 30 permits hedging portions of exposures (see IAS 39.128), considerable ineffectiveness can be eliminated when the risk designated as being hedged is equal to the risk of the hedging instrument. These risks can be equal to each other when all of the risk related to the hedging instrument is a subset of the risk in the hedged item. For example, frequently, the LIBOR swaps rate is a component of the interest rate exposure in a debt instrument. By designating it as the hedged risk, credit differences, that otherwise would result in ineffectiveness, are eliminated from the hedging relationship.

IAS 39.148 - INEFFECTIVENESS: LOCATION DIFFERENCE OF HEDGED NATURAL GAS

EXAMPLE

Company Z has 20,000 MMBTUs of natural gas stored at its location in West Texas. To hedge the fair value exposure of the natural gas, Company A sells the equivalent of 20,000 MMBTUs of natural gas futures contracts on a national mercantile exchange. The futures prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana. Because the price will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand), it will be difficult for Company Z to assume that the hedge will be highly effective in achieving offsetting changes in fair value. Company Z appropriately documents the hedging strategy and states that effectiveness will be measured based on the spot prices of natural gas in West Texas and the spot prices at the Henry Hub.

Company Z is required to demonstrate effectiveness at inception and on an ongoing basis. This is achieved typically, through a correlation method such as regression analysis or ratio analysis. If such analysis does not result in an expectation that correlation would be between 80 to 125 percent, Company Z is not permitted to use special hedge accounting. However, even if the effectiveness test is met, Company X may have ineffectiveness due to the difference in the basis, and such ineffectiveness is recognised in earnings.

IAS 39.148 - INEFFECTIVENESS: CROSS CURRENCY HEDGE OF FORECASTED FOREIGN CURRENCY TRANSACTION

EXAMPLE

Company X’s functional currency is the Singapore dollar. Company X’s forecasted purchase of equipment is expected to cost €100,000. Company X wishes to hedge its foreign currency risk. Since the British pound (sterling) is considered to move in tandem with the Euro and since the Sterling/Singapore dollar currency market is more liquid than the Euro/Singapore dollar currency market, Company X enters into a forward contract to receive £60,000 and pay 165,000 Singapore dollars. The Sterling will then be converted into Euro in the liquid spot market. The currency exchange rate between Sterling and the Euro is 0.61 and the currency exchange rate between the Euro and the Singapore dollar is 1:1.8.

Because the basis of the equipment and the forward are different (Euro vs. Sterling), Company X may not assume that the hedge will be highly effective in achieving offsetting changes in fair value. In its documentation of the hedge strategy, Company X measures effectiveness based on the correlation between Sterling and the Euro. To qualify for hedge accounting, therefore, Company X will be required to demonstrate effectiveness at inception and on an ongoing basis using a correlation method (such as regression or ratio analysis). However, even if the effectiveness test is met and hedge accounting is permitted, Company X may experience ineffectiveness in its hedge due to the difference in the basis, and such ineffectiveness is recognised in earnings.

IAS 39.150 - HEDGE OF AN EQUITY METHOD INVESTMENT

EXAMPLE

Company P has a 20 percent investment in the publicly traded common stock of Company Q and, since it exercises significant influence over Company Q’s activities, Company P accounts for its investment using the equity method. Company Q’s share price has appreciated significantly in recent years and Company P wants to hedge the current price. Company P enters into cash-settled forward contracts to sell Company Q’s shares. P uses the equity method of accounting for its investment in Q. Because the equity method is cost-based and does not recognise changes in fair value, the investment may not be a hedged item in a fair value hedge.

IAS 39.150 - HEDGE OF A CONSOLIDATED SUBSIDIARY

EXAMPLE

Company K owns 85 percent of the publicly listed shares of Subsidiary L, a technology company, and consolidates L for financial reporting purposes. Company K would like to hedge its investment in L due to the volatility of its industry. K purchases a put option to hedge a portion of its investment in Subsidiary L. The strike price on the put option is out-of-the-money and the entire premium paid by K is time value.

Because K’s investment in L is accounted for as a consolidated subsidiary, the investment may not be a hedged item under IAS 39.
IAS 39.151 - CRITICAL FACTORS NECESSARY TO CONCLUDE NO INEFFECTIVENESS

QUESTION

WHAT ARE THE CRITICAL FACTORS THAT MUST BE ASSESSED TO CONCLUDE THAT EFFECTIVENESS CAN BE ASSUMED?

IAS 39 specifies that an enterprise can conclude that there is an expectation of complete offset if the critical terms are the same. Although, IAS 39 does not provide explicit guidance, the criteria specified under US GAAP can be used as helpful indicators of factors to consider. The following factors are required under US GAAP:

Conditions applicable to both fair value hedges and cash flow hedges:

- the notional amount of the swap matches the principal amount of the interest-bearing asset or liability;
- the fair value of the swap at its inception is zero;
- the formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes either the same constant adjustment or no adjustment);
- the interest-bearing asset or liability is not pre-payable; and
- any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only:

- the expiration date of the swap matches the maturity date of the interest-bearing asset or liability;
- there is no floor or ceiling on the variable interest rate of the swap; and
- the intervals between the repricing of the variable interest rate in the swap are frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally, three to six months or less).

Conditions applicable to cash flow hedges only:

- all interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged;
- there is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap’s variable rate is LIBOR and an asset’s variable rate is LIBOR plus 2%, a 10% cap on the swap would be comparable to a 12% cap on the asset);
- the repricing dates match those of the variable-rate asset or liability; and
- the index on which the variable rate is based matches the index on which the asset or liability’s variable rate is based.

While meeting these conditions generally will mean that there is no ineffectiveness, to the extent there is some other factor not specified above, for example significant credit deterioration, there may be ineffectiveness that should be measured.

IAS 39.151 - CRITICAL TERMS: THE FIXED RATE ON A SWAP

QUESTION

IS THE FIXED RATE ON AN INTEREST RATE SWAP A CRITICAL TERM NECESSARY TO BE MATCHED WITH THE FIXED RATE ON THE DEBT INSTRUMENT DESIGNATED AS BEING HEDGED IN ORDER TO CONCLUDE THERE WILL BE NO INEFFECTIVENESS?

The fixed rate on the swap generally is not considered a critical term and does not have to match, exactly, the fixed rate on the debt. Small movements in interest rates will have a minimal affect on the fair value of each instrument. For example, if the fixed rate on a five-year interest rate swap is 9% and the fixed rate on the hedged five-year debt instrument is 8% and all other terms are identical, an enterprise should be able to conclude there will be no ineffectiveness. Even though the change in the fair value of the swap will not fully offset the change in the fair value of the debt instrument due to the fixed-rate difference, given the short lives of these instruments, any difference will be insignificant. It should be noted, also, that by designating the portion of the debt being hedged as the interest rate risk equal to the interest rate risk on the swap, any difference in the fixed interest rates can be ignored in concluding whether there will be ineffectiveness.

IAS 39.151 - CRITICAL TERMS: SPREADS ADDED TO THE VARIABLE RATE ON AN INTEREST RATE SWAP

QUESTION

IS A FIXED SPREAD ADDED TO THE VARIABLE RATE ON AN INTEREST RATE SWAP CONSIDERED A CRITICAL TERM?

Generally, no. While the form of the swap specifies that the variable leg is adjusted for a fixed spread, for example LIBOR + 150 basis points, the adjustment can be considered as an adjustment of the fixed leg of the swap and a difference in the fixed rate generally does not invalidate a conclusion of no ineffectiveness.

IAS 39.151 - CRITICAL TERMS: REPRICING DATES AND PAYMENT DATES

QUESTION

IS IT NECESSARY THAT REPRICING DATES OR PAYMENT DATES ON AN INTEREST RATE SWAP AND A HEDGED DEBT INSTRUMENT DO MATCH IN ORDER TO BE ABLE TO CONCLUDE THAT THERE WILL BE NO INEFFECTIVENESS?

No. The repricing and payment date of the swap does not have to exactly match the repricing and payment date of the hedged debt instrument to conclude that there will be no ineffectiveness. However, if the time differential is significant, for example more than three months, there may be ineffectiveness as a result of an interest rate change because such change affects the fair value of the payments and cash flows of the repricings.
IAS 39.151 - CRITICAL TERMS: CALL FEATURES

QUESTION

IF A FIXED-RATE DEBT INSTRUMENT IS CALLABLE BY THE ISSUER AND IT IS HEDGED WITH AN INTEREST RATE SWAP, DOES THE CALL FEATURE INVALIDATE A CONCLUSION THAT THERE WILL BE NO INEFFECTIVENESS?

The ability of an issuer to call its debt at par or at a specified premium is a critical component because it provides for settlement of the debt at other than its fair value. For example, from the perspective of the investor in that debt, any increase in the fair value of the investment can be eliminated by the issuer exercising its call option. Accordingly, an assumption of ineffectiveness would not be appropriate unless the hedging instrument contains an offsetting option with the same terms as the option embedded in the debt instrument. However, if only the portion of the debt instrument that is not subject to the call option is designated as being hedged, the call option would not impact the evaluation of whether there will be no ineffectiveness.

IAS 39.151 - CRITICAL TERMS: BASIS DIFFERENCES THREE-MONTH LIBOR VS. SIX-MONTH LIBOR

QUESTION

IF AN INTEREST RATE SWAP IS DESIGNATED AS HEDGING A DEBT INSTRUMENT AND THE INTEREST RATE REPRICES EVERY THREE MONTHS BUT IS INDEXED TO THE SIX-MONTH LIBOR RATE AND THE DEBT REPRICES EVERY THREE MONTHS BUT IS INDEXED TO THE THREE-MONTH LIBOR RATE, DOES THIS DIFFERENCE INVALIDATE THE CONCLUSION THAT THERE WILL BE NO INEFFECTIVENESS?

The three-month LIBOR index on the debt does not match the six-month LIBOR index on the swap. To the extent that there is a high empirical correlation between these rate indices, the rates would not be considered a critical term in determining whether effectiveness might be assumed. However, if empirical evidence suggests that the differences at any point in time could be significant, effectiveness cannot be assumed. It also should be noted that it would not be possible to designate a portion of the debt as being hedged to correspond with the interest rate exposure on the swap. Although the three-month LIBOR rate is a component of the six-month LIBOR rate, the swap must be evaluated in its entirety. It cannot be bifurcated for purposes of assessing effectiveness.

IAS 39.151 - ASSUMING NO INEFFECTIVENESS: HEDGE OF FIXED-RATE DEBT

EXAMPLE

On 1 January 2000, Company X issued $100 million of five-year, 8% fixed-rate debt. Interest on the debt is payable annually. X’s interest rate risk policy requires it to maintain a specific ratio of fixed to variable-rate debt. In order to maintain compliance with its policy, X entered into an interest rate swap on 1 January 2000, and designates the swap as a hedge of a portion of the interest rate risk on the debt, the LIBOR swap interest rate component in the debt. The swap will be a five-year pay LIBOR, receive 5.94% fixed interest rate swap. The swap effectively converts the debt to a variable rate at one-year LIBOR plus 206 basis points.

