

**Example 2.3.3A****Financial guarantee contracts (1)**

Entity A owns CU100 million of Entity X bonds that mature in 20 years. Entity X is rated BBB by the rating agencies. Entity A is concerned that Entity X may be downgraded, resulting a decline in value for the bonds. To protect against such a decline, Entity A enters into a contract with Entity B that will pay Entity A for any decline in the fair value of the Entity X bonds related to a credit downgrade to BB or below. The contract is for a five-year period, and Entity A pays CU2 million to enter into the contract. Because the contract pays Entity A in the event of a downgrade, and not in the event of a failure by Entity X to meet its payment obligations under the issued bonds, it is a derivative instrument within the scope of IFRS 9 for Entity A and Entity B.

**Example 2.3.3B****Financial guarantee contracts (2)**

Entity X owns CU100 million of single family residential mortgage loans. Entity X is concerned that defaults may increase as a result of a recession and, consequently, purchases a guarantee contract from Entity B, a mortgage insurance entity. The contract requires Entity B to pay Entity X for losses suffered as a result of mortgage defaults when Entity X forecloses on the mortgage. The contract has a CU5 million cap. Entity X pays Entity B a CU2 million fee for the contract. Because the contract provides for specified payments to be made to reimburse Entity X for a loss it incurs in the event of a failure of a specified debtor to pay when due, the contract meets the definition of a financial guarantee contract.

For the writer of the financial guarantee contract (Entity B), the instrument is within the scope of IFRS 9. Unless the contract is designated as at fair value through profit or loss at inception, the contract will be recognised initially at fair value and then measured at the higher of the amount determined in accordance with IAS 37 and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*. However, if Entity B has previously asserted explicitly that it regards such contracts as insurance contracts and used accounting applicable to insurance contracts, it could elect to apply either IFRS 9 or IFRS 4 to the specific contract. If such an election is made, it is irrevocable in respect of the contract with Entity X but it does not affect Entity B's options for the treatment of other similar contracts.

**Example 2.3.3C****Financial guarantee contracts (3)**

Entity A has a wholly-owned subsidiary, Entity B. Entity B enters into a third-party bank loan. Entity A writes a financial guarantee contract to the bank over the loan. In the separate financial statements of Entity A, the financial guarantee contract is accounted for as set out in **example 2.3.3B**. In the consolidated

financial statements of Group A, the financial guarantee contract is not separately recognised because the group as a single entity has simply borrowed money from a third party.

If Entity A instead provides a guarantee directly to Entity B in respect of its bank loan, in the separate financial statements of Entity A the guarantee is not recognised separately. The arrangement is such that Entity A has agreed to contribute more money to its subsidiary which will generally be accounted for as a capital contribution as and when it is contributed. The promise by the parent to inject money at a future date is not recognised up-front.

**2.3.4 Financial guarantee contracts (holder accounting)**

IFRS 9 does not specifically address the accounting by a holder of a financial guarantee contract (such as Entity X in **example 2.3.3B**). However, prior to the consequential amendments to IAS 39 made when IFRS 9 was revised in October 2010, IAS 39:IN6 was explicit that financial guarantee contracts held, as opposed to those issued, were outside the scope of IAS 39. The consequential amendments resulted in the deletion of IAS 39:IN6, along with all the introductory paragraphs in IAS 39. IAS 39:IN6 was not carried over into the introductory paragraphs of IFRS 9. However, given that IAS 39 and IFRS 9 scope out 'rights' under a financial instrument that meets the definition of an insurance contract in IFRS 4, it is reasonable to conclude that purchased financial guarantee contracts are outside the scope of IFRS 9.

The scope exclusion does not state which Standard should be applied for purchased financial guarantee contracts. Given that financial guarantee contracts held are not in the scope of IFRS 9, they are generally recognised as an asset equal to the premium paid and the asset is amortised to profit or loss over the period in which the benefit of the guarantee is obtained. Only if the entity considers it virtually certain that its claim under the financial guarantee contract will be successful will the asset be remeasured upwards to reflect the claim in accordance with IAS 37. The contract is not accounted for in accordance with IFRS 4 because that Standard only applies to the accounting by the issuer of insurance contracts, not the holder.

**2.3.5 General guarantees of subsidiary obligations**

In some jurisdictions, regulatory or statutory requirements state that an ultimate parent company or subsidiary (the guarantor) must, or can elect to, make representations that it will make payments to unspecified parties outside the group if a subsidiary (the obligor) fails to make payments under its obligations to those parties. The guarantor agrees to make a payment to the creditor equal to the amount that the obligor has failed to pay. The representation is open-ended (i.e. it relates to all

**Example 5.5.2C****Sale of instruments that continue to be recognised**

Entity C holds investments in debt instruments that it intends to 'repo' (i.e. to sell the assets and concurrently enter into an obligation to repurchase the assets at a specified time and specified price). The repurchase arrangements require the transferee to pay all the cash flows it receives on the transferred assets to Entity C in return for receiving a predetermined fixed amount of cash. At the maturity of the repo Entity C intends to hold the asset to collect the contractual cash flows.

Entity C does not derecognise the assets at the date of transfer because it has retained substantially all the risks and rewards of ownership via the repo. Entity C recognises a collateralised borrowing for the proceeds received upon entering into the repo. See **chapter B8**.

In this fact it is reasonable for Entity C to claim that its business is to collect the contractual cash flows on its assets subject to repo because, even though the assets are intended to be temporarily legally transferred to the transferee, Entity C continues to recognise the assets and continues to receive cash flows from the transferee equivalent to the cash flows it would have received had it not transferred the assets and following maturity of the repo Entity C intends to collect the contractual cash flows from the assets.

When an entity expects, as part of its business model, to transfer the contractual rights to cash flows on its financial assets, but to retain substantially all the risks and rewards of ownership of those financial assets (e.g. by writing a guarantee over their performance or through buying from the transferee a subordinated interest in them), it is less clear whether the entity can claim that its business is to collect the contractual cash flows on its assets. In such circumstances, the entity will not necessarily continue to receive the same cash flows that it would have received if the assets had not been transferred because some or all of those cash flows may be retained by the transferee. IFRS 9 does not address whether continued recognition of the asset is sufficient in itself for an entity to claim that the assets are held to collect the contractual cash flows, or whether a transferor that continues to recognise transferred assets also needs to argue that the expectation is to collect substantially the same cash flows under the assets as would have been received had it not transferred the assets. It will be necessary to exercise judgement in determining whether the entity's business is the collection of the contractual cash flows.

**5.5.3 Designation as at FVTPL**

An entity may irrevocably elect on initial recognition to designate a financial asset that meets the conditions for amortised cost measurement in accordance IFRS 9:4.1.2 (see **section 5.2**) or fair value through other

comprehensive income measurement in accordance with IFRS 9:4.1.2A (see **section 5.3**) as at FVTPL if that designation eliminates or significantly reduces an accounting mismatch that would have occurred if the financial asset had been measured at amortised cost or fair through other comprehensive income respectively. [IFRS 9:4.1.5]

The following are examples of the application of the fair value option.

- An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of IFRS 4 Insurance Contracts), and related financial assets that would otherwise be measured either at amortised cost or FVTOCI. Designating the assets as at FVTPL means that changes in the fair value of the financial assets are recognised in profit or loss in the same period as related changes in the value of the liabilities. [IFRS 9:B4.1.30(a)]
- An entity has financial assets, financial liabilities, or both, that share a risk (e.g. interest rate risk) that gives rise to opposite changes in the fair value of those assets and liabilities that tend to offset each other. Only some of the instruments (e.g. derivatives, or assets held for trading) are measured at FVTPL. Also, the requirements for hedge accounting may not be met (e.g. because the requirements for hedge effectiveness are not met). Designating the assets and liabilities as at FVTPL will achieve an accounting offset that reflects the existing natural economic offset. [IFRS 9:B4.1.30(b)]
- An entity has financial assets, financial liabilities, or both, that share a risk (e.g. interest rate risk) that gives rise to opposite changes in the fair value of those assets and liabilities that tend to offset each other. The assets and liabilities may be measured on a different basis and hedge accounting cannot be applied because none of the instruments are measured at FVTPL. Designating the assets and liabilities as at FVTPL will achieve an accounting offset that reflects the existing natural economic offset. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the loans but rarely, if ever, buys and sells the bonds, reporting both the loans and the bonds at FVTPL eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased. [IFRS 9:B4.1.30(c)]

**Example 5.5.3A****Fair value option: fixed rate loan**

Entity A originates a fixed rate loan and, at origination, it economically hedges that loan with an interest rate swap with matching terms, which swaps the fixed interest rate to a floating rate. Assuming the conditions for amortised cost or fair value through other comprehensive income measurement are met, measuring

purchases a portfolio of the shares contained in the FTSE 100 index and wishes to classify them as held for trading. Within that portfolio are a number of Entity F's own shares.

