

AMENDMENTS TO FRS 26 (IAS 39)

'FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT'

EXPOSURES QUALIFYING FOR
HEDGE ACCOUNTING



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*This draft is issued by the Accounting Standards Board for comment.
It should be noted that the draft may be modified in the light
of comments received before being issued in final form.*

For ease of handling, we prefer comments to be sent by e-mail (in Word format) to:

amendfrs26@frc-asb.org.uk

Comments may also be sent in hard copy form to:

Peter Godsall
ACCOUNTING STANDARDS BOARD
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Comments should reach us by 11 January 2008.

All replies will be regarded as on the public record unless the writer asks for confidentiality. If you are sending a confidential response by e-mail, please include the word 'confidential' in the subject line of your e-mail.

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PREFACE

Background

- 1 In December 2004 the Accounting Standards Board (ASB) issued Financial Reporting Standard FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement'. FRS 26 implemented the requirements of International Accounting Standard IAS 39 for those applying UK standards.
- 2 In September 2007, the International Accounting Standards Board (IASB) issued 'Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Exposures Qualifying for Hedge Accounting' proposing amendments to IAS 39.
- 3 The proposed amendments are intended to clarify the IASB's original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

IASB's proposed amendments

- 4 The proposed amendments, subject to restrictions in paragraph 79 of IAS 39 (held-to-maturity investments), specify the risks that qualify for designation as hedged risks when an entity hedges its exposure to a financial instrument, namely:
 - (a) interest rate risk;
 - (b) foreign currency rate risk;
 - (c) credit risk;
 - (d) prepayment risk; and

- (e) the risks associated with the contractually specified cash flows of a recognised financial instrument;

and an entity may designate as a hedged item one or more of the following portions of the cash flows of a financial instrument:

- (a) the cash flows of a financial instrument for part of its time period to maturity;
- (b) a percentage of the cash flows of a financial instrument;
- (c) the cash flows of a financial instrument associated with a one-sided risk of that instrument;
- (d) any contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument;
- (e) the portion of the cash flows of an interest bearing financial instrument that is equivalent to a financial instrument with a risk-free rate; and
- (f) the portion of the cash flows of an interest bearing financial instrument that is equivalent to a financial instrument with a quoted or variable inter-bank rate.

- 5 The IASB believes that a requirement to restate comparative information on first time application of this proposed amendment should not entail significant cost or effort as the information required to make any restatement is readily available. Consequently, the IASB proposes that the amendments to IAS 39 should be applied retrospectively. Early adoption would be permitted.

Regulatory Impact

- 6 In the ASB's view, the proposals set out in this exposure draft should not impose significant additional costs of preparation. The ASB believes that the clarifications will be of benefit to users of financial statements. The ASB, however, would welcome views on whether there are any significant additional costs resulting from these proposals, and, if so, whether they can be quantified. The ASB would also welcome views on whether the benefits arising from the proposals in the exposure draft outweigh any costs involved.

Conclusion

- 7 In summary, the ASB proposes to amend FRS 26 to maintain consistency with IAS 39, if the amendment is confirmed by the IASB.

Invitation to comment

- 8 The ASB is issuing this exposure draft to request comments on the IASB's proposals and on the ASB's proposals for implementing them in the UK. The IASB's Invitation to Comment is set out on pages 9 to 10 of this exposure draft. In addition, the ASB would welcome comments on the following issues:

ASB Q1: Are you aware of any issues that would affect those UK entities that will be required to implement the proposals outlined in this exposure draft?

ASB Q2: Do you agree that the benefits of the proposals in the exposure draft would outweigh any additional costs involved? If not, why not?

- 9 The ASB would also be pleased to receive copies of responses to the IASB submitted by UK and Irish commentators.

**PROPOSED AMENDMENTS TO IAS 39
FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT**

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BOARD APPROVAL OF EXPOSURE DRAFT

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INTRODUCTION

- 1 This exposure draft contains proposals by the International Accounting Standards Board to amend IAS 39 *Financial Instruments: Recognition and Measurement*. The purpose of the amendments is to clarify when an entity may designate an exposure to a financial instrument as a hedged item.
- 2 The proposed amendments specify:
 - (a) the risks that qualify for designation as hedged risks when an entity hedges its exposure to a financial instrument; and
 - (b) when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.
- 3 The proposed amendments are intended to clarify the Board's original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

INVITATION TO COMMENT

The Board invites comments on the amendments proposed in this exposure draft, particularly on the questions set out below. Comments are most helpful if they:

- (a) comment on the question as stated;
- (b) indicate the specific paragraph or group of paragraphs to which they relate;
- (c) contain a clear rationale; and
- (d) if applicable, include an alternative the Board should consider.

