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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 June 2007, London**
Project:	**Annual Improvements**
Subject:	**IAS 39 - Applicable effective interest rate on cessation of fair value hedge accounting (Agenda paper 12F)**

1. The staff has identified that the following issue would be most appropriately resolved via the annual improvements process.

   Issue: Should IAS 39, *Financial Instruments: Recognition and Measurement*, be clarified to explain whether the revised or the original effective interest rate of a debt instrument should be applied in the remeasurement of the instrument's carrying amount on the cessation of fair value hedge accounting?

Staff recommendation

2. The staff recommends that the Board:

   - should add this issue to the annual improvements project; and
   - should amend IAS 39 as proposed in paragraph 10 of this paper.

Background

3. The staff has been notified of an apparent ambiguity in the guidance in IAS 39. It relates to whether the revised or the original effective interest rate of a debt instrument should be applied in the remeasurement of the instrument's carrying amount on the cessation of fair value hedge accounting.

IAS 39 guidance: Fair value hedge accounting

4. Paragraph 89(b) of IAS 39 explains that the gain or loss on the hedged item attributable to the hedged risk in a fair value hedge shall adjust the carrying amount of the hedged item and be recognised in profit or loss.

5. Paragraph 92 of IAS 39 provides that "Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used…shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a **recalculated effective interest rate** at the date amortisation begins. …" (Emphasis added).

IAS 39 guidance: Effective interest rate

6. Paragraph AG 8 of the application guidance to IAS 39 provides that "If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability…to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss."

Analysis

7. Where an entity discontinues fair value hedge accounting in respect of an existing debt instrument because, for example, it intends to repay the debt early and the hedging instrument is no longer effective it should recalculate the effective interest rate based on the adjusted carrying amount of the debt in accordance with paragraph 92. However, paragraph AG8 is also applicable and requires remeasurement of the carrying amount using the original effective interest rate. Remeasuring using the original effective interest rate as required by paragraph AG8 would have the effect of restating the carrying amount of the debt to its amortised cost prior to the adjustment for the effect of fair value hedge accounting.

Staff recommendation

8. The staff recommends that IAS 39 be amended as proposed in paragraph 10 to require that the remeasurement of an instrument in accordance with AG8 is based on the revised effective interest rate calculated in accordance with paragraph 92 where applicable.

9. **Does the Board agree?**

Drafting

10. The staff recommends that IAS 39 should be amended as follows:

Effective interest rate

…

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate<u> or, where applicable, the revised effective interest rate calculated in accordance with paragraph 92</u>. The adjustment is recognised as income or expense in profit or loss.

Basis for Conclusions on Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Reclassification

BC1 The Board has identified an apparent inconsistency in the guidance in IAS 39. It relates to whether the revised or the original effective interest rate of a debt instrument should be applied in the remeasurement of the instrument's carrying amount on the cessation of fair value hedge accounting.

BC2 The Board has decided to address this inconsistency by clarifying that the remeasurement of an instrument in accordance with paragraph AG8 is based on the revised effective interest rate calculated in accordance with paragraph 92 where applicable rather than the original effective interest rate.