Entity F cannot classify its own purchased shares as held for trading in order to hedge economically the index tracker bond. IFRS 9 excludes from its scope instruments issued by an entity that meet the definition of equity in IAS 32. Furthermore, IAS 32 requires that treasury shares are presented in the statement of financial position as a deduction from equity and not as assets, and that no gain or loss should be recognised in profit or loss on such shares.

The amount of treasury shares held is disclosed separately either in the statement of financial position or in the notes in accordance with IAS 1. An entity provides disclosure in accordance with the requirements of IAS 24 *Related Party Disclosures* when an entity reacquires its own equity instruments from related parties. [IAS 32:34]

When an entity holds its own shares on behalf of others (as is the case when a financial institution holds its own shares on behalf of a client as a custodian), this represents an agency relationship and, consequently, the shares are not included in the statement of financial position of the entity. [IAS 32:AG36]

## 6 Derivatives over own equity

A derivative contract over an entity's own equity is accounted for as equity *only* when it will be settled by the entity delivering (or receiving) a fixed number of its own equity instruments and receiving (or delivering) a fixed amount of cash or another financial asset. Any consideration received (such as the premium received in relation to written options over own shares or warrants on the entity's own shares that satisfy the above condition) is added directly to equity. Similarly, any consideration paid for such an instrument (such as premium paid for a purchased option that satisfies the above condition) is deducted from equity. Changes in fair value of the equity instrument are not recognised in the financial statements. [IAS 32:22] At a group level, derivatives over own equity include derivatives over shares of subsidiaries.

In January 2010, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision titled *IAS 32 Financial Instruments: Presentation - Application of the 'Fixed-for-Fixed' Condition*. The IFRIC received requests for guidance on the application of IAS 32:22 which states that "except as stated in paragraph 22A, a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument" (often referred to as the 'fixed-for-fixed' condition).

As part of the IFRIC's discussions grouped the questions on the fixed-for-fixed condition into two broad groups: those related to the denomination of the fixed amount of cash being in a foreign currency and those where the fixed amount of cash or shares is not fixed, but predetermined. The IFRIC identified that diversity may exist in practice in the application of the fixed-for-fixed condition to these situations and also other situations. However, the IFRIC decided not to add this item to its agenda in anticipation of finalisation of the Board's *Financial Instruments with Characteristics of Equity* (FICE) project. Since the IFRIC reached the agenda decision the FICE project has been deferred and has been included in the IASB's research programme. See future development in **section 9**.

### Example 6A

#### Purchased call option

On 1 February 20X5, Entity A, a CU functional currency entity, purchases for CU5,000 a call option over 1,000 of its own ordinary shares. The option is exercisable at a strike price of CU102 per share only on 31 January 20X6 (i.e. it is a 'European type' option).

The option is gross physically settled, i.e. Entity A takes delivery of 1,000 of its own shares in exchange for an amount of cash paid to the counterparty equal to the option exercise price of CU102,000 (CU102 per share × 1,000 shares).

1 February 20X5

On inception of the contract, the following entry will be recorded in order to recognise the cash paid in exchange for the right to receive a fixed number of own shares in exchange for a fixed amount of cash.

	CU	CU
Dr Equity	5,000	
Cr Cash		5,000

To recognise the call option.

The premium is recognised in equity because the call option gives a right to receive a fixed number of the entity's own shares in exchange for a fixed amount of cash and, therefore, meets the definition of an equity instrument.

31 December 20X5

No entry is recorded on 31 December 20X5 because no cash is paid or received. The fair value of the option is irrelevant because the equity instrument is not remeasured.

**Example 7.1.2.1C****Fair value option: lack of accounting mismatch**

Entity A borrows (through a single instrument) €1,000,000 from a third-party bank and, at the same time, uses some of the borrowing to acquire 10 similar financial assets each of a value of €50,000 which are all classified as at FVTPL. Entity A wants to reduce the measurement inconsistency by designating the liability as at FVTPL. However, if all of the borrowing were accounted for at FVTPL, Entity A would create an accounting mismatch in profit or loss related to the portion of the borrowing (€500,000) not matched by the financial assets measured at FVTPL. This accounting mismatch is comparable to the mismatch that would arise by not applying the fair value option in the first place. Therefore, Entity A cannot apply the fair value option to its financial liabilities because it would not significantly reduce the accounting mismatch between the assets and the liability.

**7.1.2.2 Managed and performance evaluated on a fair value basis**

An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at FVTPL results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments. [IFRS 9:B4.1.33]

Applying the fair value option to financial liabilities at their initial recognition would be appropriate when financial assets and financial liabilities share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. For example, an entity could have issued 'structured products' containing multiple embedded derivatives and could be managing the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. Because the designation is based on managing and evaluating a group of financial instruments, all of the eligible financial liabilities that are managed and evaluated together must be designated. [IFRS 9:B4.1.34 & 35]

The entity's strategy for managing the group of financial instruments must be documented, although documentation need not be extensive. For example, if the performance management system as approved by the entity's key management personnel clearly demonstrates that the performance is evaluated on a total return basis, no additional documentation is required. The documentation does not need to be on an item-by-item basis (it may be on a portfolio basis), or at the level of detail required for hedge accounting. [IFRS 9:B4.1.36]

**7.1.2.3 Contracts containing one or more embedded derivative**

As detailed in 7.1.2 above, IFRS 9:4.3.5 permits a financial liability in the scope of IFRS 9 that is a hybrid contract containing one or more embedded

derivatives to be designated in its entirety as at FVTPL. Designation is permitted unless the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited.

**Example 7.1.2.3****Fair value option: commodity-linked debt**

Entity Q issues a debt instrument that has interest payments linked to a basket of commodity prices. The linking to commodity prices is considered to be a non-closely related embedded derivative that would require separation and measurement at FVTPL. Entity Q may choose at initial recognition to designate the whole debt instrument as at FVTPL to avoid separating out the embedded derivative.

IFRS 9 generally only applies to financial instruments within its scope. However, certain of its requirements (such as those in respect of embedded derivatives) apply to a wider range of contracts. For example, an operating lease that is not a financial instrument may have an embedded derivative that is separately recognised in the statement of financial position. The question arises as to whether the fair value option provisions can be extended to hybrid contracts when the host contract is a non-financial item or a financial item outside the scope of IFRS 9. In March 2007, the IFRIC (now the IFRS Interpretations Committee) was asked to consider this question with respect to IAS 39. In November 2007, the IFRIC recommended that the IASB should clarify IAS 39:11A (equivalent to IFRS 9:4.3.5) by specifying whether it applies only to contracts with embedded derivatives that have financial hosts, or whether the fair value option can be applied to all contracts with embedded derivatives. In August 2008, the IASB issued an exposure draft, *Improvements to IFRSs*, which proposed amending IAS 39 to clarify that the fair value option could only apply to financial instruments within the scope of IAS 39. In the Basis for Conclusions to the exposure draft, the Board acknowledged that the wording in IAS 39:11A was not clear. The Board noted that prior to June 2005 IAS 39 had an unrestricted fair value option which could only be applied to financial instruments within the scope of IAS 39. The objective of the fair value option that was introduced in June 2005 (and subsequently included in IFRS 9 in October 2010), was to restrict, not broaden, an entity's ability to designate financial instruments as at FVTPL. At its January 2009 meeting, the IASB decided to defer its redeliberations on the fair value option for a future period.