The Board is not seeking comments on matters in IAS 39 other than those set out in this exposure draft.

Respondents should submit comments in writing so as to be received no later than **11 January 2008**.

Question 1 – Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item.

Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why?

Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

Question 3 – Effect of the proposed amendments on existing practice

The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising.

Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

Question 4 – Transition

The proposed changes would be required to be applied retrospectively.

Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

PROPOSED AMENDMENTS TO FRS 26 (IAS 39) *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

[Note: the text of FRS 26 (IAS 39)'Financial Instruments: Recognition and Measurement' includes strike-through and underlying to show changes made by the ASB to the text corresponding to IASs. The amended text of FRS 26 set out below adopts the same convention; as a result, it is not practicable to show the changes of the standard that are proposed in this exposure draft.]

Paragraph 81 is deleted. Paragraphs 80Y and 80Z are added after the heading below paragraph 80. Paragraph 81 is reproduced for ease of reference.

Hedged items

Designation of financial items as hedged items

80Y Subject to the restrictions in paragraph 79, a financial instrument may be designated as a hedged item with respect to all of its risks. Subject to the restrictions in paragraph 79, a financial instrument may also be designated as a hedged item for one or more of the following risks:

- (a) interest rate risk: the risk that the fair value or future cash flows of the financial instrument will fluctuate because of changes in market interest rates. For example, an entity is permitted to designate as a hedged item changes in the fair value of a fixed rate sterling financial asset attributable to changes in sterling LIBOR or the Bank of England base rate.
- (b) foreign currency risk: the risk that the fair value or future cash flows of the financial instrument will

fluctuate because of changes in foreign exchange rates.

- (c) credit risk.
- (d) prepayment risk.
- (e) the risks associated with the contractually specified cash flows of a recognised financial instrument. For example, an entity may hold a financial asset that pays interest at inflation plus 3 per cent. Assuming that the entity is not required to account for the inflation embedded derivative separately, the entity is permitted to designate as a hedged item changes in the cash flows of the financial asset attributable to changes in inflation. This is because inflation is a contractually specified cash flow of the financial asset. However, an entity holding a fixed rate financial asset is not permitted to designate as a hedged item changes in its fair value attributable to changes in inflation. This is because either the inflation component is not a contractually specified cash flow or, if inflation is a contractually specified cash flow, the remaining component would be a residual.

80Z An entity may designate as a hedged item one or more of the following portions of the cash flows of a financial instrument:

- (a) the cash flows of a financial instrument for part of its time period to maturity (a ‘partial term hedge’).
- (b) a percentage of the cash flows of a financial instrument (a ‘proportion’).
- (c) the cash flows of a financial instrument associated with a one-sided risk of that instrument (for example, the cash flows resulting from a foreign exchange rate falling below a specified level).

- (d) any contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument (for example, the first four interest payments on a floating rate financial liability).
 - (e) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate.
 - (f) the portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate (for example, LIBOR).
- 81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

Effective date and transition

Paragraph ~~108C~~ 108I is added after paragraph ~~108B~~ 108H.

~~108C~~ 108I An entity shall apply the [draft] amendments deleting paragraph 81, adding paragraphs 80Y, 80Z, AG99BA, AG99BB and AG99E and amending paragraph AG99C for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies the [draft] amendments for a period beginning before [date to be inserted after exposure], it shall disclose that fact.

Due to a duplication of paragraph numbering the following amendments are made:

- (a) Current paragraph 108E is renumbered 108G and amended to read 'Except as permitted by paragraph 108H...'
- (b) Current paragraph 108F is renumbered 108H and amended to read 'Notwithstanding paragraph 108G...'

APPENDIX A APPLICATION GUIDANCE

Hedged items

Designation of financial items as hedged items

Paragraphs AG99BA and AG99BB are added after the heading below paragraph AG99B.

