

- If the share price falls, and the fall is not considered significant or prolonged, then the fair value loss will be recognised in other comprehensive income while the increase in the fair value of the option will be recognised in profit or loss. As noted above, the increase in fair value of the option will not be fully offset by the decrease in the fair value of the share because the option's fair value will also reflect changes in time value.

If an impairment loss arises, the cumulative loss recognised in other comprehensive income will be reclassified from equity to profit or loss as a reclassification adjustment (see section 5 in chapter C6). Once the impairment loss has been recognised, future falls in the fair value of the shares and further increases in the intrinsic value of the option will be recognised in profit or loss and will achieve the same accounting result as if the fair value option had not been applied. In the period when the impairment loss is recognised, not applying the fair value option would result in a greater one-off loss in profit or loss as a result of reclassification from equity compared to the net loss when applying the fair value option.

Considering all the various scenarios, it is not appropriate for Entity B to claim that applying the fair value option would eliminate or significantly reduce an accounting mismatch.

3.1.1.2 Managed and performance evaluated on a fair value basis

The following are examples of the application of the fair value option on the basis that financial assets, financial liabilities, or both, are managed and their performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

- An entity that is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from the total return in the form of interest or dividends and changes in fair value may designate such investments as at FVTPL, provided that it does not hold a controlling interest in them. [IAS 39:AG41(a)]
- An entity may have financial assets and financial liabilities that 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. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and that manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. [IAS 39:AG41(b)] This is particularly evident for investment banks that issue structured medium-term note programmes linked to a basket of equities or corporate bonds, when the bank economically hedges its liability by purchasing equity and corporate bonds in the cash market, and/or enters into derivative contracts where the underlying is the referenced equities or corporate bonds. It is common for investment banks to manage their portfolios of assets and liabilities on a fair value basis.

- An insurer holds a portfolio of financial assets, manages it so as to maximise its total return (i.e. interest / dividends and changes in fair value), and evaluates its performance on that basis. For example, a portfolio may be held to back specific liabilities, in which case the investment policy and evaluation on a fair value basis may apply to both the assets and liabilities, or to the assets alone. [IAS 39:AG41(c)]
- An entity that designates financial instruments as at FVTPL on the basis that it manages and evaluates their performance on that basis must designate all eligible financial instruments that are managed and evaluated together, i.e. it cannot cherry-pick. [IAS 39:AG4J]

The risk management or investment strategy 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.

3.1.1.3 Contracts containing one or more embedded derivative

IAS 39:11A allows a hybrid contract containing one or more embedded derivatives to be designated in its entirety at FVTPL 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 (e.g. a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost - see 7.1 in chapter C5).

Example 3.1.1.3

Fair value option: commodity-linked debt

Entity Q acquires a debt instrument that has interest payments linked to a basket of commodity prices. The link 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.

IAS 39 applies to financial instruments within its scope. However, some of the Standard's requirements (e.g. those in respect of embedded derivatives) apply to a wider range of contracts).

The fair value of the liability component on initial recognition is the present value of the contractual stream of future cash flows (including both coupon payments and redemption amount) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cash flows, on the same terms, but without the conversion option.

Example 3.1A**Convertible debt**

Entity A issues 2,000 convertible bonds on 1 January 20X5. The bonds have a 3-year term, and are issued at par with a face value of CU1,000 per bond, resulting in total proceeds of CU2 million. Interest is payable annually in arrears at an annual interest rate of 6 per cent. Each bond is convertible, at the holder's discretion, at any time up to maturity into 250 ordinary shares. When the bonds are issued, the market interest rate for similar debt without the conversion option is 9 per cent.

On initial recognition, the contractual cash flows of the liability component are valued first, and the difference between the proceeds of the bond issue (being the fair value of the instrument in its entirety) and the fair value of the liability is assigned to the equity component. The present value (i.e. fair value) of the liability component is calculated using a discount rate of 9 per cent (i.e. the market interest rate for similar bonds with the same credit standing having no conversion rights). The calculation, which excludes the income tax entries, is illustrated below.

	CU
Present value of principal at the end of 3 years*	1,544,367
Present value of interest (CU120,000 payable annually in arrears for 3 years**)	303,755
Total liability component (B)	1,848,122
Residual equity component (A-B)	151,878
Proceeds of bond issue (A)	2,000,000

* present value of principal amount at 9%:

$$2,000,000 / (1.09)^3 = 1,544,367$$

** present value of interest (CU120,000) payable at the end of each of 3 years:

$$\text{interest at end of year 1: } 120,000 / 1.09 = 110,092$$

$$\text{interest at end of year 2: } 120,000 / (1.09)^2 = 101,002$$

$$\text{interest at end of year 3: } 120,000 / (1.09)^3 = 92,661$$

$$\text{Total net present value of interest payments} = 303,755$$

Upon initial recognition of the convertible instrument in the financial statements of the issuer, the following entries are recorded.