This is a complex area, and must be considered in conjunction with IFRS 4 *Insurance Contracts*. The following examples are applications of embedded derivative features in insurance contracts.

**Example 11A****Surrender value indexed to share price index**

A policyholder has an option to surrender an insurance contract for a surrender value based on the FTSE 100. The option is not closely related to the host contract (unless the option is life-contingent to a significant extent) and should be separated from the host contract and accounted for as a derivative.

**Example 11B****Death benefit linked to share price index**

A host insurance contract contains a death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity. The equity-index feature is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs. Thus, the contract is outside the scope of IFRS 9.

**Example 11C****Surrender value linked to interest rates**

A host insurance contract contains an embedded guarantee of minimum interest rates to be used in determining its surrender or maturity values.

If the guarantee is in the money on issue, or is leveraged, then the embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent) and should be separated from the host contract.

**Example 11D****Dual-indexed payout feature**

Entity A purchases an insurance contract that contains a dual trigger such that payment is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events occur.

The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance). A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire. Therefore, although the remaining exposure is similar to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract.

A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e. without considering the host contract). [IFRS 9:B4.3.8(h)]

**12 Measurement of embedded derivatives at initial recognition**

If an embedded derivative is separated from its host contract (because it is not closely related to the host), then it must be accounted for as if it were a free-standing derivative. The embedded derivative should be recognised in the statement of financial position at fair value, with changes in fair value recognised in profit or loss as they arise, unless it is designated as an effective hedging instrument in a cash flow or a net investment hedge (see **chapter B9**).

The host contract is accounted for under IFRS 9 if it is a financial instrument within the scope of those Standard; otherwise it is accounted for under the appropriate Standard (e.g. under IAS 17 if it is a lease contract).

**Example 12****Accounting for foreign currency derivative embedded in executory contract**

Entity A, a UK-based entity with Sterling as its functional currency, enters into a contract to purchase cocoa from a local supplier, Entity B, in six months for a fixed amount of US dollars. The US dollar is not the functional currency of either party to the transaction. The cocoa will be delivered and used over a reasonable period in the normal course of business.

Because the cocoa will be physically delivered and is for use in the normal course of business, the contract qualifies for the purchase requirements scope exception and therefore is not wholly in the scope of IFRS 9. This means that the entire contract is not a derivative recognised in the statement of financial position at fair value with changes in fair value recognised in profit or loss.

The contract still needs to be assessed for embedded derivatives. The contract contains an embedded foreign currency forward that is not closely related because the contract will be settled in US dollars and US dollars is neither the functional currency of either counterparty to the contract nor the currency in which the price of cocoa is routinely denominated in commercial transactions throughout the world. It is also not the currency commonly used in contracts to purchase or sell non-financial items in the UK. This embedded derivative must be separated from the host purchase contract and accounted for in the statement of financial position at fair value. Changes in fair value (arising from changes in the Sterling/US dollar exchange rate) will be recognised in profit or loss.

### 5.2.2.2 Timing of recognising lifetime expected credit losses

The general approach to impairment hinges on appropriately identifying when a significant increase in credit risk has occurred as this determines when an entity recognises a loss allowance based on lifetime expected credit losses instead of 12-month expected credit losses.

Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs. The assessment of whether lifetime expected credit losses should be recognised is based on significant increases in the likelihood or risk of a default occurring since initial recognition (irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk) instead of on evidence of a financial asset being credit-impaired at the reporting date or an actual default occurring. [IFRS 9:B5.5.7]

If a financial instrument was repriced to reflect a significant increase in credit risk, it could be argued that such a financial instrument should continue to have a loss allowance measured at an amount equal to the 12-month expected credit loss. As explained in IFRS 9:BC5.152-153, this is because the contractual interest rate has been repriced to reflect the entity's expectations about credit losses and is similar to the economic position on initial recognition of a similar financial instrument with a similar credit risk at origination. However, under IFRS 9 the assessment of whether lifetime expected credit losses should be recognised should be based solely on the increase in the risk of a default occurring since initial recognition. Consequently, an entity should recognise a loss allowance measured at an amount equal to lifetime expected credit losses when there is a significant increase in credit risk, irrespective of whether the instrument's terms are repriced to reflect a significant increase in credit risk.

The significance of a change in the credit risk since initial recognition depends on the risk of a default occurring as at initial recognition. Thus, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring. [IFRS 9:B5.5.9]

#### Example 5.2.2.2A

##### Absolute credit risk versus relative change in credit risk

At the reporting date Entity A has two financial assets that both have a probability of default of x per cent. At initial recognition financial instrument one had a probability of default of y per cent whereas financial instrument Y had a probability of default of z per cent. Even though both financial assets have the same absolute probability of default at the reporting date Entity A considers that for financial instrument one the credit risk has increased significantly since initial recognition whereas for financial instrument two it has not.

The risk of a default occurring on financial instruments that have comparable credit risk is higher the longer the expected life of the instrument; for example, the risk of a default occurring on an AAA-rated bond with an expected life of 10 years is higher than that on an AAA-rated bond with an expected life of five years. [IFRS 9:B5.5.10]

Because of the relationship between the expected life and the risk of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes. In such a case, an entity should consider other qualitative factors that would demonstrate whether credit risk has increased significantly since initial recognition. [IFRS 9:B5.5.11]

For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract. [IFRS 9:B5.5.8]

#### Example 5.2.2.2B

##### Probability of default applied to written financial guarantee contracts

Entity K writes a financial guarantee contract over a bond issued by Entity P.

When the financial guarantee contract is issued by Entity K the probability of default on the bond issued by Entity P is x per cent. At each reporting date Entity K reassesses the probability of default of Entity P's bond.

At the reporting date Entity K estimates that the probability of default has risen to y per cent and given the shorter time to the maturity of the bond Entity K considers the credit risk of the bond has increased significantly since the financial guarantee contract was issued.

An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input per se, such as a credit loss rate approach, can be consistent with the requirements in IFRS 9, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses,

## 6.1 Exposure to market risks

Consistent with the normal fair value measurement requirements, when measuring the fair value of a group of assets and liabilities based on the net exposure to one or more market risks, IFRS 13 requires an entity to apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the entity's net exposure to those market risks. [IFRS 13:53]

In order to measure a group of financial assets and financial liabilities on a net basis for a particular market risk, it is necessary for that market risk within that group of financial assets and financial liabilities to be substantially the same. For example, an entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the entity's exposure to interest rate risk or commodity price risk. [IFRS 13:54]

In some cases, the market risk parameters will not be identical due to basis differences. In those cases the basis risk should be taken into account in the fair value measurement of the financial assets and financial liabilities within the group. [IFRS 13:54]

Similarly, the term of the entity's exposure to market risk arising from the financial assets and financial liabilities should be substantially the same. For example, an entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a five-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (i.e. Years 2-5) on a gross basis. [IFRS 13:55]

## 6.2 Exposure to the credit risk of a particular counterparty

When applying the fair value measurement exception described in section 6 above for financial instruments with the same counterparty, the entity should include the effect of the entity's net exposure to the credit risk of that counterparty or the counterparty's net exposure to the credit risk of the entity in the fair value measurement when market participants would take into account any existing arrangements that mitigate credit risk exposure (e.g. a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party) in the event of default. The fair value measurement should reflect market participant expectations about the likelihood that such an arrangement would be legally enforceable in the event of default. [IFRS 13:56]

Reflecting in the fair value measurement of the portfolio of items the net credit risk exposure with the same counterparty is appropriate where the two parties have an agreement that requires that in the case of default the reporting entity is only required to pay or receive the net amount of the various contracts that are owed to and due from the counterparty.

Applying the fair value measurement exception in this case reduces the extent of credit risk included in the measurement of the portfolio of items relative to including credit risk in the measurement of each of the individual items and summing the assets and liabilities together.