The terms of the interest rate swap are as follows:

<table>
<thead>
<tr>
<th>Notional Amount</th>
<th>$100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Date</td>
<td>01/01/00</td>
</tr>
<tr>
<td>Start Date</td>
<td>01/01/00</td>
</tr>
<tr>
<td>Maturity Date</td>
<td>31/12/04</td>
</tr>
<tr>
<td>Company X pays</td>
<td>LIBOR</td>
</tr>
<tr>
<td>Company X receives</td>
<td>5.94% (fixed leg)</td>
</tr>
<tr>
<td>Pay and receive dates</td>
<td>Annually on the debt pay dates</td>
</tr>
<tr>
<td>Variable reset</td>
<td>Annually (on 31/12)</td>
</tr>
<tr>
<td>Initial LIBOR</td>
<td>5.69%</td>
</tr>
<tr>
<td>First pay/receive date</td>
<td>31/12/00</td>
</tr>
<tr>
<td>Last pay/receive date</td>
<td>31/12/04</td>
</tr>
</tbody>
</table>

An inception, the interest rate swap is considered to be highly effective because the critical terms of the component of the debt being hedged and the swap match. X has designated as the hedged item the portion of interest rate risk attributable to the LIBOR swap component of the debt. Further, X is using a LIBOR based swap. Consequently, X has determined that the hedge will be fully effective. That is, there can be no ineffectiveness on the component of the interest rate risk being hedged. Therefore, X measures the fair value of the changes in both the hedged item and the hedging instrument (the interest rate swap) based on the fair value of the interest rate swap.

<table>
<thead>
<tr>
<th>LIBOR Rate at Inception and Each Reset Date</th>
<th>Fair Value of the Interest Rate Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2000</td>
<td>3.69%</td>
</tr>
<tr>
<td>31 December 2000</td>
<td>5.46%</td>
</tr>
<tr>
<td>31 December 2001</td>
<td>6.98%</td>
</tr>
<tr>
<td>31 December 2002</td>
<td>8.02%</td>
</tr>
<tr>
<td>31 December 2003</td>
<td>6.62%</td>
</tr>
</tbody>
</table>

Company X accrues interest expenses at the effective LIBOR rate. The fair value of the swap is recognised as an asset or liability with an offsetting fair value adjustment to the debt.
31 December 2000

Interest rates declined during the period ended 31 December 2000, resulting in a fair value of the interest rate swap of $1,768,000. Because the swap is considered completely effective, the fair value of the hedged debt obligation also is increased by $1,768,000. Company X received $252,500 in net cash settlements on the swap at 31 December 2000. The LIBOR rate for the next period is 5.46%.

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative Asset</td>
<td>$ 1,768,000</td>
</tr>
<tr>
<td>Hedging Income</td>
<td>$ 1,768,000</td>
</tr>
<tr>
<td>Hedging Loss</td>
<td>1,768,000</td>
</tr>
<tr>
<td>Debt Obligation</td>
<td>1,768,000</td>
</tr>
<tr>
<td><strong>To record the change in fair value of the hedged item and derivative as a fair value hedge.</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>252,500</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>252,500</td>
</tr>
<tr>
<td><strong>To record payment of fixed-rate interest on debt obligation and the net cash settlement as an adjustment to the yield on the debt based on the change in the fair value of the interest rate swap. Effective yield is 7.75% or LIBOR (9.69%) plus 206 basis points.</strong></td>
<td></td>
</tr>
</tbody>
</table>

31 December 2001

Interest rates increased during the period ending 31 December 2001, compared to rates at the previous period (31 December 2000), resulting in a fair value of the interest rate swap of ($3,404,000). Because the swap is considered completely effective, the fair value of the hedged debt obligation is decreased to $96.596 million. Company X received $498,000 in net cash settlements on the swap at 31 December 2000. The LIBOR rate for the next period is 6.98%.

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2001</th>
<th>Debit Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Loss</td>
<td>$ 5,172,000</td>
</tr>
<tr>
<td>Derivative Asset</td>
<td>$ 1,768,000</td>
</tr>
<tr>
<td>Derivative Liability</td>
<td>3,404,000</td>
</tr>
<tr>
<td>Debt Obligation</td>
<td>5,172,000</td>
</tr>
<tr>
<td>Hedging Income</td>
<td>5,172,000</td>
</tr>
<tr>
<td><strong>To record the change in fair value of the hedged item and derivative as a fair value hedge.</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2001</th>
<th>Debit Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>480,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>480,000</td>
</tr>
<tr>
<td><strong>To record payment of fixed-rate interest on debt obligation and the net cash settlement as an adjustment to the yield on the debt using the interest rate swap short-cut method. Effective yield is 7.52% or LIBOR (5.46%) plus 206 basis points.</strong></td>
<td></td>
</tr>
</tbody>
</table>
31 December 2002

Interest rates increased during the period ended 31 December 2002, compared to rates at the previous period (31 December 2001), resulting in a fair value of the interest rate swap of ($3,624,000). Because the swap is considered completely effective, the fair value of the hedged debt obligation decreased to $96,576 million. Company X paid $1,040,000 in net cash settlements on the swap at 31 December 2002. The LIBOR rate for the next period is 8.02%.

Journal Entry: 31 December 2002

Debit | Credit
--- | ---
Debt Obligation | Hedging Income | $220,000 | $220,000
Hedging Loss | Derivative Liability | 220,000 | 220,000

To record the change in fair value of the hedged item and derivative as a fair value hedge.

Journal Entry: 31 December 2002

Debit | Credit
--- | ---
Interest Expense | Cash | 8,000,000 | 8,000,000
Interest Expense | Cash | 1,040,000 | 1,040,000

To record payment of fixed-rate interest on debt obligation and the net cash settlement as an adjustment to the yield on the debt based on the change in the fair value of the interest rate swap. Effective yield is 9.04% or LIBOR (6.98%) plus 206 basis points.

31 December 2003

Interest rates decreased during the period ended 31 December 2003, compared to rates at the previous period (31 December 2002), resulting in a fair value of the interest rate swap of ($405,000). Because the swap is considered completely effective, the fair value of the hedged debt obligation increased to $99,595 million. Company X paid $2,080,000 in net cash settlements on the swap at 31 December 2003. The LIBOR rate for the next period is 6.62%.

Journal Entry: 31 December 2003

Debit | Credit
--- | ---
Derivative Liability | Hedging Income | $3,219,000 | $3,219,000
Hedging Loss | Debt Obligation | 3,219,000 | 3,219,000

To record the change in fair value of the hedged item and derivative as a fair value hedge.

Journal Entry: 31 December 2003

Debit | Credit
--- | ---
Interest Expense | Cash | 8,000,000 | 8,000,000
Interest Expense | Cash | 2,080,000 | 2,080,000

To record payment of fixed-rate interest on debt obligation and the net cash settlement as an adjustment to the yield on the debt based on the change in the fair value of the interest rate swap. Effective yield is 10.08% or LIBOR (8.02%) plus 206 basis points.
At the end of the period, the interest swap terminated and the debt obligation matured and was paid by X. X paid a net cash settlement on the swap of $680,000.

### Journal Entry: 31 December 2004

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative Liability</td>
<td>$ 405,000</td>
</tr>
<tr>
<td>Hedging Income</td>
<td>$ 405,000</td>
</tr>
<tr>
<td>Hedging Loss</td>
<td>405,000</td>
</tr>
<tr>
<td>Debt Obligation</td>
<td>405,000</td>
</tr>
</tbody>
</table>

To record the change in fair value of the hedged item and derivative as a fair value hedge.

### Journal Entry: 31 December 2004

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 8,000,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>680,000</td>
</tr>
<tr>
<td>Cash</td>
<td>680,000</td>
</tr>
</tbody>
</table>

To record payment of fixed-rate interest on debt obligation and the net cash settlement as an adjustment to the yield on the debt based on the change in the fair value of the interest rate swap. Effective yield is 8.68% or LIBOR (6.62%) plus 206 basis points.

### COMPARISON WITH US GAAP

Under US GAAP, if the critical terms match, and certain other conditions are met, hedge effectiveness can be presumed, and no ineffectiveness is required to be measured or recognised. This approach is referred to as the ‘shortcut method’ under US GAAP. It permits an entity that qualifies for its use to ignore certain differences such as credit that would otherwise cause ineffectiveness in the hedging relationship. Since credit is not identified as a critical term under US GAAP, changes in the fair value of the hedged instrument as a result of credit changes that create ineffectiveness are not recognised. An assumption of no ineffectiveness is especially important because it significantly simplifies the computations necessary to make the accounting entries. The purpose of the exception is to provide relief from the burden of computing the change in fair value for both the derivative instrument and the hedged item.

Although under IAS 39 it can be expected that a hedge will be highly effective when critical terms match, if there is ineffectiveness in a hedging relationship, it cannot be ignored. To the extent that there would be significant ineffectiveness as a result of credit differences, critical terms do not match, and it cannot be concluded that there will be no effectiveness.

However, IAS 39 provides another method of limiting ineffectiveness. It permits an entity to designate portions of assets, liabilities, transactions, and exposures as the hedged item, which can have the effect of eliminating risks such as credit risk that could not be hedged effectively from the hedging relationship. Therefore, an entity can achieve ‘shortcut-like’ results. US GAAP does not permit hedge accounting for portions of risks except as specifically provided.

By permitting the designation of specific portions of risks as the hedged item, the portion of the risk being hedged often can be limited and equal to the risk of the hedging instrument. This approach reduces the ineffectiveness that otherwise would result from being required to hedge the entire instrument.

### CONCLUSION OF NO INEFFECTIVENESS: FAIR VALUE HEDGE OF A FIRM COMMITMENT

**EXAMPLE**

Company X enters into a firm commitment to buy 10,000 ounces of gold at the current six-month forward rate of $310. On the same day, Company X enters into a forward contract (which is a derivative) to sell 10,000 ounces of gold at the current six-month forward rate of $310. Company X appropriately documents the hedging strategy and states that effectiveness will be measured based on changes in the six-month forward price of gold.

Because the critical terms of the firm commitment and the forward contract match, Company X may conclude that the changes in the fair value of the firm commitment are expected to offset completely the change in the fair value of the derivative.
IAS 39.151 - CONCLUSION OF NO INEFFECTIVENESS: EVALUATION OF AN INTEREST RATE SWAP

EXAMPLE

On 1 January 2000, Company X issued R100 million of five-year 15% fixed-rate debt. Interest on the debt is payable annually. X enters into a fair value hedge of its debt with an interest rate swap. The interest rate swap resets off the JIBAR benchmark rate.

The terms of both instruments follow:

<table>
<thead>
<tr>
<th></th>
<th>Debt</th>
<th>Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notional Amount</td>
<td>R 100 million</td>
<td>R 100 million</td>
</tr>
<tr>
<td>Trade Date</td>
<td>01/01/00</td>
<td>01/01/00</td>
</tr>
<tr>
<td>Start Date</td>
<td>01/01/00</td>
<td>01/01/00</td>
</tr>
<tr>
<td>Maturity Date</td>
<td>31/12/04</td>
<td>31/12/04</td>
</tr>
<tr>
<td>Company X pays</td>
<td>15.00% Fixed</td>
<td>JIBAR</td>
</tr>
<tr>
<td>Company X receives</td>
<td>15.00%</td>
<td></td>
</tr>
<tr>
<td>Pay and receive dates</td>
<td>Annually</td>
<td>Annually</td>
</tr>
<tr>
<td>Variable reset</td>
<td>Annually</td>
<td></td>
</tr>
<tr>
<td>Initial JIBAR</td>
<td>16.69%</td>
<td></td>
</tr>
<tr>
<td>First pay/receive date</td>
<td>31/12/00</td>
<td>31/12/00</td>
</tr>
<tr>
<td>Last pay/receive date</td>
<td>31/12/04</td>
<td>31/12/04</td>
</tr>
</tbody>
</table>

All of the critical terms match. Therefore, Company X may assume no ineffectiveness, provided there are no significant differences in the credit that are part of the designated hedging relationship.

