

Proposed Amendments to AASB 139 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting

Prepared by the
Australian Accounting Standards Board



Australian Government

**Australian Accounting
Standards Board**

Commenting on this Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 30 November 2007. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 11 January 2008. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@asb.com.au

Respondents to the IASB are asked to send their comments electronically to the IASB website www.iasb.org, using the 'Open to Comment' page

A copy of all non-confidential submissions to the AASB will be placed on public record on the AASB website: www.aasb.com.au and forwarded to the IASB.

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AASB website: www.aasb.com.au. Alternatively, printed copies of this Exposure Draft are available by contacting:

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PREFACE

Background

Australian Accounting Standards

The Australian Accounting Standards Board (AASB) makes Australian Accounting Standards to be applied by:

- (a) entities required by the *Corporations Act 2001* to prepare financial reports;
- (b) all reporting entities engaged in either for-profit, not-for-profit or public sectors; and
- (c) any other entity that prepares general purpose financial reports.

Australian Accounting Standards include Australian equivalents to International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

Although IFRSs are developed to apply to for-profit entities, the AASB has decided to continue to make transaction-neutral accounting standards as between for-profit, not-for-profit private and not-for-profit public sectors. Accordingly, Australian Accounting Standards (including Australian equivalents to IFRSs) generally require the same accounting treatment for similar transactions occurring in both for-profit and not-for-profit entities, including public sector entities. An Australian equivalent to an IFRS uses the corresponding IFRS as the “foundation” Standard to which the AASB adds material detailing its scope and applicability in the Australian environment. Additions are made, where necessary, to broaden the content of the Australian equivalent to an IFRS to cover domestic, regulatory or other issues.

In addition to making accounting standards that are Australian equivalents to IFRSs, the AASB also continues to make other Australian Accounting Standards that are specific to the not-for-profit or public sectors or that are purely of a domestic nature.

Exposure Drafts

The use of an Exposure Draft (ED) is an essential piece of the due process that the AASB follows before making a new or amending an existing Australian Accounting Standard. The ED is designed to seek public comment on the AASB’s proposals for a new Australian Accounting Standard or amendments to an existing Australian Accounting Standard.

Reasons for Issuing this Exposure Draft

The purpose of this ED is to invite comments from Australian constituents on proposed amendments to AASB 139 *Financial Instruments: Recognition and Measurement*, which is the Australian equivalent to IAS 39 *Financial Instruments: Recognition and Measurement*.

These proposed amendments are contained in the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting that was issued by the IASB in September 2007. If these amendments are approved by the IASB, and subsequently by the AASB, they are expected to be applicable from the time that the IASB makes the IFRS standard applicable.

Structure of this Exposure Draft

The AASB has decided to:

- (a) reproduce the IASB Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting without amendment as part of this ED;
- (b) identify the main changes in this Preface; and
- (c) seek constituents’ views on the proposals.

Main Features of this Exposure Draft

The ED proposes that, subject to paragraph 79, a financial instrument may be designated as a hedged item for one or more of its risks. These include:

- interest rate risk;
- foreign currency risk;
- credit risk;
- prepayment risk; and
- risks associated with the contractually specified cash flows of a recognised financial instrument.

The ED also clarifies when an entity may designate, as a hedged item, a portion of the cash flows of a financial instrument, including clarification that 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.

Application Date

The AASB intends to make the amended AASB 139 applicable from the same date as the IASB. Earlier application is proposed to be permitted for annual reporting periods beginning on or after the date the amendments are made by the AASB. The IASB has not yet specified an application date.

Request for Comments

Comments are invited on any of the proposals in the ED, including the questions on the proposed amendments to IAS 39 as listed in the Invitation to Comment sections of the IASB ED.

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 30 November 2007. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 11 January 2008. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Specific Matters for Comment

In addition, the AASB would value comments on:

- (a) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
 - (i) not-for-profit entities;
 - (ii) public sector entities;
- (b) whether, overall, the proposals would result in financial reports that would be useful to users; and
- (c) whether the proposals are in the best interests of the Australian economy.

Exposure Draft of Proposed

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

**EXPOSURES QUALIFYING FOR
HEDGE ACCOUNTING**

Comments to be received by 11 January 2008

This Exposure Draft of proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement—*Exposures Qualifying for Hedge Accounting* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IAS 39. Comments on the Exposure Draft and the Basis for Conclusions should be submitted in writing so as to be received by **11 January 2008**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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BASIS FOR CONCLUSIONS

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 IAS 39 *Financial Instruments: Recognition and Measurement*

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 is added after paragraph 108B.

108C 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.

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 Engström

Robert P Garnett

Gilbert Gélard

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.

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.