Netting the credit risk exposure with the counterparty and reflecting only the credit risk associated with the net open credit risk position is often referred to as a CVA (credit valuation adjustment, or a 'positive CVA') in the case where the reporting entity has a net credit exposure to the counterparty, i.e. where the reporting entity is net owed amounts by the counterparty; or as a DVA (debit valuation adjustment, or a 'negative CVA') in the case where the counterparty has a net credit exposure to the reporting entity, i.e. where the reporting entity owes amounts to the counterparty.

## 7 Fair value measurement at initial recognition

### 7.1 Potential for difference between the transaction price and fair value at initial recognition

IFRS 9:5.1.1 requires that all financial assets and financial liabilities, except certain trade receivables, should be recognised initially on the basis of 'fair value'. The exception applies to trade receivables that do not have a significant financing component (determined in accordance with IFRS 15 *Revenue from Contracts with Customers*) that are not initially measured at fair value, rather they are initially measured at their transaction price.

If the asset has been acquired, or the liability assumed, in a market transaction, it might be assumed that the transaction price (i.e. the price paid to acquire an asset or received to assume a liability) can be taken to be the fair value of the asset or the liability. However, the price paid to acquire an asset, or received to assume a liability, is an *entry* price and, consequently, it is not necessarily the same as the fair value of the asset or liability for IFRS 13 purposes (which is an *exit* price – see section 3). The Standard notes that entities do not necessarily sell assets at the prices paid to acquire them; nor do they necessarily transfer liabilities at the prices received to assume them. [IFRS 13:57]

### 7.2 Indicators that the transaction price differs from fair value at initial recognition

When determining whether the fair value at initial recognition equals the transaction price, an entity should take into account factors specific to the transaction and to the asset and liability. [IFRS 13:59]

In many cases the transaction price and the fair value will be equal (e.g. when the transaction date is the same as the measurement date and the asset is acquired in the market in which the asset would be sold).

## 3.1.4.3 Consideration of the likelihood that the transferor will default

The likelihood that the transferor will default under the pass-through arrangements as a result of a default on other creditor obligations is not considered an impediment to meeting the pass-through criteria because the transferor is assumed to be a going concern. In many cases, the transferee may limit this risk by ensuring that the transferred assets reside in a bankruptcy remote special purpose entity so that the wider credit risk of the transferor is not borne by the transferee.

## 3.1.4.4 Pass-through arrangements with credit enhancement

A transferor may provide credit enhancement in a transfer arrangement so that it suffers the first loss on the asset up to a specified amount. In such circumstances, if the debtor fails to pay, the transferor absorbs the first loss fully, with the eventual recipient only suffering a loss after the first loss has been fully absorbed. A credit enhancement may be in the form of over-collateralisation or may be in the form of purchasing a subordinated interest in a consolidated SPE (in the latter case, the entity is applying the pass-through tests at a consolidated level). Providing credit enhancement will not in itself result in failure of the pass-through tests if all cash received by the transferor on transferred assets is paid on to the eventual recipient, although the credit enhancement may result in failure of derecognition due to the transferor retaining substantially all the risks and rewards of ownership of the assets. The pass-through tests must be considered prior to considering the entity's exposure to risk and rewards.

If a greater amount of cash is realised on the assets than is needed to pay the eventual recipient (i.e. the eventual recipient's initial investment is fully paid), then the entity will retain the remainder of the cash and will not pass it on. In all cases the entity passes "any cash it collects on behalf of the eventual recipients".

**Example 3.1.4.4****Pass-through arrangements with credit enhancement**

Entity B enters into an arrangement with Entity C under which where Entity C pays Entity B CU0.9 million in return for receiving cash flows on CU1.0 million of assets when expected losses on the assets are 10 per cent of all cash flows (interest and principal). Entity B retains the contractual rights to receive the cash flows from the assets but assumes an obligation to pay cash flows from the asset to Entity C. The maximum cash flows that Entity C can receive under the arrangement are interest and principal on a notional of CU0.9 million. If actual credit losses are lower than expected (say, only 5 per cent), Entity B will pay Entity C interest and principal on CU0.9 million and retain interest and principal on CU0.05 million.

Entity B will apply the derecognition model to the full CU1.0 million of assets (see **section 3.1.2**). Entity B will pass the pass-through tests, assuming all

other conditions are met, because Entity B will pass interest and principal on a notional up to CU0.9 million of the cash flows to Entity C.

However, if the form of the transaction were different, in that Entity C pays Entity B CU1.0 million for the assets and purchases a financial guarantee contract from Entity B for CU0.1 million, then the pass-through tests would not be met because Entity B will pay the eventual recipient, Entity C, even when it does not collect the equivalent amount from the original assets.

## 3.1.4.5 Revolving structures

In a revolving structure, cash received on the assets is reinvested in buying new receivables assets. In other words, cash 'revolves' into new assets instead of being returned immediately to the investors. Upon maturity, the reinvested assets are used to repay the beneficial interest holders. Such 'revolving' structures do not meet the pass-through tests because they involve a material delay before the original cash is passed on to the eventual recipients and the reinvestment would typically be not in cash or cash equivalents. The treatment of revolving structures described above was confirmed by the IFRIC (now the IFRS Interpretations Committee) in September 2005.

## 3.1.4.6 Retention of servicing rights

An entity may enter into an arrangement with a third party to transfer the contractual rights to receive the cash flows of a financial asset, but also agree to continue to act as an agent to administer collection and distribution of cash flows to the recipient (i.e. it retains servicing rights on the cash flows).

IFRS 9:3.2.4(a) focuses on whether an entity transfers the contractual rights to receive the cash flows from a financial asset. The determination as to whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Retention of servicing rights by the entity transferring the financial asset does not, in itself, cause the transfer to fail the requirements in IFRS 9:3.2.4(a). However, careful judgement must be applied to determine whether the entity providing servicing is acting solely as an agent for the owner of the financial asset (i.e. whether it has transferred all risks and rewards).

## 3.1.4.7 Transfer of legal title

When the Board considered a number of derecognition issues in September 2006 at the request of the IFRIC, it discussed whether any transfer in which legal ownership of the asset is not transferred can be considered an outright transfer of contractual rights under IAS 39:18(a)

Features	Applying derecognition in IFRS 9
The repurchase provision is a put option at a fixed price (where the put option is neither deeply in nor out of the money) and the asset is <i>not</i> readily obtainable in the market.	The transferor has neither transferred nor retained substantially all of the risks and rewards of the asset and has retained control of the asset; hence, it continues to recognise the asset to the extent of its continuing involvement because the asset is not readily obtainable in the market (i.e. the transferee does not have the practical ability to sell the asset). When the asset is measured at fair value, the transferor recognises a liability equal to the option exercise price plus the time value of the option; when the asset is measured at amortised cost, the transferor recognises a liability for the consideration received and adjusts it for the amortisation between the consideration received and amortised cost of the asset on the expiration date of the option.
The asset sold is subject to the transferor receiving a deferred consideration receipt/ payment based on the increases/decreases in the fair value of the asset respectively for a specified period of time.	The deferred consideration passes the changes in the fair value of the asset back to the transferor, thus the transferor has retained substantially all of the risks and rewards of ownership of the asset; hence, the transferor continues to recognise the asset and recognises a liability for the initial cash consideration received.
The asset is subject to a varying repurchase price such that original purchase price is adjusted retrospectively to pass variations in the value of the asset to the transferor.	The variation in the repurchase price so as to pass the changes in the value of the asset back to the transferor means that the transferor retains substantially all the risks and rewards of ownership; hence, the transferor continues to recognise the asset and recognises a liability for the cash consideration received.
The transferor provides a residual value guarantee to the transferee or subordinated debt to protect the transferee from falls in the value of the asset.	Provided that the asset has upside potential, the transferor has neither retained nor transferred substantially all the risks and rewards of ownership (transferred the upside, but retained the downside). The transferor continues to control the asset where the guarantee is sufficiently valuable to the transferee and limits its ability to transfer the asset and, therefore, the transferor continues to recognise the asset to the extent of its continuing involvement (i.e. at the date of the transfer the asset is measured at the lower of its carrying amount and the guarantee amount). The transferor recognises an associated liability equal to the guarantee amount plus the fair value of the guarantee. When the guarantee does not restrict the transferee's ability to sell the asset, the transferor derecognises the asset.
The repurchase price, whether put/call or forward, is the market price at the time of repurchase.	The transferor has transferred substantially all of the risks and rewards of ownership of the asset because the transferor can only repurchase it at its fair value. Hence, the asset is derecognised.