IAS 39.152 - HEDGE OF INTEREST RATE RISK WITH AN EMBEDDED PREPAYMENT OPTION

EXAMPLE

Bank G has a fixed-rate commercial loan maturing in five years. The borrower can prepay the loan without penalty after year two.

If Bank G wants to hedge the fair value of the loan due to changes in interest rate risk, it must consider the effect on fair value of the embedded option (a prepayment option is a sub-component of overall interest rate risk). A five-year receive-variable, pay-fixed swap might or might not be sufficiently effective to qualify as a hedge. A swap, cancellable at Bank G’s option after year two, would be a more effective hedging instrument because it hedges all of the interest rate risk, including the embedded prepayment option.

IAS 39.154 - FAIR VALUE HEDGE ACCOUNTING ILLUSTRATED: HEDGE OF INVENTORY

EXAMPLE

Company F maintains an inventory of cocoa that it uses in the production of chocolate. Company F wants to hedge the risk of price changes in the cocoa inventory, and on 1 July 2000 enters into a forward derivative instrument that is indexed to cocoa. The derivative has basis risk because of location differences between the inventory and the derivative instrument. Company F measures effectiveness by comparing the entire change in the fair value of the derivative to the change in the fair value of the cocoa inventory. At 30 September 2000, there is no ineffectiveness. The fair value of the cocoa inventory has decreased by $25,000, and the fair value of the derivative increased by $25,000.

Journal Entry: 1 July 2000

No entries are required because the forward was entered into at market (it has a fair value of zero).

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward Derivative Contract</td>
<td>$ 25,000</td>
<td></td>
</tr>
<tr>
<td>Hedging Gain</td>
<td></td>
<td>$ 25,000</td>
</tr>
</tbody>
</table>

To record the increase in the fair value of the derivative.

Journal Entry: 30 September 2000

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Loss</td>
<td>$ 25,000</td>
<td></td>
</tr>
<tr>
<td>Cocoa Inventory</td>
<td></td>
<td>$ 25,000</td>
</tr>
</tbody>
</table>

To record the decrease in the fair value of the inventory.
At 31 December 2000, the hedge has some ineffectiveness; however, the hedge still meets the effectiveness criteria (the correlation with the hedged item is in the range of 80 to 125 percent), and the inventory has decreased in fair value by $25,000, while the derivative has increased in fair value by $22,500. The following journal entries illustrate the appropriate accounting at 31 December 2000:

### Journal Entry: 31 December 2000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward Derivative Contract</td>
<td>$22,500</td>
</tr>
<tr>
<td>Hedging Gain</td>
<td>$22,500</td>
</tr>
</tbody>
</table>

To record the increase in the fair value of the derivative.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Loss</td>
<td>$25,000</td>
</tr>
<tr>
<td>Cocoa Inventory</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

To record the decrease in the fair value of the inventory.

The ineffectiveness in this hedging relationship ($2,500) is recorded to earnings, which is reflected in the fact that the amounts do not offset completely one another.

### IAS 39.154

**FAIR VALUE HEDGE ACCOUNTING ILLUSTRATED: HEDGE OF AFS WITH A PUT OPTION**

**EXAMPLE**

Company XYZ owns 1,000 shares of ABC with a market price of €50 per share. XYZ wants to hedge the downside price risk, and on 1 January 2000, XYZ purchases an at-the-money put option on 1,000 ABC shares expiring in three years. The exercise price is €50 per share and XYZ paid a premium of €9,000. Effectiveness is measured by comparing decreases in fair value of the investment below the €50 strike price with the intrinsic value of the option. At 31 December 2000, the intrinsic value of the option is €5,000, and the time value is €6,000. The fair value of the shares is €45,000.

The following table illustrates the three-year calculation of the fair values in this example:

<table>
<thead>
<tr>
<th></th>
<th>01/01/00</th>
<th>31/12/00</th>
<th>31/12/01</th>
<th>31/12/02</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC share price</td>
<td>50</td>
<td>45</td>
<td>48</td>
<td>42</td>
</tr>
<tr>
<td>Put strike price</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Volatility</td>
<td>35%</td>
<td>40%</td>
<td>25%</td>
<td>N/A</td>
</tr>
<tr>
<td>Risk-free rate</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>N/A</td>
</tr>
<tr>
<td>Fair value</td>
<td>9.00</td>
<td>11.00</td>
<td>5.00</td>
<td>8.00</td>
</tr>
<tr>
<td>Time Value</td>
<td>9.00</td>
<td>6.00</td>
<td>3.00</td>
<td>0</td>
</tr>
<tr>
<td>Intrinsic Value</td>
<td>0</td>
<td>5.00</td>
<td>2.00</td>
<td>8.00</td>
</tr>
</tbody>
</table>

The journal entries for the fair value hedge of the shares in ABC are as follows:

### Journal Entry: 1 January 2000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option Contract</td>
<td>€ 9,000</td>
</tr>
<tr>
<td>Cash</td>
<td>€ 9,000</td>
</tr>
</tbody>
</table>

To record payment of option premium.

### Journal Entry: 31 December 2000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Loss</td>
<td>€ 5,000</td>
</tr>
<tr>
<td>Investment in ABC</td>
<td>€ 5,000</td>
</tr>
</tbody>
</table>

To record unrealised loss on investment in ABC.

### Journal Entry: 31 December 2000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option Contract Asset</td>
<td>€ 2,000</td>
</tr>
<tr>
<td>Hedging Loss (time value)</td>
<td>€ 3,000</td>
</tr>
<tr>
<td>Hedging Gain (intrinsic value)</td>
<td>€ 3,000</td>
</tr>
</tbody>
</table>

To record the derivative option contract at fair value and the change in fair value of the time and intrinsic value of the option.

### Journal Entry: 31 December 2001

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC</td>
<td>€ 3,000</td>
</tr>
<tr>
<td>Securities Gain</td>
<td>€ 3,000</td>
</tr>
</tbody>
</table>

To record unrealised gain on investment in ABC.

### Journal Entry: 31 December 2001

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Loss (time value)</td>
<td>€ 3,000</td>
</tr>
<tr>
<td>Hedging Loss (intrinsic value)</td>
<td>€ 3,000</td>
</tr>
<tr>
<td>Option Contract Asset</td>
<td>€ 6,000</td>
</tr>
</tbody>
</table>

To record the derivative option contract at fair value and the change in fair value of the time and intrinsic value of the option.

### Journal Entry: 31 December 2002

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Loss</td>
<td>€ 6,000</td>
</tr>
<tr>
<td>Investment in ABC</td>
<td>€ 6,000</td>
</tr>
<tr>
<td>Hedging Loss (time value)</td>
<td>€ 3,000</td>
</tr>
<tr>
<td>Option Contract Asset</td>
<td>€ 6,000</td>
</tr>
<tr>
<td>Hedging Gain (intrinsic value)</td>
<td>€ 6,000</td>
</tr>
</tbody>
</table>

To record the derivative option contract at fair value and the change in fair value of the time and intrinsic value of the option.
IAS 39.159 - INEFFECTIVENESS OF CASH FLOW HEDGE RECOGNISED IN NET PROFIT OR LOSS: FORECASTED ISSUANCE OF DEBT

EXAMPLE

Company S is hedging the forecasted issuance of fixed-rate debt using a Euro future (a derivative). The debt is expected to be issued in three months. At the end of three months the derivative has accumulated losses of €2 million because of a decline in Euro deposit rates. The estimated fair value of the cumulative positive change in expected future cash flows on the anticipatory debt issuance was €1.8 million.

Company S should recognise €200,000 of the hedging loss immediately in net profit or loss because that portion of the hedge was ineffective. Euro deposit rates declined faster than rates on Company S’s anticipated debt issuance. The remaining €1.8 million is recognised directly in equity in accordance with Company S’s policy. At the end of three months S issued fixed-rate debt and closed-out the Euro futures position by paying the clearing agent on the exchange €2 million. The €1.8 million is reclassified out of equity and recorded as a reduction of the proceeds on the debt, thereby recording the debt at a discount. It will be amortised as additional interest expense over the life of the debt.

IAS 39.160 - BASIS ADJUSTMENT: ANTICIPATED FOREIGN CURRENCY DEBT ISSUANCE

EXAMPLE

Company F has an Australian dollar measurement currency and expects to issue fixed-rate, Euro-denominated notes within the next three months to take advantage of favourable funding opportunities. The expected issuance of the notes meets the definition of a forecasted transaction. Company F wants to hedge against both an increase in interest rates and a strengthening of the Australian dollar. Company F executes a derivative instrument that provides both interest rate and currency protection and designates the contract as a hedge of the forecasted transaction.

Assuming that the other hedge accounting criteria are met, the designated hedging relationship qualifies for hedge accounting as a cash flow hedge. When the debt is issued, any gain or loss resulting from the hedge that is recorded in equity is reclassified and becomes part of the net proceeds of the debt (a basis adjustment to the carrying amount of the debt).
IAS 39.162 - CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: USING COMBINATION OPTIONS

EXAMPLE

Company X acquired 1,000 shares of company ABC ordinary shares on 4 January 2000. Company ABC is listed on the Frankfurt Stock Exchange, and company X accounts for the equity securities as available-for-sale (AFS) in accordance with IAS 39. Company X plans to sell the common stock in 12 months and wants to hedge against a decline in price. Company X wants to minimise the cost of hedging the ABC shares, and on 4 January 2000 entered into a cost-less collar. A cost-less collar is a purchased option and a written option, one of which is a put option and the other which is a call option indexed to the shares with no premium paid or received. The collar meets the definition of a derivative and is considered a combination option. Company X designates the cost-less collar as a cash flow hedge of the forecasted sale of ABC ordinary shares. Alternatively, company X could have designated the collar as a fair value hedge of the stock. Company X will measure effectiveness using the intrinsic method.