	CU	CU
Dr Cash	2,000,000	
Cr Financial liability		1,848,122
Cr Equity		151,878

To recognise the convertible instrument.

Any transaction costs are allocated between the debt component and the equity component using their relative fair values.

The financial liability component will be subsequently measured in accordance with the measurement requirements in IAS 39 depending on its classification (either as a financial liability at FVTPL, or as an 'other' liability, measured at amortised cost using the effective interest method).

The equity component will not be remeasured.

Example 3.1B**Perpetual interest-bearing preference shares**

Entity A, a CU functional currency entity, issues non-redeemable preference shares. The preference shares have a cumulative, mandatory dividend fixed at CU 424 per share per year. If earnings are not sufficient to cover the dividend in any given year, such dividends will be paid in future years. Additional dividends may be declared but only if dividends of the same amount are declared on the other classes of shares.

The preference share is a compound financial instrument that contains both liability and equity components. The liability is the contractual obligation by the issuer to deliver cash (CU 424 per year), while the equity component is represented by the holder's right to receive an equity return in the form of additional dividends, if declared.

The fair value of the liability will be calculated as the present value of the mandatory dividend of CU424 per share per year in perpetuity discounted at the market interest rate for a similar instrument that does not entitle the holder to additional discretionary dividends. The equity component is calculated as the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.

3.2 Separating the liability and equity components when the instrument has embedded derivatives

In addition to the financial liability and equity components, a compound instrument may also have embedded derivatives (see **chapter C5**). For example, the instrument may contain a call option exercisable by the issuer. The value of any such embedded derivative features must be

Example 2.4.5**Offsetting loans**

Entity A makes a 5-year fixed rate loan to Entity B on market terms. Simultaneously, Entity B makes a 5-year variable rate loan to Entity A on market terms over the same notional amount. The combination of these two loans is similar in effect to an interest rate swap. Even if amounts are exchanged at inception of the two loans, the net fair value of the amounts exchanged is zero. Therefore, the loans should be considered together and the entire arrangement accounted for as a derivative.

2.5 Future settlement

The third part of the definition of a derivative is that it is settled at a future date. Settlement can occur in different ways, either gross or net [IAS 39:IG.B.3], and does not just mean exchange of cash. For example, it may be expected that an out of the money option will not be exercised. However, expiry of the contract is a form of settlement, even if at maturity of the instrument no cash or underlying changes hands. [IAS 39:IG.B.7]

3 Scoped-in contracts

Certain contracts to buy or sell non-financial items are within the scope of IAS 39 (see 2.5 in chapter C1). If a contract to buy or sell a non-financial item is within the scope of IAS 39 and meets the definition of a derivative, it will be recognised at fair value.

Example 3**Contract over a non-financial item**

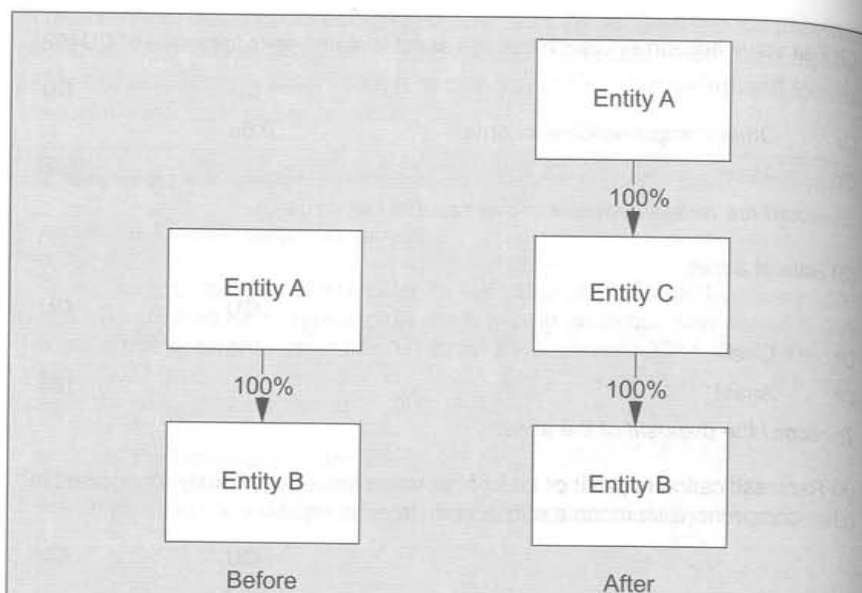
Entity A enters into a futures contract to purchase 1,000 bushels of corn for CU1 per bushel in three months. No cash is paid at inception. Assuming the contract is within the scope of IAS 39 (i.e. because it is not entered into for the purpose of the receipt of the corn bushels), the contract meets the definition of a derivative.