Features	Applying derecognition in IFRS 9
Asset repurchased is substantially the same as the asset that is transferred or the transferee can substitute the asset with one that is similar or is of equal fair value.	The transferor retains substantially all the risks and rewards of ownership of the asset and, therefore, derecognition is precluded.

### 3.7 Debt factoring

Debt factoring is used extensively as a method for obtaining one or more of the following benefits: obtaining financing, bad debt protection or sales ledger administration. A factoring transaction normally takes the form of an entity receiving cash consideration in exchange for the rights to cash collected from its receivables. In many situations, the rights to the cash flows on the receivables are subject to certain restrictions or guarantees. Sometimes the transferee may have recourse to the transferor over the performance of the receivables either up to a certain limit or to the extent to which there is a shortfall of the cash collected on the receivables. In a non-recourse transaction, there is no obligation of the transferor to make good to the transferee for any shortfall on the assets. In order to receive a market return from the receivables (the receivables are collected over time), the transferee charges interest.

The table below sets out some of the common features of debt factoring transactions and application of derecognition principles to a 'vanilla' debt factoring transaction (an entity receives cash consideration in exchange for the rights to cash collected from its receivables) with each of those features. It is assumed that the transferee cannot sell receivables (i.e. the transferor continues to control them).

Features	Applying derecognition in IFRS 9
For all receivables not recovered after a certain period (e.g. 120 days), whether due to late payment or default, the transferor provides a guarantee.	The guarantee may represent substantially all the risks of ownership of receivables (e.g. where most receivables are long term due to the credit terms offered). If so, derecognition is precluded. When the transferor has neither transferred nor retained substantially all the risks and rewards of ownership, the transferor continues to recognise receivables to the extent of its continuing involvement, i.e. to the extent that amounts may be repaid under the guarantee.

Hedge accounting is voluntary on a hedge by hedge basis and can only be applied prospectively from the point that a hedging instrument and hedged item are formally designated in a hedging relationship and the other qualifying criteria are met, including an assessment of the expected effectiveness of the hedge (see **section 5.2**). Once a hedge is formally designated and the conditions are met, hedge accounting must be applied and is only discontinued when certain conditions are no longer met (see **section 6.3**). If for any reason a hedging relationship does not meet all of the necessary conditions, hedge accounting cannot be applied.

### 1.3 The mechanics of hedge accounting

The mechanics through which hedge accounting achieves offsetting of gains or losses on the hedging instrument with the hedged item varies depending on the nature of the hedge.

Generally, hedges of exposures to variability in cash flows are dealt with by deferring changes in value of the hedging instrument in other comprehensive income, with amounts later removed or reclassified and ultimately recognised in profit or loss at the same time as the hedged item. This is referred to as cash flow hedge accounting (see **section 6.5**).

Generally, hedges of existing (rather than forecast) hedged items that are hedged for changes in fair value (such as an equity investment or fixed rate loan) are matched in profit or loss with the hedging instrument by also re-measuring the hedged item through profit or loss to reflect changes in value due to the hedged risk. An exception to this is where an entity hedges an equity investment designated at FVTOCI, where the hedging instrument's gains or losses are recognised and matched in other comprehensive income. In both of these cases, this is referred to as fair value hedge accounting (see **section 6.4**).

Another type of hedge accounting is a hedge of a net investment, which applies to hedges of foreign currency risk on net investments in foreign operations and is accounted for in a similar way to cash flow hedge accounting (see **section 6.6**).

In addition to the mechanics for offsetting gains or losses, there are also specific requirements for accounting for certain costs of hedging, such as the cost or premium for purchasing an option contract (see **sections 6.8 – 6.10**).

When an entity elects to apply hedge accounting, it also brings itself into the scope of the hedge accounting disclosures in IFRS 7 (see **chapter B11**). These disclosures provide insights into the reporting entity's risk management strategies and makes the effect that hedge accounting has on the financial statements more transparent.

Although the hedge accounting model in IFRS 9 allows some limited groups of hedged items to be hedge accounted, it does not include a macro hedge

accounting model to cater for hedges of dynamic (open) portfolios. The IASB is undertaking a project to explore the development of a model to address the measurement inconsistencies that arise from macro hedging. Given the early stage of this project, IFRS 9 allows entities to apply the specific hedge accounting requirements in IAS 39 in respect of portfolio fair value hedging of interest rate risk (including designating as the hedged item a portion that is a currency amount and complying with the hedge effectiveness requirements of IAS 39, see paragraphs 81A, 89A and AG114-AG132 of IAS 39). [IFRS 9:6.1.3]

In addition to this, IFRS 9 also allows those transitioning to IFRS 9 from IAS 39, as an accounting policy choice, to continue to apply the IAS 39 hedge accounting requirements, in full, in place of the requirements in Chapter 6 of IFRS 9. The rationale behind this option is to allow entities the opportunity to see the outcome of the macro hedging project before being required to adopt the new general model and hence avoid changing to the new general model and then potentially changing again to a new macro model. As such, the IASB anticipates removing this option once the macro hedging project is completed.

This chapter discusses the (general) hedge accounting model contained in Chapter 6 of IFRS 9 and follows a similar structure. **Chapter B10** includes additional detailed illustrative examples of the application of the hedge accounting requirements.

### 1.4 Alternative to hedge accounting

Given all of the requirements for hedge accounting and the fact that it is voluntary, some entities may choose not to apply hedge accounting and accept the accounting volatility that arises, or they may consider alternatives to hedge accounting that can achieve a similar outcome. One of these alternatives involves designating the underlying exposure at FVTPL to reduce the accounting mismatch arising from measuring financial instruments used to hedge at FVTPL.

Four specific fair value options are available when the designation eliminates or significantly reduces a recognition inconsistency that would otherwise arise (i.e. an accounting mismatch). Three of these options are only available on initial recognition and each apply separately to financial assets (see **chapter B2**), financial liabilities (see **chapter B3**) and contracts to buy or sell a non-financial item that are otherwise outside scope of IFRS 9 (see **chapter B1**).

The fourth fair value option applies to exposures hedged for credit risk, which has its own specific eligibility conditions and is more flexible in that it is available after initial recognition of the exposure and can also later be revoked (see **section 7**).

The simplicity of applying the fair value option in these cases can come at a cost. For example, with the exception of the fair value option for credit exposures, the designation must be made at inception of the contract and

### 3.11 Risk components

Changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), can be designated as the hedged item provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable. [IFRS 9:6.3.7(a)]

The ability to designate risk components allows entities some flexibility in how the hedged risk is defined, allowing it to be defined in a way that more closely resembles the risk that is hedged from a risk management perspective. A basic example of hedging a risk component is hedging the foreign currency risk component of a highly probable forecast transaction denominated in a foreign currency and excluding from the hedge any other variability in price of that forecast transaction. More complex examples arise in practice, particularly in respect of hedging other risk components in non-financial items. Further examples are provided below.

The ability to designate risk components has important consequences when it comes to demonstrating compliance with the hedge effectiveness requirements (see 5.2). An entity's ability to define the hedged risk in such a way that it closely matches the terms of the hedging instrument, will make it easier for the entity to demonstrate that there is an economic relationship between the hedged item and hedging instrument and identify the appropriate hedge ratio to use. Furthermore, more closely matching the designated risk component to the hedging instrument will reduce hedge ineffectiveness, and any ineffectiveness recognised will more closely align with ineffectiveness anticipated in the entity's risk management strategy. However, it is important to note that IFRS 9 does not allow an entity to simply assume that a risk component equivalent to the hedging instrument exists within the hedged item. Instead it must independently assess the hedged item to determine whether the risk component is separately identifiable and reliably measurable.