The terms of the combination option at inception were:

<table>
<thead>
<tr>
<th>Purchased Put</th>
<th>Written Call</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Option</td>
<td>European</td>
</tr>
<tr>
<td>Notional Amount</td>
<td>1,000 shares</td>
</tr>
<tr>
<td>Strike Price</td>
<td>98</td>
</tr>
<tr>
<td>Maturity Date</td>
<td>31/12/00</td>
</tr>
<tr>
<td>Fair Value</td>
<td>14.15</td>
</tr>
</tbody>
</table>

ASSUME THE FOLLOWING SCENARIO:

<table>
<thead>
<tr>
<th>Share Price of ABC Ordinary Shares</th>
<th>04/01/00</th>
<th>31/03/00</th>
<th>30/06/00</th>
<th>30/09/00</th>
<th>31/12/00</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Stock Price</td>
<td>100</td>
<td>120</td>
<td>140</td>
<td>100</td>
<td>95</td>
</tr>
<tr>
<td>Put Strike</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
</tr>
<tr>
<td>Volatility</td>
<td>45%</td>
<td>50%</td>
<td>50%</td>
<td>55%</td>
<td>N/A</td>
</tr>
<tr>
<td>Risk-Free Rate</td>
<td>4.616%</td>
<td>4.582%</td>
<td>4.583%</td>
<td>4.551%</td>
<td>N/A</td>
</tr>
<tr>
<td>Fair Value</td>
<td>14.15</td>
<td>8.30</td>
<td>3.83</td>
<td>9.24</td>
<td>3.00</td>
</tr>
<tr>
<td>Time Value</td>
<td>14.15</td>
<td>8.30</td>
<td>3.83</td>
<td>9.24</td>
<td>0.00</td>
</tr>
<tr>
<td>Intrinsic Value</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>3.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fair Value of Purchased Put Option</th>
<th>04/01/00</th>
<th>31/03/00</th>
<th>30/06/00</th>
<th>30/09/00</th>
<th>31/12/00</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Stock Price</td>
<td>100</td>
<td>120</td>
<td>140</td>
<td>100</td>
<td>95</td>
</tr>
<tr>
<td>Put Strike</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
</tr>
<tr>
<td>Volatility</td>
<td>45%</td>
<td>50%</td>
<td>50%</td>
<td>55%</td>
<td>N/A</td>
</tr>
<tr>
<td>Risk-Free Rate</td>
<td>4.616%</td>
<td>4.582%</td>
<td>4.583%</td>
<td>4.551%</td>
<td>N/A</td>
</tr>
<tr>
<td>Fair Value</td>
<td>14.15</td>
<td>8.30</td>
<td>3.83</td>
<td>9.24</td>
<td>3.00</td>
</tr>
<tr>
<td>Time Value</td>
<td>14.15</td>
<td>8.30</td>
<td>3.83</td>
<td>9.24</td>
<td>0.00</td>
</tr>
<tr>
<td>Intrinsic Value</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>3.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fair Value of Written Call Option</th>
<th>04/01/00</th>
<th>31/03/00</th>
<th>30/06/00</th>
<th>30/09/00</th>
<th>31/12/00</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Stock Price</td>
<td>100</td>
<td>120</td>
<td>140</td>
<td>100</td>
<td>95</td>
</tr>
<tr>
<td>Call Strike</td>
<td>115</td>
<td>115</td>
<td>115</td>
<td>115</td>
<td>115</td>
</tr>
<tr>
<td>Volatility</td>
<td>45%</td>
<td>50%</td>
<td>50%</td>
<td>55%</td>
<td>N/A</td>
</tr>
<tr>
<td>Risk-Free Rate</td>
<td>4.616%</td>
<td>4.582%</td>
<td>4.583%</td>
<td>4.551%</td>
<td>N/A</td>
</tr>
<tr>
<td>Fair Value</td>
<td>(14.15)</td>
<td>(24.39)</td>
<td>(36.08)</td>
<td>(6.00)</td>
<td>0.00</td>
</tr>
<tr>
<td>Time Value</td>
<td>(14.15)</td>
<td>(19.39)</td>
<td>(11.08)</td>
<td>(6.00)</td>
<td>0.00</td>
</tr>
<tr>
<td>Intrinsic Value</td>
<td>0.00</td>
<td>(5.00)</td>
<td>(25.00)</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Combined Fair Value</td>
<td>0.00</td>
<td>(16.09)</td>
<td>(32.25)</td>
<td>3.24</td>
<td>3.00</td>
</tr>
<tr>
<td>Time Value</td>
<td>0.00</td>
<td>(11.09)</td>
<td>(7.25)</td>
<td>3.24</td>
<td>0.00</td>
</tr>
<tr>
<td>Intrinsic Value</td>
<td>0.00</td>
<td>(5.00)</td>
<td>(25.00)</td>
<td>0.00</td>
<td>3.00</td>
</tr>
</tbody>
</table>
The relevant journal entries would be:

<table>
<thead>
<tr>
<th>Journal Entry: 4 January 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the acquisition of ABC ordinary shares.

No entry required for the cost-less collar at 4 January 2000 because the fair value of the collar was zero.

Company X appropriately designates the collar in accordance with its risk management policy.

<table>
<thead>
<tr>
<th>Journal Entry: 31 March 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - Cash Flow Hedge</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Hedging Loss</td>
<td>$11,090</td>
<td></td>
</tr>
<tr>
<td>Combination Option</td>
<td>$16,090</td>
<td></td>
</tr>
</tbody>
</table>

To record the change in fair value of the combination option and the change in time value and intrinsic value components in net profit or loss (time value) and equity (intrinsic).

<table>
<thead>
<tr>
<th>Journal Entry: 31 March 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC</td>
<td>$20,000</td>
<td></td>
</tr>
<tr>
<td>Equity - AFS Securities</td>
<td>$20,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the ABC investment at fair value in accordance with the classification requirements of IAS 39 with changes in fair value recorded in equity.

<table>
<thead>
<tr>
<th>Journal Entry: 30 June 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - Cash Flow Hedge</td>
<td>$20,000</td>
<td></td>
</tr>
<tr>
<td>Hedging Gain</td>
<td>$3,840</td>
<td></td>
</tr>
<tr>
<td>Combination Option</td>
<td>$16,160</td>
<td></td>
</tr>
</tbody>
</table>

To record the change in fair value of the combination option and the change in time value and intrinsic value components in income (time value) and equity (intrinsic).

<table>
<thead>
<tr>
<th>Journal Entry: 30 June 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC</td>
<td>$20,000</td>
<td></td>
</tr>
<tr>
<td>Equity - AFS Securities</td>
<td>$20,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the ABC investment at fair value in accordance with the classification requirements of IAS 39 with changes in fair value recorded in equity.

<table>
<thead>
<tr>
<th>Journal Entry: 30 September 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combination Option</td>
<td>$35,490</td>
<td></td>
</tr>
<tr>
<td>Equity - Cash Flow Hedge</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>Hedging Gain</td>
<td>$10,490</td>
<td></td>
</tr>
</tbody>
</table>

To record the change in fair value of the combination option and the change in time value and intrinsic value components in income (time value) and equity (intrinsic).

<table>
<thead>
<tr>
<th>Journal Entry: 30 September 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - AFS Securities</td>
<td>$40,000</td>
<td></td>
</tr>
<tr>
<td>Investment in ABC</td>
<td>$40,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the ABC investment at fair value in accordance with the classification requirements of IAS 39 with changes in fair value recorded in equity.

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging Loss</td>
<td>$3,240</td>
<td></td>
</tr>
<tr>
<td>Combination Option</td>
<td>$240</td>
<td></td>
</tr>
<tr>
<td>Equity - Cash Flow Hedge</td>
<td>$3,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the change in fair value of the combination option and the change in time value and intrinsic value components in income (time value) and equity (intrinsic).

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - AFS Securities</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Investment in ABC</td>
<td>$5,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the ABC investment at fair value in accordance with the classification requirements with changes in fair value recorded in equity.

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Combination Option</td>
<td>$3,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the settlement of the combination option asset.

<table>
<thead>
<tr>
<th>Journal Entry: 31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Investment in ABC</td>
<td>$95,000</td>
<td></td>
</tr>
<tr>
<td>Realised Loss</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Equity - AFS Securities</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Equity - Cash Flow Hedge</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Realised Gain</td>
<td>$3,000</td>
<td></td>
</tr>
</tbody>
</table>

To record the sale of Investment in ABC and the recognition of equity amounts related to unrealised AFS losses and the cash flow hedge.
IAS 39.162 - CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: USING AN INTEREST RATE CAP

EXAMPLE
On 4 January 2000 Company X issued a 5-year $100 million variable-rate bond. The bond pays interest based on LIBOR plus a spread of 200 basis points on an annual basis, reset on December 31. Company X wants to hedge against increases in the interest expense on the bonds by capping the maximum interest expense at 9% (LIBOR of 7.00% + 2.00% spread). Company X purchased an interest rate cap that is indexed to LIBOR with a $100 million notional amount. The cap pays company X the difference between 7% and LIBOR if LIBOR rises above 7%. The interest rate cap is designated as a cash flow hedge of the variable-rate debt. The terms of the cap are as follows:

- Notional Amount $100 million
- Trade Date 04/01/00
- Start Date 04/01/00
- Expiration Date 31/12/04
- Strike rate 7.00%
- Index 12 month LIBOR
- Initial LIBOR 5.56%
- Premium $1.44 million

The payments on each caplet are made 12 months after the expiration. For example, the caplet that expires on 31 December 2000 will be paid, if applicable, on 31 December 2001. The fair value of the cap throughout the term of the cap is summarised below:

<table>
<thead>
<tr>
<th>Date</th>
<th>LIBOR</th>
<th>Cap Rate</th>
<th>Fair Value of Cap</th>
<th>Intrinsic Value of Cap*</th>
<th>Time Value of Cap</th>
<th>Cap Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 January 2000</td>
<td>5.56%</td>
<td>7.00%</td>
<td>$1,440,000</td>
<td>$1,440,000</td>
<td>$1,440,000</td>
<td>-</td>
</tr>
<tr>
<td>31 December 2000</td>
<td>5.00%</td>
<td>7.00%</td>
<td>1,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31 December 2001</td>
<td>5.50%</td>
<td>7.00%</td>
<td>850,000</td>
<td>-</td>
<td>850,000</td>
<td>-</td>
</tr>
<tr>
<td>31 December 2002</td>
<td>7.50%</td>
<td>7.00%</td>
<td>1,500,000</td>
<td>895,000</td>
<td>605,000</td>
<td>500,000</td>
</tr>
<tr>
<td>31 December 2003</td>
<td>8.00%</td>
<td>7.00%</td>
<td>925,000</td>
<td>925,000</td>
<td>-</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

* Intrinsic value is computed on a discounted basis.

The forecasted cash flows are $1,100,000 and the actual cash flows are $25,000 from the derivative and $1,075,000 from the sale of inventory, which totals $1,100,000. The variability of the cash flows related to the forecasted inventory sale is offset by the change in the value of the derivative.

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Wheat Futures Contract | $25,000
Equity | $25,000
To record the wheat futures contract at fair value (note the changes in fair value of the derivative are recorded in Equity until the hedged forecasted sale occurs).

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Cash | $25,000
Wheat Futures Contract | $25,000
To record the settlement of the wheat futures contract.

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Cash | $1,075,000
Cost of Goods Sold
Revenue | $1,075,000
Inventory | $1,000,000
To record the inventory sale

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Equity | $25,000
Revenue | $25,000
To record the amount reclassified from equity to earnings upon the inventory sale.

IAS 39.162 - CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: FORECASTED SALE OF WHEAT

EXAMPLE
On 4 January 2000 Company B has a forecasted sale of 500 tonnes of wheat expected to occur on or about 31 December 2000. On 4 January 2000 company B designates the cash flows of the forecasted sale as a hedged item and entered into a wheat futures contract to sell 500 tonnes at $1.1 million on 31 December 2000. At hedge inception, the derivative is at-the-money (fair value is zero). The terms of the commodity and the derivative match. On 31 December 2000, the wheat futures contract has a fair value of $25,000 and is closed out. Company B sells the inventory for $1,075,000.