It has an underlying (the price of corn bushels), there is no initial investment, and the contract will be settled in the future. The contract must be recognised in Entity A's statement of financial position at fair value, with changes in fair value recognised in profit or loss unless the contract qualifies as a hedging instrument in an effective hedge relationship.

4 Examples of contracts that meet the definition of a derivative

Some common examples of derivatives are set out in the following table.

Contract	Notional amount/ payment provision	Underlying	Initial investment	Future settlement
A futures contract to buy 1,000 barrels of crude oil at \$60 a barrel in one month and the contract is not entered into for the physical delivery of oil for the entity's normal business usage requirements	1,000 barrels of crude oil	Price of oil barrels	\$0	Yes – one month
A forward to buy \$500 for £300 in one year	\$500 (or £300)	£/\$ ex- change rate	£0	Yes – one year
An option to buy 80,000 shares in Entity B at CU75 per share in one month. The option costs CU1.1 million	80,000 shares	Entity B's share price	CU1.1 mil- lion	Yes – one month
A pay LIBOR + 25 basis points, receive fixed 5% interest rate swap over CU100 million, settled quarterly	CU100 million	LIBOR	CU0	Yes – quarterly
A pay floating £ on £100 million, receive floating US\$ on \$170 million currency swap, settled annually	£100 million or \$170 mil- lion	£/\$ ex- change rate	£0	Yes – an- nually
A contract to receive CU10 million if Entity A's share price increases by CU5 per share at the end of six months. The initial investment is CU1.0 million.	Payment provision	Entity A's share price	CU1.0 mil- lion	Yes – six months
A pay variable Euro amount based on the entity's sales, receive £ at a fixed exchange rate of €1.5:£1 based on the entity's sales, settled monthly	Variable notional	€/£ ex- change rate and sales volume	£0	Yes – monthly
A 5-year interest rate cap over CU100 million. The cap will pay if LIBOR increases beyond 8%. The premium paid to enter into the cap is CU1.0 million.	CU100 million	LIBOR	CU1.0 mil- lion	Yes – if, during the 5-year pe- riod, LIBOR exceeds 8%.



In its separate financial statements, Entity A will not derecognise its investment in Entity B. Although Entity A has transferred its contractual rights to receive cash flows under the Entity B shares in accordance with IAS 39:18(a), Entity A has not transferred substantially all the risks and rewards of ownership of the Entity B shares in accordance with IAS 39:20(b) because the consideration received for transferring the shares in Entity B are shares in Entity C, whose only asset is the investment in Entity B. Entity A's exposure to the risks and rewards of Entity B are unchanged. Because Entity A has not derecognised the shares in Entity B, the fair value gain previously recognised in other comprehensive income and accumulated in the AFS reserve in equity will not be reclassified to profit or loss at the date of the group reorganisation.

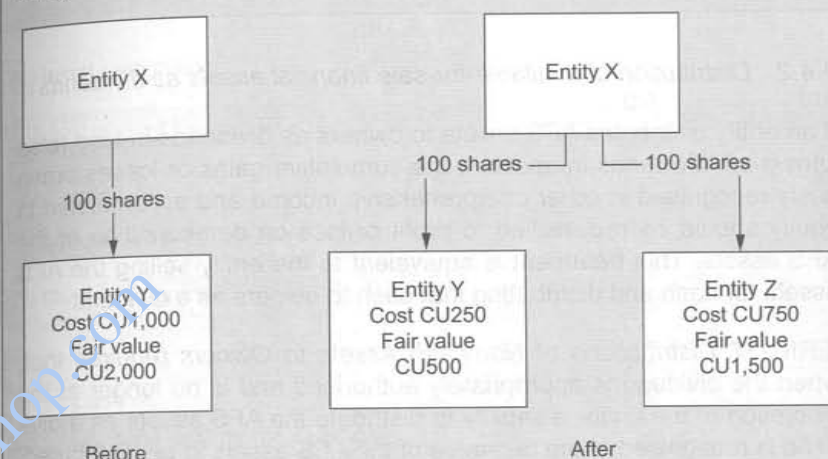
Example 3.1.4.1B

Available-for-sale equity instrument – group restructuring (2)

Entity X purchases 100 equity shares of Entity Y, a listed entity, for CU1,000 (i.e. at a price of CU10 per each share). The investment is classified as AFS. At Entity X's period end, 31 December 20X1, Entity Y's share price has increased to CU20 per share. As a result, the fair value of Entity X's holding has increased to CU2,000 with Entity X recognising a fair value gain on its AFS financial asset of CU1,000 in other comprehensive income.