Risk components may be identified in financial or non-financial items and can be contractually specified (see **example 3.11A**) or implicit in the cash flows or fair value of an item (see **example 3.11C**). Where the risk component is contractually specified it will generally be regarded as identifiable (since it is contractually specified) and will often be reliably measurable (since its measurement will be required to establish the cash flows under the contract), however, this would not always be the case, for example where although spot prices are available for determining the contract cash flows, forward prices may not be reliably measurable.

Where a risk component is implicit in the cash flows or fair value of an item, more judgement will be required to establish whether it is separately identifiable and reliably measurable. IFRS 9 provides some guidance to

assist entities in identifying what risk components qualify for designation as a hedged item, which will be particularly relevant in these cases. It notes an entity should assess such risk components within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market. [IFRS 9:B6.3.9]

In cases in which an entity hedges a physical item, such as finished electrical goods, the physical components of that item, such as copper components, may be a starting point used by an entity to identify risk components that could be hedged. However, the presence of a physical component in an item would not necessarily mean that such a component is eligible to be designated as a hedged item because that physical component may not be a separately identifiable and reliably measurable component of the fair value or cash flows of the item. For example, changes in the price of copper may not result in an identifiable change in the price of finished electrical goods because, given the market structure, there are many influencers on the price of the finished goods and the effect of a change in the price of the copper component on the overall price is not separately identifiable and reliably measurable. That said, there will be some cases where the presence of a physical component does have an identifiable and reliably measurable impact on the price of an overall item. One such example provided in IFRS 9 is a hedge of the crude oil component of jet fuel (see **example 3.11C**). In these cases, it will be important to apply careful judgement and clearly understand the workings of the market, how prices are determined and the basis for entering into the hedge from a risk management perspective.

Risk components can be identified in a number of different ways provided the risk component is separately identifiable and reliably measurable. For example, a risk component can be identified from specific identified cash flows of an item (e.g. only hedging a risk component from the first five years of interest flows on a 10-year loan with annual interest payments). Risk components can also include only changes in the cash flows or the fair value of a hedged item:

- above or below a specified price or other variable (i.e. a one-sided risk, see **section 3.11.2**); and
- that are part of the term of the cash flow or fair value exposure (i.e. a partial term hedge, see **section 3.11.3**).

When designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. For example, the qualifying criteria, including the hedge effectiveness assessment and measurement requirements apply in the same way. [IFRS 9:B6.3.11]

hedge or because the documented risk management objective is no longer consistent with the entity's risk management strategy) the qualifying criteria for hedge accounting would no longer be met.

As a consequence of the above, the IASB included specific examples in IFRS 9 to illustrate scenarios where a hedging relationship no longer reflected the risk management objective for the hedge (see **examples 6.3.1.6A–C**) and hedge accounting would have to be discontinued and provided further guidance distinguishing between risk management strategy and objective.

The risk management strategy is established at the highest level at which an entity determines how it manages its risk. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk management strategy is typically in place for a longer period and may include some flexibility to react to changes in circumstances that occur while that strategy is in place (for example, different interest rate or commodity price levels that result in a different extent of hedging). This is normally set out in a general document that is cascaded down through an entity through policies containing more specific guidelines. In contrast, the risk management objective for a hedging relationship applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item. Hence, a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy. [IFRS 9:B6.5.24]

#### Example 6.3.1.6A

##### Hedging of interest rate risk where the risk management objective subsequently changes

[IFRS 9:B6.5.24(a)]

An entity has a strategy of managing its interest rate exposure on debt funding that sets ranges for the overall entity for the mix between variable-rate and fixed-rate funding. The strategy is to maintain between 20 per cent and 40 per cent of the debt at fixed-rates.

The entity decides from time to time how to execute this strategy (i.e. where it positions itself within the 20 per cent to 40 per cent range for fixed-rate interest exposure) depending on the level of interest rates. If interest rates are low the entity fixes the interest for more debt than when interest rates are high.

The entity's debt is CU100 of variable-rate debt of which CU30 is swapped into a fixed-rate exposure. The entity takes advantage of low interest rates to issue an additional CU50 of debt to finance a major investment, which the entity does by issuing a fixed-rate bond. In the light of the low interest rates, the entity

decides to set its fixed interest-rate exposure to 40 per cent of the total debt by reducing by CU20 the extent to which it previously hedged its variable-rate exposure, resulting in CU60 of fixed-rate exposure.

In this situation the risk management strategy itself remains unchanged. However, in contrast the entity's execution of that strategy has changed and this means that, for CU20 of variable-rate exposure that was previously hedged, the risk management objective has changed (i.e. at the hedging relationship level).

Consequently, in this situation hedge accounting must be discontinued for CU20 of the previously hedged variable-rate exposure. This could involve reducing the swap position by a CU20 nominal amount but, depending on the circumstances, an entity might retain that swap volume and, for example, use it for hedging a different exposure or it might become part of a trading book.

Conversely, if an entity instead swapped a part of its new fixed-rate debt into a variable-rate exposure, hedge accounting would have to be continued for its previously hedged variable-rate exposure.

#### Example 6.3.1.6B

##### Micro hedges of open portfolios of debt instruments where subsequently the risk management objective ceases to apply

[IFRS 9:B6.5.24(b)]

Some exposures result from positions that frequently change, for example, the interest rate risk of an open portfolio of debt instruments. The addition of new debt instruments and the derecognition of debt instruments continuously change that exposure (ie it is different from simply running off a position that matures). This is a dynamic process in which both the exposure and the hedging instruments used to manage it do not remain the same for long.

Consequently, an entity with such an exposure frequently adjusts the hedging instruments used to manage the interest rate risk as the exposure changes. For example, debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets or maturity periods. After a short period of time, the entity discontinues all, some or a part of the previously designated hedging relationships for maturity periods and designates new hedging relationships for maturity periods on the basis of their size and the hedging instruments that exist at that time.

The discontinuation of hedge accounting in this situation reflects that those hedging relationships are established in such a way that the entity looks at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist. In such a situation, the discontinuation of hedge accounting applies to the extent to which the risk management objective has changed. This depends on the situation of an entity and could, for example, affect all or only some hedging relationships of a maturity period, or only part of a hedging relationship.

On 1 January 20X1, Entity A with a local functional currency (LC), issues foreign currency (FC) floating rate debt that matures on 31 December 20X5. The principal amount of the debt is FC100m and interest of FC LIBOR is paid annually in arrears. At 1 January 20X1 the FC:LC spot rate is 15.8:1 and so the principal is equivalent to LC6,329,113.

Period ended	Spot rate (FC/LC)	LIBOR of period	Interest FC accrual in period (LC '000s – FC at average rate)	Interest accrual on retranslation of debt (LC '000s)	Gain/(Loss) on retranslation of debt (LC '000s)	Carrying amount of debt before cash settlement (LC '000s)	Cash settlement translated at spot rate (LC '000s)	Carrying amount of debt after cash settlement (LC '000s)
31/12/X1	12.6	12.26	(12,260)	(863)	(1,717)	(8,909)	973	(7,936)
31/12/X2	11.4	7.47	(7,470)	(622)	(869)	(9,427)	655	(8,772)
31/12/X3	11	6.51	(6,510)	(581)	(330)	(9,683)	592	(9,091)
31/12/X4	12.8	5.49	(5,490)	(461)	1,311	(8,241)	428	(7,813)
31/12/X5	15	5.49	(5,490)	(395)	1,175	(7,033)	7,033	0

On 1 January 20X1, Entity A also enters into a floating-floating cross currency interest rate swap that matures on 31 December 20X5. Entity A will receive FC LIBOR interest on FC100m and pay LC LIBOR -35 bps interest on LC6,329,113. Interest will be exchanged annually in arrears and principal amounts will also be exchanged at maturity. The fair value of the cross currency interest rate swap is nil on 1 January 20X1.