- AG99BA A financial instrument may be designated as a hedged item with respect to all of its risks. However, an entity may be managing only a single risk, for example, interest rate risk. To avoid recognising ineffectiveness for the risks not being hedged, an entity is permitted to hedge the financial instrument with respect to one or more of the risks specified in paragraph 80Y. The risks designated as hedged risks must not in aggregate exceed the total risk of the financial instrument.
- AG99BB Hedge effectiveness may be improved if only a portion of the cash flows of a financial instrument is designated as the hedged item. For example, an entity may wish to hedge its exposure to changes in fair value attributable to LIBOR of a CU1,000 fixed rate asset that pays interest at 10 per cent. In order to achieve this, the entity enters into an interest rate swap at market rates under which the entity pays 7 per cent fixed interest and receives LIBOR. If the entity designates as the hedged item all of the cash flows of the entire fixed rate asset (ie CU1,000 + 10 per cent interest) ineffectiveness will arise. However, ineffectiveness might be reduced if the entity designates as the hedged item a portion of the cash flows of the fixed rate asset. For example, the entity could designate a portion of the fixed rate asset that is equal to the cash flows of a CU1,000 fixed rate asset that pays interest at 7 per cent (ie the inter-bank swap rate on the date the swap

is entered into). Designating a portion of a financial instrument is permitted only in the situations described in paragraph 80Z. If an entity designates as a hedged item a portion of the cash flows of a financial instrument in accordance with paragraph 80Z, the risks eligible for designation are also restricted to those risks described in paragraph 80Y.

Paragraph AG99C is amended. New text is underlined.

AG99C If, in accordance with paragraph 80Z, a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, as discussed in paragraph AG99BA, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (ie principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

Paragraph AG99E is added after paragraph AG99D.

AG99E In designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole. For example, in designating a one-sided risk (such as the decrease in the fair value of a financial asset) as a hedged portion, an entity cannot include any cash flows that are imputed or inferred in the designated hedged portion (for example, inferring the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset).

Approval of exposure draft of proposed amendments to IAS 39 by the Board

The exposure draft of proposed amendments to International Accounting Standard 39 Financial Instruments: Recognition and Measurement—*Exposures Qualifying for Hedge Accounting* was approved for publication by eleven of the thirteen members of the International Accounting Standards Board. Mr Cooper and Dr Zhang abstained in view of their recent appointment to the Board.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Stephen Cooper	
Philippe Danjou	
Jan Engstrom	
Robert P Garnett	
Gilbert Gelard	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

BASIS FOR CONCLUSIONS

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to IAS 39.

ASB Note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. All references in this section to 'the Board' and 'Board members' are references to IASB Board and IASB Board members.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the exposure draft of proposed Amendments to IAS 39—*Exposures Qualifying for Hedge Accounting*. Individual Board members gave greater weight to some factors than to others.
- BC2 The International Financial Reporting Interpretations Committee (IFRIC) received requests for guidance on what IAS 39 permits to be designated as a hedged item. In particular, constituents asked the IFRIC to provide guidance on when a portion of the cash flows of a financial instrument can be designated as a hedged item. Rather than dealing with these requests individually, the IFRIC attempted to develop a principle that could be used as guidance on what IAS 39 permits to be designated as a hedged item. However, the IFRIC was unable to develop such a principle. Consequently, the IFRIC asked the Board for guidance on how to address this issue.
- BC3 The Board acknowledged that additional guidance is required on what can be designated as a hedged item in accordance with IAS 39. Although the Board is currently undertaking research work that will ultimately lead to the replacement of IAS 39, this work is at an early stage.

Consequently, the Board decided to propose the amendments to IAS 39 contained in the exposure draft.

- BC4 The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.
- BC5 The proposed amendments relate only to situations in which an entity designates as a hedged item a financial instrument (or some part of that financial instrument). The exposure draft does not deal with situations in which an entity designates a non-financial item as a hedged item because the Board concluded that the requirements of IAS 39 are clear in this respect.