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Wheat Futures Contract | $25,000
Equity | $25,000
To record the wheat futures contract at fair value (note the changes in fair value of the derivative are recorded in Equity until the hedged forecasted sale occurs).

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Cash | $25,000
Wheat Futures Contract | $25,000
To record the settlement of the wheat futures contract.

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Cash | $1,075,000
Cost of Goods Sold
Revenue | $1,075,000
Inventory | $1,000,000
To record the inventory sale

Journal Entry: 31 December 2000

**Debit** | **Credit**
--- | ---
Equity | $25,000
Revenue | $25,000
To record the amount reclassified from equity to earnings upon the inventory sale.
The following journal entries are made:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>4 January 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100,000,000</td>
<td></td>
<td>$100,000,000</td>
</tr>
<tr>
<td><strong>To record the issuance of debt.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>4 January 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option Asset</td>
<td>$1,440,000</td>
<td></td>
<td>$1,440,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$1,440,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the purchase of the interest-rate cap.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$7,560,000</td>
<td></td>
<td>$7,560,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$7,560,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the interest expense (LIBOR at reset plus 200 basis points (5.56% + 2.00%) on the 100 million principal amount.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2000</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Loss</td>
<td>$440,000</td>
<td></td>
<td>$440,000</td>
</tr>
<tr>
<td>Option Asset</td>
<td></td>
<td>$440,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>To record the cap option asset at fair value with changes in time value recognised in income (there was no intrinsic value to record).</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2001</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$7,000,000</td>
<td></td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$7,000,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the interest expense (LIBOR at reset plus 200 basis points (5.00% + 2.00%) on the 100 million principal amount.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2001</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Loss</td>
<td>$150,000</td>
<td></td>
<td>$150,000</td>
</tr>
<tr>
<td>Option Asset</td>
<td></td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the cap option asset at fair value with changes in time value recognised in income (there was no intrinsic value to record).</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2002</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$7,500,000</td>
<td></td>
<td>$7,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$7,500,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the interest expense (LIBOR at reset plus 200 basis points (5.50% + 2.00%) on the 100 million principal amount.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2002</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option Asset</td>
<td>$650,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedge Loss</td>
<td>$245,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>$895,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the cap option asset at fair value with changes in time value recognised in income and changes in intrinsic value recognised in equity.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2003</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$9,500,000</td>
<td></td>
<td>$9,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$9,500,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record the interest expense (LIBOR at reset plus 200 basis points (7.50% + 2.00%) on the 100 million principal amount.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2003</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$500,000</td>
<td></td>
<td>$500,000</td>
</tr>
<tr>
<td>Hedge Loss</td>
<td>$605,000</td>
<td></td>
<td>$605,000</td>
</tr>
<tr>
<td>Option Asset</td>
<td></td>
<td>$575,000</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>$30,000</td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$500,000</td>
<td></td>
<td>$500,000</td>
</tr>
<tr>
<td><strong>To record the cap option asset at fair value with changes in time value recognised in income and changes in intrinsic value recognised in equity and to record the receipt on the interest-rate cap [(7.50% LIBOR - 7.00% cap rate) X 100 million] - the effect of the cap is a 9.00% ceiling on the interest expense.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2004</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$10,000,000</td>
<td></td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$10,000,000</td>
<td></td>
</tr>
<tr>
<td><strong>To record interest expense (LIBOR at reset plus 200 basis points (8.00% + 2.00%) on the 100 million principal amount.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>31 December 2004</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000,000</td>
<td></td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>$925,000</td>
<td></td>
</tr>
<tr>
<td>Option Asset</td>
<td></td>
<td>$925,000</td>
<td></td>
</tr>
<tr>
<td><strong>To recognize the cap asset at fair value and equity at intrinsic (zero) and to record the receipt on the interest rate cap [(8.00% LIBOR - 7.00% cap rate) X 100 million] - the effect of the cap is a 9% ceiling on the interest expense.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**IAS 39.162 • CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: ANTICIPATED DEBT ISSUANCE**

**EXAMPLE**

Company X is expecting to issue €100 million of five-year, fixed-rate bonds on 30 June 2000. Company X has a BBB credit rating and believes that interest rates may increase during the next six months and wants to hedge against such an increase by locking in existing five-year fixed rates. Company X entered into a forward starting five-year swap on 1 January 2000 (the swap starts in six months) with a notional amount equal to the expected principal amount of the anticipated debt issuance. At the date of the hedge, swap rates were 5.50% and five-year BBB rates were 6.10%.

Company X measures effectiveness based on the change in fair value of the derivative and the change in the discounted or fair value of expected future interest payments on fixed-rate BBB bonds. Changes in spreads during the hedge period will result in hedge ineffectiveness. At the inception of the hedge the spread between the swap rates and five-year BBB corporate bonds was 60 basis points. Historically there is a high degree of correlation between swaps and BBB corporate bonds.

The following journal entries should be made:

**Journal Entry: 1 January 2000**

No entry required as the derivative has a fair value of zero.

**Journal Entry: 31 March 2000**

On 31 March 2000 five-year swap rates were 5.10% and five-year BBB rates were 5.65%. The derivative has a negative fair value of €1,744,000 as a result of a decrease in five-year swap rates of 40 basis points subsequent to 1 January 2000. The spread between five-year swap rates and five-year BBB corporate bond rates decreased to 55 basis points. Because the hedge underperformed the changes in BBB rates, the loss on the hedge was smaller than the present value decrease in expected future interest expense on the anticipated issuance of debt and, therefore, the hedge was fully effective to the extent that it had been taken out. Had the decrease in the expected future interest expense on the anticipated issuance of debt been lower than the loss on the hedge, a portion of the loss on the derivative would have been ineffective.

**Journal Entry: 31 March 2000**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>€1,744,000</td>
<td>€1,744,000</td>
</tr>
</tbody>
</table>

To record the derivative at fair value with changes in fair value recorded in equity.

**Journal Entry: 30 June 2000**

On 30 June 2000 five-year swap rates were 5.30% and five-year BBB rates were 5.90%. The derivative had a negative fair value of €867,000 million as a result of an increase in five-year swap rates of 20 basis points from 31 March 2000, spreads at 31 March 2000 returned to 60 basis points. The hedge was completely effective on a cumulative basis as the spreads remained constant at 60 basis points.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>€877,000</td>
<td>€877,000</td>
</tr>
</tbody>
</table>

To record the derivative at fair value with changes in fair value recorded in equity.

**Journal Entry: 30 June 2000**

Debit | Credit |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>€100,000,000</td>
<td>€100,000,000</td>
</tr>
<tr>
<td>854,000</td>
<td>854,000</td>
</tr>
<tr>
<td>867,000</td>
<td>867,000</td>
</tr>
</tbody>
</table>

To record the debt issuance (adjusted for the amount formerly recognised in equity) and close out of the derivative.

The €854,000 debit transferred out of Equity and included in the carrying amount of the debt, effectively results in a yield adjustment over the life of the bond (since the bond is issued at a greater discount) and will result in an effective yield on the bond of approximately 6.10%, which was the rate in effect at 1/1/00, the date the hedge was initiated.

**IAS 39.162 • CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: HEDGE OF VARIABLE-RATE DEBT WITH AN INTEREST RATE SWAP**

**EXAMPLE**

Company X issued $100 million of five-year variable-rate debt on 4 January 2000. The variable-rate on the debt is LIBOR plus a spread of 200 basis points. Initial LIBOR is 5%. The debt pays interest on an annual basis and the swap resets on an annual basis on 31 December. On 4 January 2000, Company X entered into a five-year pay fixed, receive LIBOR interest rate swap with a notional amount of $100 million. The swap is designated as a hedge of the forecasted interest payments on the debt and meets all of the criteria for a cash flow hedge.
The terms of the interest rate swap are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notional Amount</td>
<td>$100 million</td>
</tr>
<tr>
<td>Trade Date</td>
<td>04/01/00</td>
</tr>
<tr>
<td>Start Date</td>
<td>04/01/00</td>
</tr>
<tr>
<td>Maturity Date</td>
<td>31/12/04</td>
</tr>
<tr>
<td>Company X pays</td>
<td>5.50%</td>
</tr>
<tr>
<td>Company X receives</td>
<td>LIBOR</td>
</tr>
<tr>
<td>Pay and receive dates</td>
<td>Annually on the debt-payment dates</td>
</tr>
<tr>
<td>Variable reset</td>
<td>Annually (on 31 December)</td>
</tr>
<tr>
<td>Initial LIBOR</td>
<td>5.00%</td>
</tr>
<tr>
<td>First pay/receive date</td>
<td>31/12/00</td>
</tr>
<tr>
<td>Last pay/receive date</td>
<td>31/12/04</td>
</tr>
</tbody>
</table>

The interest rate swap is considered to be highly effective because the critical terms of the debt and the swap match and therefore Company X concludes that there will be no ineffectiveness and the entire change in the fair value of the interest rate swap is recognized in equity.

<table>
<thead>
<tr>
<th>LIBOR Rate at Inception and Each Reset Date</th>
<th>Fair Value of the Interest Rate Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 January 2000</td>
<td>5.00%</td>
</tr>
<tr>
<td>31 December 2000</td>
<td>6.57%</td>
</tr>
<tr>
<td>31 December 2001</td>
<td>7.70%</td>
</tr>
<tr>
<td>31 December 2002</td>
<td>6.79%</td>
</tr>
<tr>
<td>31 December 2003</td>
<td>5.76%</td>
</tr>
</tbody>
</table>

Company X accrues its interest expense at LIBOR plus 200 basis points on the debt and accrues the swap payments or receipts at each reporting date as an adjustment to interest expense. The effect of the debt and swap accruals is a 7.50% fixed rate. The fair value of the swap is recognised as an asset or liability with an offsetting adjustment in equity.
Interest rates decreased during the period ended 31 December 2002 resulting in a fair value of the interest rate swap of $2,101,000. Because the swap is considered to be completely effective, the change in total fair value of the swap is recorded in equity. Company X received $2,200,000 in net cash settlements on the swap at 31 December 2002. The LIBOR rate for the next period is 6.79%.

**Journal Entry: 31 December 2002**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>$3,490,000</td>
</tr>
<tr>
<td>Swap Asset</td>
<td>$3,490,000</td>
</tr>
</tbody>
</table>

To record the fair value of derivative and equity as a cash flow hedge.

**Journal Entry: 31 December 2002**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$9,700,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$9,700,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$1,070,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$2,200,000</td>
</tr>
</tbody>
</table>

To record payment of LIBOR plus 200 basis points (7.79% + 2.00%) on debt obligation and the net cash settlement receipt on the swap as an adjustment to the yield on the debt. Effective yield is 7.50%.

Interest rates decreased during the period ended 31 December 2003 resulting in a fair value of the interest rate swap of $2,411,000. Because the swap is considered to be completely effective, the total change in fair value of the swap is recorded in equity. Company X received $1,290,000 in net cash settlements on the swap at 31 December 2003. The LIBOR rate for the next period is 5.76%.

**Journal Entry: 31 December 2003**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>$2,062,000</td>
</tr>
<tr>
<td>Swap Asset</td>
<td>$2,062,000</td>
</tr>
</tbody>
</table>

To record the fair value of derivative and equity as a cash flow hedge.