Period ended	LC LIBOR at start of period	Fair value gain/(loss) during period (LC '000s)	Fair value of swap before cash settlement (LC '000s)	Cash settlement (LC '000s)*	Fair value of swap after cash settlement (LC '000s)
31/12/X1	5.13	2,225	2,225	(670)	1,555
31/12/X2	0.59	1,498	3,053	(640)	2,413
31/12/X3	0.55	922	3,335	(679)	2,756
31/12/X4	0.60	(851)	1,905	(413)	1,492
31/12/X5	0.56	(801)	691	(691)	0

\* The cash settlement is the foreign currency cash flow translated at the spot rate plus the local currency cash flow e.g.  $[-(FC100,000,000 \cdot 12.26\%) / (12.6 FC/LC)] + [LC6,329,113 \cdot (5.13 - 0.35\%)] = -LC670,484$

On 1 January 20X1, Entity A designates the cross currency interest rate swap in a cash flow hedge of the variability of the interest and principal cash flows of the FC denominated debt due to changes in the spot rate. Entity A does not exclude the foreign currency basis spread element from the designation which gives rise to ineffectiveness.

The hypothetical derivative (which is derived from the hedged item) is in this example a swap with a foreign currency leg that matches the actual swap and a local currency leg equal to the local currency leg of the actual swap excluding the spread of -35 bps. The change in the present value of the hypothetical derivative is calculated for the purposes of hedge accounting by applying non-currency basis adjusted discount curves (i.e. a LC non-currency basis adjusted discount curve to the LC cash flows and a FC non-currency basis adjusted discount curve to the FC cash flows).

Period ended	Present value gain/(loss) during period (LC '000s)	Present value before cash settlement (LC '000s)	Cash settlement (LC '000s)**	Present value after cash settlement (LC '000s)
31/12/X1	2,256	2,256	(648)	1,608
31/12/X2	1,453	3,061	(618)	2,443
31/12/X3	876	3,319	(557)	2,762
31/12/X4	(887)	1,875	(391)	1,484
31/12/X5	(816)	668	(668)	0

\*\* The cash settlement is the foreign currency cash flow translated at the spot rate plus the local currency cash flow e.g.  $[-(FC100,000,000 \cdot 12.26\%) / (12.6 FC/LC)] + [LC6,329,114 \cdot 5.13\%] = -LC648,332$

Period ended	Cumulative fair value gain/(loss) hedging instrument (LC '000s)	Cumulative present value gain/(loss) on hypothetical derivative (LC '000s)	Cumulative ineffectiveness (LC '000s)***	Ineffectiveness during period (LC '000s)
31/12/X1	2,225	2,256	0	0
31/12/X2	3,723	3,709	14	14
31/12/X3	4,645	4,585	60	46
31/12/X4	3,794	3,698	96	36
31/12/X5	2,993	2,882	111	15

\*\*\* If the cumulative fair value gain or loss on the hedging instrument is less than that on the hypothetical derivative (i.e. there is an under hedge), the cumulative ineffectiveness will be nil.

Amounts are reclassified from the cash flow hedge reserve to profit or loss in the period during which the hedged expected future cash flows affect profit or loss. The cumulative amount reclassified in order to offset the interest accrual on the FC debt is calculated as the difference between the cumulative amount recognised in the cash flow hedge reserve and the lower of the cumulative clean fair value gain or loss on the hedging instrument and the cumulative clean present value gain or loss on the hypothetical derivative.

Period ended	Cumulative amount recognised in the cash flow hedge reserve (LC '000s)	The lower of the cumulative clean fair value gain/(loss) on the hedging instrument and the cumulative clean present value gain/(loss) on the hypothetical derivative (LC '000s)	Cumulative reclassification of amounts to offset the interest accrual (LC '000s)	Reclassification of amounts to offset the interest accrual in period (LC '000s)****
31/12/X1	2,225	1,555	670	670
31/12/X2	3,709	2,413	1,296	626
31/12/X3	4,585	2,756	1,829	533
31/12/X4	3,698	1,484	2,214	385
31/12/X5	2,882	338	2,544	330

\*\*\*\* We have chosen to allocate this amount first to offset the retranslation of the interest accrual, then the remainder to offset the accrual of interest at the average rate.

(the 'second level relationship'). This hedging relationship is designated at the end of Period 2 with a term to the end of Period 5. The aggregated exposure that is designated as the hedged item represents the FX risk that is the effect of exchange rate changes, compared to the forward FX rate at the end of Period 2 (i.e. the time of designation of the FX risk hedging relationship), on the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship, which are the forecast coffee purchase and the commodity forward contract. Entity A's long-term view of the basis spread between the price of the coffee that it actually buys and the price for the benchmark coffee has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Entity A enters into (the nominal amount of the FX forward contract of FC140,625) reflects the cash flow exposure associated with a basis spread that had remained at -5 per cent. However, Entity A's actual aggregated exposure is affected by changes in the basis spread. Because the basis spread has moved from -5 per cent to -5.5 per cent during Period 2, Entity A's actual aggregated exposure at the end of Period 2 is FC140,027.

The following table sets out the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness:<sup>4</sup>

**Example 1 – Calculations**

		Period	1	2	3	4	5
<b>Commodity price risk hedging relationship (first level relationship)</b>							
<i>Forward purchase contract for coffee</i>							
Volume (lbs)	112,500						
Forward price [FC/lb]	1.25	Price (fwd) [FC/lb]	1.25	1.01	1.43	1.22	2.15
		Fair value [FC]	0	(26,943)	20,219	(3,373)	101,250
		Fair value [LC]	0	(20,258)	14,339	(2,310)	70,804
		Change in fair value [LC]		(20,258)	34,595	(16,650)	73,114
<i>Hedged forecast coffee purchase</i>							
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
Hedged volume	118.421	Price (fwd) [FC/lb]	1.19	0.95	1.34	1.18	2.00
Implied forward price	1.1875	Present value [FC]	0	27,540	(18,528)	1,063	(96,158)
		Present value [LC]	0	20,707	(13,140)	728	(67,243)
		Change in present value [LC]		20,707	(33,847)	13,868	(67,971)
Accounting		LC	LC	LC	LC	LC	LC
Derivative		0	(20,258)	14,339	(2,310)	70,804	
Cash flow hedge reserve		0	(20,258)	13,140	(728)	67,243	
Change in cash flow hedge reserve			(20,258)	33,399	(13,868)	67,971	
Profit or loss			0	1,199	(2,781)	5,143	
Retained earnings		0	0	1,199	(1,582)	3,561	

		Period	1	2	3	4	5
<b>FX risk hedging relationship (second level relationship)</b>							
FX rate [FC/LC]		Spot	1.3800	1.3300	1.4100	1.4600	1.4300
		Forward	1.3683	1.3220	1.4058	1.4571	1.4300
<b>Commodity price risk hedging relationship (first level relationship)</b>							
<i>FX forward contract (buy FC/sell LC)</i>							
Volume [FC]	140,625						
Forward rate (in P <sub>2</sub> )	1,3220	Fair value [LC]		0	(6,313)	(9,840)	(8,035)
		Change in fair value [LC]			(6,313)	(3,528)	1,805
<b>Hedged FX</b>							
Aggregated FX exposure		Hedged volume [FC]		140,027	138,932	142,937	135,533
		Present value [LC]		0	6,237	10,002	7,744
		Change in fair value [LC]			6,237	3,765	(2,258)
Accounting		LC	LC	LC	LC	LC	LC
Derivative		0	(6,313)	(9,840)	(8,035)		
Cash flow hedge reserve		0	(6,237)	(9,840)	(7,744)		
Change in cash flow hedge reserve				(6,237)	(3,604)	2,096	
Profit or loss				(76)	76	(291)	
Retained earnings		0	(76)	0	(291)		

The commodity price risk hedging relationship is a cash flow hedge of a highly probable forecast transaction that starts at the end of Period 1 and remains in place when the FX risk hedging relationship starts at the end of Period 2, i.e. the first level relationship continues as a separate hedging relationship.

The volume of the aggregated FX exposure (in FC), which is the hedged volume of the FX risk hedging relationship, is the total of:<sup>5</sup>

- (a) the hedged coffee purchase volume multiplied by the current forward price (this represents the expected spot price of the actual coffee purchase); and
- (b) the volume of the hedging instrument (designated nominal amount) multiplied by the difference between the contractual forward rate and the current forward rate (this represents the expected price differential from benchmark coffee price movements in FC that Entity A will receive or pay under the commodity forward contract).