Specifying the qualifying risks (paragraph 80Y)

- BC6 The Board considered whether to amend IAS 39 to specify the risks that qualify for designation as a hedged risk. The Board concluded that specifying eligible risks would help clarify the Board's original intentions regarding what can be designated as a hedged item. Consequently, the Board decided to propose an amendment to IAS 39 to specify which risks qualify for designation.
- BC7 The Board noted that US generally accepted accounting principles (GAAP) restrict the risks that can be designated as hedged risks to benchmark interest rate risk, foreign currency risk and credit risk. The Board concluded that all of these risks should be eligible for designation as hedged risks. However, the Board noted that in practice entities applying IAS 39 designate any market interest rate as a hedged risk rather than restricting the risks to benchmark interest rate risk. Because the Board's intention is not to change existing practice significantly, the Board decided to permit the designation of any market interest rate as a hedged risk.

- BC8 The Board also noted that IAS 39 permits an entity to hedge the risk that a financial asset will be repaid early ('prepayment risk') except when the financial asset is classified as a held-to-maturity investment. Consequently, the Board decided that the proposed amendments to IAS 39 should specify prepayment risk as a risk that qualifies for designation as a hedged risk.
- BC9 Lastly, the Board decided to permit the risks associated with the contractually specified cash flows of a recognised financial instrument to be designated as a hedged risk. This is because a contractually specified cash flow represents a separately identifiable and measurable risk of the financial instrument.

Designating a portion of a financial instrument as a hedged item (paragraph 80Z)

- BC10 The Board also decided to propose an amendment to IAS 39 to provide additional guidance on when a portion of the cash flows of a financial instrument can be designated as a hedged item.
- BC11 The Board discussed four possible approaches to providing guidance on this point:
- (a) remove the ability to hedge a portion of the cash flows of a financial instrument;
 - (b) develop a principle that could be used to determine when a portion of the cash flows of a financial instrument can be designated as a hedged item;
 - (c) converge with US GAAP on this point; or
 - (d) specify when a portion of the cash flows of a financial instrument can be designated as a hedged item.
- BC12 The Board decided to propose approach (d). In specifying when an entity can designate a portion of the cash flows of

a financial instrument as a hedged item, the Board considered its objectives for the amendment, ie to provide additional guidance without significantly changing existing practice. Consequently, the situations in which the Board proposes that an entity should be permitted to designate as a hedged item a portion of the cash flows of a financial instrument are, to the extent that they are consistent with the Board's original intentions, those that the Board understands are most commonly designated in practice.

- BC13 The Board acknowledges that the approach proposed in this exposure draft is rules rather than principle-based and does not lead to convergence with US GAAP. However, the Board considers that this approach has the following advantages:
- (a) The situations in which an entity can designate a portion of the cash flows of a financial instrument are clearly defined in this proposed approach, making application of the hedge accounting requirements of IAS 39 simpler.
 - (b) It places effective restrictions on when an entity can designate as a hedged item a portion of the cash flows of a financial instrument. This ensures that the situations in which ineffectiveness exists but is not recognised are minimised.
 - (c) Limiting the situations in which an entity can designate as a hedged item a portion of the cash flows of a financial instrument to those situations that are commonly used in practice minimises the impact of the proposed amendments on practice.
 - (d) Amendments of this type are relatively simple to implement, requiring only minor changes to IAS 39.
- BC14 Paragraph AG99E of the exposure draft clarifies that IAS 39 does not permit an entity to designate as a hedged item a

cash flow that does not exist in the financial instrument as a whole. For example, in designating as a hedged portion the one-sided risk of a decrease in the fair value of a financial asset, an entity may not include in the designated portion cash flows associated with the time value of a hypothetical written option. During the development of the exposure draft, the IFRIC was asked whether it is possible to designate as a hedged item changes in the cash flows of a hypothetical written option in a non-derivative financial instrument. The IFRIC tentatively concluded that IAS 39 does not permit such an approach and published a tentative agenda decision to this effect in May 2007. However, the IFRIC decided to withdraw its tentative agenda decision pending the publication of the exposure draft. Comment letters received in response to the IFRIC's agenda decision suggest that there is diversity in practice in this area. Consequently, the guidance in paragraph AG99E may result in a change to existing practice for some entities.

Transition

- BC15 The Board believes that a requirement to restate comparative information on first-time application of this proposed amendment should not entail significant cost or effort, because the requirement in IAS 39 to document hedging relationships should mean that the information required to make any restatement is readily available. Consequently, the Board proposes that the amendments to IAS 39 should be applied retrospectively.

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