**Journal Entry: 31 December 2003**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$8,790,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$8,790,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$1,290,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$1,290,000</td>
</tr>
</tbody>
</table>

To record payment of LIBOR plus 200 basis points (6.79% + 2.00%) on debt obligation and the net cash settlement receipt on the swap as an adjustment to the yield on the debt. Effective yield is 7.50%.

The swap matured at 31 December 2004. Company X received $260,000 in net cash settlements on the swap at 31 December 2004.

**Journal Entry: 31 December 2004**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>$241,000</td>
</tr>
<tr>
<td>Swap Asset</td>
<td>$241,000</td>
</tr>
</tbody>
</table>

To record the fair value of derivative and equity as a cash flow hedge.

**Journal Entry: 31 December 2004**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$7,760,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$7,760,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$260,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$260,000</td>
</tr>
</tbody>
</table>

To record payment of LIBOR plus 200 basis points (5.76% + 2.00%) on debt obligation and the net cash settlement receipt on the swap as an adjustment to the yield on the debt. Effective yield is 7.50%.

**IAS 39.162 - CASH FLOW HEDGE ACCOUNTING ILLUSTRATED: HEDGE OF A FIRM COMMITMENT EXAMPLE**

On 4 January 2000, XYZ entered into a firm commitment to buy 10,000 units of commodity T at the current forward rate of $310 per unit on 30 June 2000. On 4 January 2000, XYZ also entered into a net-settled forward contract to sell 10,000 units of commodity T at the current forward rate of $310 per unit. XYZ measures hedge effectiveness based on changes in the 30 June 2000, forward price of commodity T.

The following table outlines the changes in the spot rate of commodity T at 31 March 2000 and 30 June 2000. The appropriate journal entries follow.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward Rate for 30/06/00 Maturity</th>
<th>Fair Value of Forward</th>
<th>Fair Value of Firm Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/00</td>
<td>$300</td>
<td>$310</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>31/3/00</td>
<td>$292</td>
<td>$297</td>
<td>128,079(1)</td>
<td>(128,079)(1)</td>
</tr>
<tr>
<td>30/6/00</td>
<td>$285</td>
<td>-</td>
<td>250,000(2)</td>
<td>(250,000)(2)</td>
</tr>
</tbody>
</table>

(1) $128,079 = (310 - 297) x 10,000. present valued at 6% for three months
(2) $250,000 = (310 - 285) x 10,000

Note that although the hedge of the firm commitment results in a fair value exposure, it is accounted for as a cash flow hedge in terms of IAS 39.17(b).

No journal entry is recorded at 4 January 2000 because the forward contract is entered into at market.
IAS 32 and IAS 39: Summaries, Guidance, Examples, and US GAAP Comparisons

Journal Entry: 31 March 2000
Debit Credit
Forward contract $ 128,079
Equity - Cash Flow Hedge $ 128,079
To record the change in fair value of the forward contract.

Journal Entry: 30 June 2000
Debit Credit
Forward contract $ 121,921
Equity - Cash Flow Hedge $ 121,921
To record the change in fair value of the forward contract (121,921 = 250,000 - 128,079).

Journal Entry: 30 June 2000
Debit Credit
Cash $ 250,000
Forward contract $ 250,000
To record cash receipt upon settlement of forward contract.

IAS 39.163(a) - DE-DESIGNATION OF A HEDGE
EXAMPLE
On 3 February 20X1, Company J forecasts the purchase of 1,000 tonnes of aluminium on 20 May 20X1. It expects to sell finished products produced from the aluminium on 31 May 20X1. On 3 February 20X1, Company J enters into 20 futures contracts on the London Metals Exchange (LME), each for the purchase of 500 tonnes of aluminium on 20 May 20X1 (1,000 in total) and immediately designates those contracts as a hedge of the forecasted purchase of aluminium. Company J measures effectiveness by comparing the entire change in fair value of the futures contracts to the fair value of the changes in the cash flows on the forecasted transaction. On 3 February 20X1, the futures price of aluminium for delivery to London on 20 May 20X1 is $1,485 per tonne resulting in a total price of $148,500 for 1,000 bushels. On 1 May 20X1, Company J closes out the futures contracts. As of that date, Company J had recognised in equity gains on the futures contracts of $26,250. Company J still plans to purchase 1,000 bushels of aluminium on 20 May 20X1.

The gains that occurred prior to the de-designation will remain in equity until the finished products are sold. If Company J had not closed out the futures contracts, but simply de-designated them as a hedge, any subsequent gains or losses would have been recognised in net profit or loss.

IAS 39.163(b) - HEDGE NO LONGER MEETS HEDGE ACCOUNTING CRITERIA
EXAMPLE
MNO Incorporated enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable interest payments on a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5%) and receives interest at LIBOR. MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in five years. At the end of the second year of the five-year hedging relationship, MNO discontinues its practice of issuing 90-day notes. Instead, MNO issues a three-year, $5 million note with a fixed rate of interest (7.25%). Because the interest rate on the three-year note is fixed, the variability of the payments has been eliminated.

The hedging relationship qualified for hedge accounting until the end of the second year when MNO issued three-year debt, at which time, there no longer exists a cash flow exposure to interest rates. Thus, Swap 1 no longer qualifies for cash flow hedge accounting. However, the net gain or loss on Swap 1 is recognised in equity and is not reclassified to earnings immediately. Immediate reclassification is required if the forecasted hedged transactions (future interest payments) are no longer expected to occur. The variability of the payments has been eliminated, but it still is probable that cash flows at the rates established at the end of year two will occur. Thus, the gain or loss on the swap that have been incurred up to the date in which the three-year note is issued is not recognised in net income. Instead the gain or loss is an adjustment to the basis of the fixed-rate note that was issued. Unless the swap is redesignated as a cash flow hedge of another exposure, subsequent changes in the fair value of the swap will be recognised in net income because it no longer qualifies as a hedge.
**IAS 39.163(b) - HEDGING RELATIONSHIP ADJUSTED WITH BASIS SWAP**

**EXAMPLE**

MNO Incorporated enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable interest payments on a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5%) and receives interest at LIBOR. MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in five years. At the end of the second year of the five-year hedging relationship, MNO discontinues its practice of issuing 90-day notes and instead issues a three-year, $5 million note with a rate of interest that adjusts every 90 days to the prime rate quoted on that day.

Swap 1 is no longer effective as a cash flow hedge because the receive-variable rate on the swap is LIBOR, and the prime rate and LIBOR are expected to change differently. MNO wants to continue the hedging relationship and offset fully changes in cash flows caused by changes in the prime rate. Rather than liquidate Swap 1 and obtain a separate derivative to hedge the variability of the prime-rate-based interest payments, MNO enters into a pay-LIBOR, receive-prime basis swap. The basis swap has a $5 million notional amount and a three-year term and requires a settlement every 90 days. MNO designates Swap 1 and the basis swap in combination as the hedging instrument in a cash flow hedge of the variable interest payments on the three-year note.

Although IAS 39 does not specifically deal with whether combinations of derivatives qualify for designation as hedging instruments, it does not restrict the use of derivatives for hedging purposes, except in specified circumstances. On the three-year note, MNO pays interest at prime. On the basis swap, MNO receives interest at prime and pays interest at LIBOR. On Swap 1, MNO receives interest at LIBOR and pays interest at 6.5%.

Together, the cash flows from the two derivatives are effective at offsetting changes in the interest payments on the three-year note. Changes in fair values of the two swaps are recognised directly in equity and are reclassified to net profit or loss when the hedged forecasted transactions (the variable interest payments) affect earnings.

**IAS 39.163(c) - DISCONTINUATION OF A CASH FLOW HEDGE ACCOUNTING: TRANSACTION NO LONGER PROBABLE**

**EXAMPLE**

Company D is hedging the forecasted issuance of £100 million of 10-year, fixed-rate debt using a rate lock agreement (a derivative). Company D expects to issue the debt in the second quarter of 2000. Company D’s credit rating is BB. In the first quarter of 2000, the debt markets experience a flight to quality and spreads between government and corporate bond rates widen significantly. As a result Company D does not expect to issue its bonds in the second quarter. Company D’s advisors believe that the markets will stabilise in the third or fourth quarter of 2000 or the first quarter of 2001. Once the markets stabilise and spreads return to normal levels, Company D will issue its bonds. Company D closed its rate lock agreement in the first quarter because of the widening of spreads and significant losses incurred on the derivative. The loss at 31 March 2000 was £8 million of which £4 million related to the widening of spreads.

Company D should recognise the entire £8 million loss in income because the original forecasted transaction is not expected to occur. While it is possible that D will issue debt later in 2000 or early 2001, the original transaction will not occur.

**IAS 39.164 - HEDGING A NET INVESTMENT IN A FOREIGN ENTITY WITH A CROSS CURRENCY SWAP**

**QUESTION**

**IAS 39.165 - HEDGED FORECASTED TRANSACTIONS: REASONABLY POSSIBLE BUT NOT PROBABLE**

**QUESTION**

**WHAT IS THE IMPACT ON HEDGE ACCOUNTING IF A HEDGED FORECASTED TRANSACTION IS NO LONGER PROBABLE OF OCCURRING, BUT IT IS STILL REASONABLY POSSIBLE THAT IT WILL OCCUR?**

Because the transaction is no longer probable of occurring, the hedging relationship no longer qualifies for hedge accounting and changes in the fair value of the hedging instrument subsequent to the determination that the transaction is no longer probable is recognised in net profit or loss. Changes in the fair value of the hedging instrument that occurred prior to the determination that the forecasted transaction is no longer probable remain in equity until the transaction occurs or until it is determined that the forecasted transaction is not probable of occurring.
IAS 39.164 - HEDGING A NET INVESTMENT IN A FOREIGN ENTITY USING A CURRENCY SWAP
EXAMPLE

P, a German Company, has a foreign subsidiary with a measurement currency different from P’s measurement currency. P’s investment in the subsidiary is €4,000,000. In accordance with IAS 21.30(c), P records the translation adjustments relating to its Polish subsidiary as a component of its equity. On 30 June 2000, P entered into a currency swap to hedge the net investment in the Polish subsidiary. At inception P pays 14,000,000 Zloty, and receives €3,594,600. Semi-annually, throughout the term of the currency swap, P pays a fixed rate of 6% on €3,594,600, and receives a fixed rate of 6% on 14,000,000 Zloty. At the termination date of the currency swap, P pays €3,594,600 and receives 14,000,000 Zloty. The currency swap has a term of five years. The currency swap is a hedge of the net investment in the foreign subsidiary.

The periodic interest settlements are recognised in net profit or loss after being translated into P’s measurement currency. The changes in the value of the currency swap are recognised in equity to offset the changes in the translation of P’s net investment into its measurement currency. As a result of operating income and loss and changes in exchange rates, P’s net investment in its Polish subsidiary changes. As a result, P should monitor the effectiveness of the hedge. If P’s net investment fell to 7,000,000 Zloty, P would no longer have an effective hedge to the extent that the notional amount of the hedging instrument exceeded P’s net investment. To the extent P determines it is overhedges, the currency swap could be terminated and replaced with another currency swap having a notional amount equal to or less than P’s net investment or P could redesignate the hedge to the lowest portion of its investment. Therefore, only a portion of the derivative would be ineffective and would be marked to market through earnings.