The present value (in LC) of the hedged item of the FX risk hedging relationship (i.e. the aggregated exposure) is calculated as the hedged volume (in FC) multiplied by the difference between the forward FX rate at the measurement date and the forward FX rate at the designation date of the hedging relationship (i.e. the end of Period 2).<sup>6</sup>

Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 6.5.11 of IFRS 9).

The disclosure of the existence of such collateral is important because it provides information to users of the financial statements regarding the amount of collateral used and available for use that may not be recognised in the statement of financial position of the entity.

Disclosure of collateral that the entity does not have the right to sell or pledge in the absence of default by the borrower is required in the credit risk disclosures note – see **section 5.2.1.2**.

#### 4.1.8 Allowance account for credit losses

For assets measured FVTOCI in accordance with IFRS 9:4.1.2A, i.e. those debt instruments held which meet the cash flow characteristics tests and are held in a business with an objective to collect contractual cash flows and selling financial assets, the carrying value is equal to fair value and is therefore not reduced by an allowance for credit losses. Consequently, the loss allowance shall be disclosed in the notes to the financial statements. [IFRS 7:16A]

See **section 5.2.1** for detailed disclosures around expected credit losses.

#### 4.1.9 Compound financial instruments with multiple embedded derivatives

IAS 32 prescribes how a compound financial instrument should be separated into its liability and equity components. For a compound financial instrument, the value of the debt or equity component may be affected by the other component. For instance, for convertible debt, the value of the debt component may depend in part on the relative attractiveness of early conversion. Therefore, the aggregate fair value of the convertible bond could differ from the sum of the estimated fair values of the debt and equity components if these were valued independently of each other. IAS 32 assigns the full value of these interdependencies to the liability component and treats equity as the residual. This allocation is arbitrary and could be argued to misstate the amount of the liability and, thereby, misstate the 'true' interest cost.

The interdependencies become even more significant when a compound instrument contains multiple embedded features whose values are also interdependent. For example, the values of an embedded purchased call option and a written equity conversion option in a callable convertible debt instrument depend in part on each other; because the equity conversion option is extinguished if the issuer exercises its purchased call option to redeem early, and vice versa, the value of the issuer purchased call option depends on the likelihood that the holder will exercise its right to convert early into shares. Because of the importance of these features, IFRS 7:17 requires an issuer of a compound instrument that has multiple embedded derivatives whose values are interdependent to disclose the existence of those features.

#### 4.1.10 Defaults and breaches

For loans payable recognised at the end of the reporting period, disclosure is required of any defaults during the period of principal, interest, sinking fund, or redemption terms. In addition, the entity is required to disclose the carrying amount of any such loans that are in default at the end of the reporting period and whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue. [IFRS 7:18] Loans payable are defined as "financial liabilities, other than short-term trade payables on normal credit terms". [IFRS 7:Appendix A] It is important to note that disclosure regarding defaults is required even when those defaults were rectified by the end of the reporting period.

If, during the period, there were breaches of loan agreement terms other than those described in the IFRS 7:18 (see previous paragraph), the entity is required to disclose the same information as required by IFRS 7:18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period). [IFRS 7:19] Examples of such defaults include breaches of collateral requirements or loan covenant features, or a failure to administer the loan in terms of the loan agreement.

Such disclosures are designed to provide the users with relevant information about the entity's creditworthiness and its prospects for obtaining future loans. [IFRS 7:BC32]

The presentation of such loans as either current or non-current in accordance with the requirements of IAS 1 may also be affected by such defaults.

#### 4.2 Disclosures relating to the statement of comprehensive income disclosures

IFRS 7 requires disclosure of specified income, expense, gains or loss items either in the statement of comprehensive income or in the notes to the financial statements.

##### 4.2.1 Net gains or net losses

An entity is required to disclose in the statement of comprehensive income or in the notes the net gains or net losses for:

[IFRS 7:20(a)]

- (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those relating to financial assets or financial liabilities designated as such upon initial recognition, and those relating to financial assets or financial liabilities that are mandatorily measured at fair value in accordance with IFRS 9. For financial liabilities designated at FVTPL, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss;

at FVTPL with the underlying being the entity's own equity price, they will need to be considered for the purposes of the sensitivity analysis.

**(iii) Determine what is a reasonably possible change in the relevant risk variable**

An entity needs to determine what it considers to be a reasonably possible change in the relevant risk variable, and should consider both the economic environment in which it operates and the time frame over which it is making the assessment. A reasonably possible change in a relevant risk variable in one environment may not be the same in another environment (e.g. a reasonably possible change in interest rates may be 100bp for Sterling denominated debt, but the same could not be said for Yen denominated debt, for which a reasonably possible change may be substantially smaller). Entities are required to judge what those reasonably possible changes are and should not include remote or 'worse case scenarios' or 'stress tests'. A reasonably possible change in the relevant risk variable should be assessed over the time frame until the entity will next present these disclosures, which is usually until the end of the entity's next annual reporting period. [IFRS 7:B19]

While the range of reasonably possible changes may be wide, disclosure is not required for each change within that range. It is sufficient to disclose the effects of the changes at the limits of the reasonably possible range. [IFRS 7:B18(b)]

IFRS 7 requires comparative information to be presented. If the volatility of a given risk variable changes and, therefore, an entity alters its view of what is a reasonably possible change, this would not prompt restatement of the comparative risk disclosures. The entity should, however, carefully disclose the fact that there has been a change in what is considered to be a reasonably possible change in the risk variable.

**(iv) Determine the appropriate level of aggregation that should be provided in the disclosures**

An entity should aggregate the output from sensitivity analysis in order to provide a broad view of the entity's overall sensitivity to market risk but without combining information with different characteristics about exposures to risks from significantly different economic environments. Disclosures may, for example, be provided separately for financial instruments that are held for trading from those that are not. Alternatively, disclosures may be disclosed for each risk. As a minimum, sensitivity analyses for each currency to which an entity has a significant exposure should be provided. [IFRS 7:B24]

An entity should provide sensitivity analysis for the whole of its business but may provide different types of sensitivity analyses for different classes of financial instruments. [IFRS 7:B21]

An entity could provide different types of sensitivity analysis for different parts of its business if this is consistent with how it manages risk internally. For example, a financial institution may comprise a retail banking division and an investment banking division. The entity could choose to provide a conventional sensitivity analysis, as described in the steps above, in relation to the retail banking division and a value-at-risk (VaR) analysis in relation to the investment banking division, if the latter analysis is used for internal risk management purposes within the investment banking division. However, the entity in this case would need to consider carefully how to treat any transactions and exposures between the two divisions so that the disclosure is not misleading (see (vi) below for discussion of VaR as an alternative disclosure of market risk).

**(v) Calculate and present the sensitivity analyses**

Entities should disclose the effect on profit or loss and equity for exposures at the end of the reporting period assuming that a reasonably possible change in the relevant risk variable had been applied to those exposures at the end of the reporting period. [IFRS 7:B18]

The sensitivity may be reported separately for different lines in profit or loss or for consolidated profit or loss and equity. An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk. [IFRS 7:IG34]

The sensitivity of profit or loss and the sensitivity of other comprehensive income should be disclosed separately (for example, investments in equity instruments whose changes in fair value are presented in other comprehensive income). [IFRS 7:B27]

The sensitivity analysis is prepared based on financial instruments that are recognised at the end of the reporting period. This is the case even when those exposures did not exist for the entire period or when the exposure changed materially during the period.

For example, an entity is building a road. To finance the construction of the road, it negotiates a floating rate debt facility. The entity starts to draw down on the facility half-way through the year and, by year end, it has fully drawn down the facility. A sensitivity analysis will be prepared for the loan showing profit or loss sensitivity assuming that the loan was in place for the entire period. A similar situation would arise in the case of an amortising loan where the exposure has reduced over the period due to part repayment of the principal. In that instance, the sensitivity analysis would be prepared on the basis of the exposure at the end of the reporting period, notwithstanding the significantly higher exposures during the period.