IAS 39.164 - HEDGING A NET INVESTMENT IN A FOREIGN ENTITY USING A RECOGNISED LIABILITY
EXAMPLE

P, a French company, has a foreign subsidiary with a functional currency different from P’s reporting currency. P’s investment in the subsidiary is C$2,000,000. In accordance with IAS 21, P records the translation adjustments relating to its Canadian subsidiary as a component of its equity. P has a long-term debt agreement in the amount of C$3,000,000. P designates C$3,000,000 of the debt at the beginning of the year as a hedge of its net investment in the foreign subsidiaries and measures effectiveness based on the spot rate.

The debt agreement is a non-derivative financial instrument used to hedge the net investment in the foreign subsidiary. Company P measures hedge effectiveness at the beginning of each year based on spot rates. Because the debt agreement and the net investment are denominated in the same currency, the hedge is expected to be highly effective. The portion of the debt instrument that is not designated in the hedging relationship is translated to spot in net profit or loss in accordance with IAS 21.

IAS 39.166 - DISCLOSURE CHECKLISTS
EXAMPLE

The disclosure provisions of IAS 32 and IAS 39 are summarised in two checklists in Appendix A to this book. Checklist 1 contains those disclosures under IAS 32 and 39 that are mandatory and Checklist 2 summarises those disclosures that are encouraged.

IAS 39.172(c) - TRANSITION: PRE-IAS 39 GAINS/LOSSES ON OPEN DERIVATIVE HEDGES
QUESTION


They are shown as a separate component of equity. If the derivative does not qualify as a hedging instrument under the IAS 39 hedge accounting criteria, or the enterprise chooses not to designate them as a hedge, IAS 39.172(c) requires that the pre-IAS 39 gain or loss be recognised as an adjustment of retained earnings at 1 January 2001. This does not apply, however, to derivatives that are designated hedging instruments. Treating the pre-IAS 39 fair value changes in hedging derivatives as a component of equity at 1 January 2001 is consistent with the requirement in IAS 39.172(f) for treating the pre-IAS 39 gains and losses that had been deferred in the balance sheet as a separate component of equity on adoption of IAS 39.

If these derivatives were hedges prior to 1 January 2001, it is necessary to also determine what they were hedging and, if an asset not at fair value, to adjust the asset. If it was a cash flow hedge of a forecasted transaction, it is necessary to consider whether the forecasted transaction is expected to occur.
Appendices

A Disclosure Checklists

B Topics Addressed By The IASB IAS 39
     Implementation Guidance Committee
## APPENDIX A - DISCLOSURE CHECKLISTS

### CHECKLIST 1 - REQUIRED DISCLOSURE

<table>
<thead>
<tr>
<th>QUESTION DISCLOSURE - GENERAL</th>
<th>ANSWER</th>
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<tbody>
<tr>
<td>1. Was the extent of disclosure determined based on the exercise of professional judgement?</td>
<td>Note: It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements, and obscuring significant information as a result of too much aggregation. (IAS 32.45)</td>
</tr>
<tr>
<td>2. Are financial instruments grouped into classes that are appropriate to the nature of the information to be disclosed, taking into account matters such as the characteristics of the instruments, whether they are recognised or unrecognised, and if recognised, the measurement basis that has been applied? (IAS 32.46)</td>
<td></td>
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<tr>
<td>3. Where amounts disclosed in notes or supplementary schedules relate to recognised instruments, is sufficient information provided to permit a reconciliation to the relevant line items on the balance sheet? (IAS 32.46)</td>
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<tr>
<th>DISCLOSURE - ACCOUNTING POLICIES</th>
<th>ANSWER</th>
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<tbody>
<tr>
<td>4. For each class of financial asset, financial liability and equity instrument, has the enterprise provided clear and concise disclosure of the accounting policies adopted, including the criteria for recognition and the basis for measurement that is applied? (IAS 32.47)</td>
<td>In the case of financial instruments, policy disclosure includes (IAS 32.42-55 and IAS 39.167): The criteria applied in determining when to recognise a financial instrument on the balance sheet and when to cease to recognise it; The basis of measurement (cost, amortised cost, or fair value) both at and subsequent to initial recognition and the method of applying that basis. For example, for instruments carried at cost or amortised cost, this may include disclosing how the following are accounted for: Cost of acquisition or issuance; Premiums/discounts; continued...</td>
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</table>
Changes in the estimated amount of determinable future cash flows (for example, bonds indexed to the commodity price),

Changes in circumstances that result in significant uncertainty about the timely collection of all contractual amounts due from monetary financial assets and when the carrying amount is reduced;

How income is recognised on the asset subsequent to impairment and whether the reduction in carrying amount may be reversed in future if circumstances change,

Declines in the fair value of financial assets below their carrying amount;

Restructured financial liabilities.

Note: Where the accounting treatment of any of the above items is clearly spelt out by IAS 39 and where no alternative treatments are offered, it may not be necessary or meaningful for the enterprise to separately disclose such treatment.

For instruments carried at fair value, the accounting policy disclosure should include the methods used (that is, whether carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or another appropriate method), as well as any significant assumptions made in applying that method (including prepayment rates, rates of estimated credit losses and interest or discount rates where appropriate);

The basis on which income and expenses from financial instruments are recognised/measured, for example, basis for disclosure of realised and unrealised gains/losses, gains/losses from hedged instruments; the reason for setting off income/expense items when balance sheet items have not been offset if applicable.

This must include stating whether gains and losses arising from changes in the fair value of available-for-sale (AFS) financial assets are included in net profit or loss for the period or are recognised directly in equity until the assets are disposed of;

For each of the 4 primary classification categories of financial assets defined in IAS 39.10, whether ‘regular way’ purchases of financial assets are accounted for at trade date or at settlement date.

Policy notes may be necessary for the following types of transactions:

Transfers of financial assets when there is a continuing interest in/involvement with the assets by the transferor, for example, securitisation of financial assets, repurchase agreements,

Transfers of financial assets to a trust for the purpose of satisfying liabilities when they mature without the obligation of the transferor being discharged at time of transfer, for example, in-substance defeasance trust.

Acquisition/issuance of separate financial instruments as part of series of transactions designed to ‘synthesize’ the effect of acquiring/issuing one instrument,

Acquisition/issuance of financial instruments as hedges of risk/exposures,

Acquisition/issuance of monetary financial instruments bearing stated interest rate that differs from the prevailing market rate at date of issue. (IAS 32.53)

5. For each class of financial asset, financial liability and equity instrument, has the enterprise disclosed information on the nature and extent of the financial instrument, including significant terms and conditions that may affect the amount, timing, and certainty of future cash flows?

Note: If instruments are not individually significant, their essential characteristics of the instruments are described by reference to their groupings. (IAS 32.48)

Additional Guidance: Where financial instruments, individually or as a class, create a potentially significant exposure to any risks (see above), the terms and conditions that may warrant disclosure include:

The principal, stated, face or similar amount on which future payments are based,

The date of maturity, expiry or execution,

Early settlement options held by either party (and the period in which they may be exercised, maturity date, exercise prices, etc.).

Options held by either party to convert/exchange the instrument for another instrument (including the period in which, or date at which conversion may occur, conversion ratios, etc.).

Amount and timing of scheduled future cash flows of principal and related amounts (including installment repayments, sinking fund etc.).

Stated rate/amount and timing of interest, dividend or other periodic return on principal,
### DISCLOSURE - TERMS AND CONDITIONS RELATING TO FINANCIAL INSTRUMENTS

<table>
<thead>
<tr>
<th>ANSWER</th>
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<tbody>
<tr>
<td>Currency in which cash flows are required (if different from reporting currency).</td>
</tr>
<tr>
<td>Collateral held or pledged.</td>
</tr>
<tr>
<td>In the case of an instrument that provides for an exchange, the above information for the instrument to be acquired in the exchange. (IAS 32, paragraph 49)</td>
</tr>
<tr>
<td>Any condition of the instrument that, if contravened, would significantly alter any of the other terms, for example, maximum debt-equity ratio that if contravened, would make the full principal amount of the bond due and payable immediately.</td>
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<tr>
<td>Information on an instrument’s legal form when it differs from the presentation form,</td>
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<tr>
<td>Information on any relationships between individual instruments that may affect the amount, timing, or certainty of future cash flows, for instance, hedging relationships, relationships between components of ‘synthetic instruments’. (IAS 32.51)</td>
</tr>
</tbody>
</table>

In the case of securitisations or repurchase agreements, has the enterprise disclosed (separately for the current and prior financial reporting periods):

- The nature and extent of these transactions, including a description of any collateral and quantitative information about the key assumptions used in calculating the fair values of new and retained interests;
- Whether the financial assets have been derecognised. (IAS 39.170)

If the enterprise has reclassified a financial asset from a category that requires it to be carried at fair value to one that requires it to be carried at amortised cost, has the enterprise disclosed the reason for the reclassification? (IAS 39.175)

### DISCLOSURE - INTEREST RATE RISK INFORMATION

<table>
<thead>
<tr>
<th>ANSWER</th>
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<tbody>
<tr>
<td>6. For each class of financial asset and liability, has the enterprise disclosed information on its exposure to interest rate risk, including:</td>
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<tr>
<td>- Information concerning its exposure to the effects of future changes in the prevailing level of interest rates;</td>
</tr>
<tr>
<td>- Contractual repricing or maturity dates, whichever dates are earlier (providing users with a basis for evaluating the interest rate price risk and therefore the potential gain/loss);</td>
</tr>
<tr>
<td>- Effective interest rates (internal rate of return on instrument for period), when applicable;</td>
</tr>
<tr>
<td>- Financial assets and liabilities that are exposed to:</td>
</tr>
<tr>
<td>- Interest rate price risk, such as fixed interest rate assets/liabilities,</td>
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<tr>
<td>- Interest rate cash flow risk, such as floating rate financial instruments where the interest rates reset as market rates change.</td>
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<tr>
<td>- No interest rate risk, such as some equity security investments. (IAS 32.56-62)</td>
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Supplemental disclosure: An enterprise may elect to disclose information about expected repricing or maturity dates when these differ significantly from the contractual dates, for example, reasonable certainty of prepayment of loans. This must then include disclosure of the fact that it is based on management’s expectations of future events, and explain the assumptions made and how they differ from contractual dates. (IAS 32.59)

Note: The ‘effective interest rate’ information applies to bonds, notes, etc. involving future payments that create a return to the holder, reflecting the time value of money. It does not apply to financial instruments such as non-monetary and derivative instruments (for example, swaps) that do not bear a determinable effective interest rate (IAS 32.64). The enterprise should, however, disclose the effect of these on its interest rate exposure where applicable.

Additional Guidance: Several alternative suggested formats of disclosure are presented in IAS 32.64, including either tabular or narrative descriptions based on maturity time bands, fixed and floating rate exposures, interest rate sensitivity analysis (for example based on a 1% change in interest rates) and through the use of weighted average rates or ranges of rates. **continued...**
7. Has the enterprise disclosed information that will enable users to understand the nature and extent of its exposure to interest rate risks associated with:
   - Financial assets removed from its balance sheet (as a result of securitisation, etc.), or
   - Financial assets/liabilities not recognised on the balance sheet. (IAS 32.63)
   
   Additional Guidance: Note that the circumstances in which this disclosure is required are expected to be extremely rare as a result of the derecognition provisions in IAS 39. In the event that disclosure is required, for securitisations, the information would normally include the nature of the assets transferred, their stated principal, interest rate and term to maturity and any terms of the transaction giving rise to retained exposure to interest rate risk. For commitments to lend funds that do not meet the definition of a derivative, disclosure would normally include stated principal, interest rate and term to maturity of amount to be lent and significant terms.

8. For each class of financial asset, has the enterprise disclosed information on its exposure to credit risk, including:
   - Information to permit users to assess the extent to which failure by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date;
   - The amount that best represents its maximum credit risk exposure at the balance sheet date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments (including third party guarantees); and
   - Significant concentration of credit risk, including a description of the shared characteristic that identifies each concentration and amount of maximum credit risk exposure associated with all financial assets sharing that characteristic. (IAS 32.66)

9. Where the enterprise has guaranteed any obligations of third parties, or is obliged under any recourse provisions to indemnify the purchaser of assets for credit losses, has this information (including the terms and maximum loss that could arise) been disclosed for credit risk purposes? (IAS 32.73)

Note: The statement does not require an enterprise to disclose an assessment of the probability of losses arising in the future. (IAS 32.67)

Additional Guidance: For recognised financial assets, the carrying amount at balance sheet date usually represents the amount exposed to credit risk, for example, for an interest-rate swap carried at fair value, the maximum exposure is the carrying amount since it represents the cost at current market rates of replacing the swap in the event of default. But for some financial assets, the maximum loss can differ significantly from the carrying or fair value - additional disclosure is required in these instances:

A financial asset subject to a legally enforceable right of set-off. When the financial asset is expected to be collected before the financial liability is to be settled, users are informed of the extent to which exposure to credit risk has been reduced (should the counterparty default, the liability will not require settlement).

A master netting arrangement that does not meet the criteria for offsetting, but significantly reduces the credit risk associated with financial assets. Additional disclosure should indicate:

That the credit risk associated with financial assets subject to master netting agreement is eliminated only to the extent that financial liabilities due to same counterparty will be settled after the assets are realised; and

The extent to which an enterprise’s overall exposure to credit risk, reduced through a master netting arrangement, may change substantially within a short period because the exposure is affected by each transaction within the arrangement. (IAS 32.71-72)

Guidance on credit risk concentration: This may arise from exposure to a single debtor, or group of debtors with similar characteristics that will be similarly affected by changes in economic or other conditions. The segment report provides useful guidance in identifying industry and geographic segments within which credit risk concentration may arise. (IAS 32.74-76)
<table>
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<tr>
<th>DISCLOSURE - CREDIT RISK INFORMATION (CONTINUED)</th>
<th>ANSWER</th>
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<tr>
<td>10. Has the enterprise disclosed information about fair value for each class of financial asset and liability, including the valuation method adopted and significant assumptions made, or where it is not practicable within constraints of timeliness or cost to determine the fair value of a financial asset or financial liability with sufficient reliability, has that fact been disclosed together with information about the principal characteristics of the underlying financial instrument that are pertinent to its fair value, to enable users in making their own judgments on the difference between the carrying amount and fair values, as well as information about the market for the instruments? (IAS 32.77)</td>
<td>This disclosure is not required for those instruments measured at fair value under IAS 39. (IAS 39.166)</td>
</tr>
<tr>
<td>Has the enterprise disclosed the nature and amount of any impairment loss or reversal of an impairment loss recognised for each significant class of financial asset? (IAS 39.170)</td>
<td>Where the gain/loss from remeasuring available-for-sale assets to fair value is recognised directly in equity, has the enterprise disclosed:</td>
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<tr>
<td>Where the gain/loss from remeasuring available-for-sale assets to fair value is recognised directly in equity, has the enterprise disclosed:</td>
<td></td>
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<tr>
<td>■ The amount recognised directly in equity in the current period, and,</td>
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<tr>
<td>■ The amount removed from equity and reported in net profit or loss for the period? (IAS 39.170)</td>
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<tr>
<td>If the presumption that fair value can be reliably measured for available-for-sale and held for trading assets has been overcome, and therefore the assets are measured at amortised cost, has this fact been disclosed together with a description of the financial assets, their carrying amounts, an explanation of why fair value cannot be reliably measured and, if possible a range of estimates within which fair value is expected to lie? (IAS 39.170)</td>
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<tr>
<td>If such assets for which fair value could not previously be measured reliably are subsequently sold, has the enterprise disclosed that fact, the carrying amount of the assets at the time of sale as well as the amount of gain/loss? (IAS 39.170)</td>
<td></td>
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<tr>
<td>Additional Guidance: Fair value information relating to classes of financial assets and liabilities that are carried on the balance sheet at other than fair value is provided in a way that permits comparison between the carrying amount and the fair value. Accordingly, fair values are recognised and offset in the same classes and on the same basis as the carrying amounts; and unrecognised instruments are disclosed in separate classes. (IAS 32.87)</td>
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<td>continued...</td>
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<thead>
<tr>
<th>DISCLOSURE - CREDIT RISK INFORMATION (CONTINUED)</th>
<th>ANSWER</th>
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<tbody>
<tr>
<td>Where an instrument is not traded in an organised market and is not required to be carried at fair value under IAS 39, it may be more appropriate to disclose a range of amounts within which the fair value of a financial instrument in reasonably believed to lie. (IAS 32.84)</td>
<td>For each significant class of assets, has the enterprise disclosed the nature and amount of any impairment loss or reversal of an impairment loss recognised? (IAS 39.170)</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>DISCLOSURE - FINANCIAL ASSETS CARRIED AT AN AMOUNT IN EXCESS OF FAIR VALUE</th>
<th>ANSWER</th>
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<tbody>
<tr>
<td>11. Where the enterprise carries any financial assets at an amount in excess of their fair value, has the enterprise disclosed:</td>
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<tr>
<td>■ The carrying amount and the fair value of either the individual assets or appropriate grouping of those individual assets; and</td>
<td></td>
</tr>
<tr>
<td>■ Reasons for not reducing the carrying amount, including the nature of the evidence that provides the basis for management’s belief the carrying amount will be recovered? (IAS 32.88)</td>
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<tr>
<td>This disclosure is not required for those instruments measured at fair value under IAS 39. (IAS 39.166)</td>
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</tr>
<tr>
<td>Note: Management exercises judgment in determining the amount it expects to recover from a financial asset and whether to write down the carrying amount of the asset when it is in excess of fair value. The above information provides users with a basis for understanding management’s judgment and for assessing the possibility that circumstances may change and lead to a reduction in the asset’s carrying amount in future. The accounting policy notes, already discussed, should assist in explaining why particular financial assets are carried at amounts in excess of fair value. (IAS 32.89-90)</td>
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</tbody>
</table>
12. Has the enterprise disclosed its policy for hedging each major type of forecasted transaction, the circumstances in which a financial instrument is accounted for as a hedge? (IAS 39, paragraphs 142(a) and 167). This discussion should include:

- A description of the hedge;
- A description of the hedging instruments and their fair values at the balance sheet date;
- The nature of the risks being hedged;
- For hedges of forecasted transactions, the periods in which the transactions are expected to occur, when they are expected to enter into the determination of net profit or loss and a description of any forecasted transaction for which hedge accounting had previously been used but that is no longer expected to occur.
- For cash flow hedges where the gain/loss on the hedging instruments is recognised directly in equity, has the enterprise disclosed:
  - The amount recognised in equity during the current period;
  - The amount removed from equity and reported in net profit/loss for the period; and
  - The amount that was removed from equity and added to the initial carrying amount of the asset/liability in a hedged forecasted transaction during the current period. (IAS 39.169)

13. Has the enterprise disclosed all significant items of income/expense, gains/losses whether included in net profit or loss or as a separate component of equity? (IAS 39.170) For this purpose, the following should be separately disclosed:

- Total interest income and total interest expense (both on a historical cost basis) should be disclosed separately;
- For available-for-sale assets, both realised and unrealised profits/losses for the period should be disclosed separately;
- The amount of interest income accrued on impaired loans that has not yet been received in cash.

Has the enterprise disclosed the reason for the reclassification of assets from categories carried at fair value to categories carried at amortised cost? (IAS 39.170(e))

Has the enterprise separately disclosed the carrying amount of financial assets pledged as collateral for liabilities and any significant terms and conditions relating to pledged assets? (IAS 39.170(g))

Has the enterprise separately disclosed the fair value of collateral that it has accepted and that it is permitted to sell or repledge (as well as the fair value of any collateral that it has sold or repledged) and any significant terms and conditions associated with its use of collateral? (IAS 39.170(h))

Has the enterprise separately classified the interest and dividend portions of expenses relating to compound (hybrid) instruments with equity and liability characteristics and classified the dividend portion of shares that are classified as liabilities as interest expense? (IAS 32.31)

Note: Gains/losses associated with redemptions/refinancings of instruments classified as liabilities are reported in the income statement while those in respect of instruments classified as equity of the issuer are reported as movements in equity. Dividends classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate item. Disclosure of interest and dividends is subject to the requirements of IAS 1, IAS 30, and IAS 39. Disclosures of the related tax effects are made in accordance with IAS 12. (IAS 32.31-32)

Where the enterprise has reacquired its own equity instruments (treasury shares) during the current period, for each class of share capital, has it disclosed the shares held by itself or by its subsidiaries or associates as well as the amounts of reductions to equity? (SIC 16, paragraphs 6, 10)

Note: The acquisition cost of treasury shares held by the enterprise itself or one of its subsidiaries or associates may be presented in the following ways:

- The total costs as a one-line adjustment of equity;
- The par value, if any, as a deduction from share capital with adjustment of premiums/discounts against other categories of equity; or
- Each category of equity may be adjusted. (SIC 16.10)
CHECKLIST 2 - RECOMMENDED DISCLOSURE

Additional disclosures are encouraged when they are likely to enhance financial statement users’ understanding of financial instruments. Professional judgment is required in determining the appropriate level of disclosure. It may be desirable to disclose such information as:

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<td>- The total amount of the change</td>
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<td>assets and financial liabilities</td>
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<td>that has been recognised as</td>
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<td>income or expense in the period;</td>
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<td>- The average aggregate carrying</td>
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<td>amount during the year of</td>
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<td>recognised financial assets and</td>
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<td>financial liabilities;</td>
<td></td>
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<tr>
<td>- The average aggregate fair value</td>
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<td>during the year of all financial</td>
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<td>assets and liabilities,</td>
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<td>particularly when the amounts</td>
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<td>on hand at the balance sheet date</td>
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<td>are unrepresentative of amounts</td>
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<td>on hand during the year?</td>
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2. Has the company included a general discussion of the extent to which financial instruments are used, the associated risks and the business purposes served?

APPENDIX B

TOPICS Addressed by IASB Implementation Guidance Committee

The following are the topics of the IAS 39 Implementation Guidance Committee’s (IGC’s) questions and answers, Batches 1-5, published July 2001. IGC questions are numbered sequentially in relation to the paragraph in IAS 39. For example, IGC question 1-2 means IAS 39 paragraph 1, question 2. IGC Q&A are available at www.iasb.org.uk.

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