On 1 January 20X2, Entity Y undergoes a corporate restructuring such that certain assets, liabilities and activities of Entity Y are transferred into a newly-created Entity Z whose shares will be distributed to the shareholders of Entity Y. The restructuring means that Entity Y will continue with certain core activities while Entity Z will undertake certain other activities that were previously undertaken

by Entity Y. As part of the demerger, shareholders in Entity Y will receive 1 new share in Entity Z (in addition to retaining their existing shares in Entity Y) for each share owned in Entity Y. After the reorganisation, Entity X will hold 100 shares in Entity Z in addition to the 100 shares it originally owned in Entity Y. Following the demerger, the assets and liabilities within Entity Y and Entity Z are those originally within Entity Y with no new assets or liabilities introduced. The shares in Entity Z are not listed. At the time of the demerger, the share price of Entity Y decreases to CU5 per share.



On receipt of the additional shares in Entity Z, the balance in the AFS reserve should not be reclassified to profit or loss because the original financial asset (shares of Entity Y) does not meet the requirements for derecognition. Entity X has not transferred the contractual rights to receive cash flows from the Entity Y shares nor has it retained the contractual rights to receive the cash flows to one or more recipients in an arrangement that meets the pass through conditions (IAS 39:18). At the point of the demerger, from the point of view of Entity X, some of the value of the Entity Y shares has been distributed to the newly-established Entity Z. In addition, Entity X's investment in Entity Y is not considered to be impaired because the reduction in fair value of Entity Y shares is only the result of a redistribution of assets to existing shareholders for nil consideration.

Although the gain of CU1,000 previously recognised in other comprehensive income should not be reclassified to profit or loss at the point of the demerger, Entity X will need to take the following actions.

- (i) Recognise the shares in Entities Y and Z at their fair values upon the demerger. The fair value of the Entity Y shares upon demerger will be equal to CU500 (fair value of CU5 multiplied by 100 shares). In the absence of a quoted market price, the fair value of the shares in Entity Z should be estimated using a valuation technique. In the event that the fair value of

At 31/12/X2, Entity E determines there is further impairment due to a further decline in recoverable cash flows. Entity E estimates the expected recoverable cash flows to be CU85 at maturity, instead of CU90 as was previously estimated. The fair value of the debt security is CU66. The difference between CU65 plus interest at the instrument's revised effective interest rate of 8.5% less its fair value of CU66 is a fair value loss of CU4.5 and is recognised initially in other comprehensive income and accumulated in the AFS reserve. In accordance with IAS 39:67, the amount initially recognised in other comprehensive income is reclassified from equity to profit or loss.

	CU	CU
Dr AFS asset	5.5	
Cr Interest income - profit or loss		5.5

To recognise interest income at the revised effective interest rate of 8.5%. The effective interest rate is applied to the instrument's opening fair value, not the prior period's amortised cost, because the effective interest rate was reset following the reclassification of the impairment loss from equity to profit or loss.

	CU	CU
Dr Other comprehensive income	4.5	
Cr AFS asset		4.5

To recognise the fair value loss directly in other comprehensive income.

	CU	CU
Dr Impairment loss - profit or loss	4.5	
Cr Other comprehensive income		4.5

To record the reclassification of the fair value loss initially recognised in other comprehensive income from equity to profit or loss as an impairment loss.

Entity E must revise the instrument's effective interest rate at 1/1/X3. The effective interest rate is the rate that discounts the estimated recoverable cash flows, CU85 in three years, to the instrument's carrying amount, CU66. The revised effective interest rate is 8.8%.

At 31/12/X3, there is objective evidence of a reversal of a credit event that has led to an increase in recoverability in cash flows. Entity E estimates the expected recoverable cash flows to be CU98 at maturity, instead of CU85 as was previously estimated. The fair value of the debt security is CU84. The difference between CU66 plus interest at the instrument's revised effective interest rate of 8.8% less its fair value of CU84 is a fair value gain of CU12.2 and is recognised in other comprehensive income and accumulated in the AFS reserve. In accordance with IAS 39:70, the fair value gain initially recognised in other comprehensive income is reclassified from equity to profit or loss as a reversal of an impairment loss.

	CU	CU
Dr AFS asset	5.8	
Cr Interest income - profit or loss		5.8

To recognise interest income at the revised effective interest rate of 8.8%. The effective interest rate is applied to the instrument's opening fair value, not the prior period's amortised cost, because the effective interest rate was reset following the reclassification of the impairment loss from equity to profit or loss.

	CU	CU
Dr AFS asset	12.2	
Cr Other comprehensive income		12.2

To recognise the fair value gain directly in other comprehensive income.

	CU	CU
Dr Other comprehensive income	12.2	
Cr Impairment reversal - profit or loss		12.2

To recognise the fair value gain initially recognised in other comprehensive income from equity to profit or loss as a reversal of an impairment loss.

Entity E must revise the instrument's effective interest rate at 1/1/X4. The effective interest rate is the rate that discounts the estimated recoverable cash flows, being CU98 in two years, to the instrument's carrying amount, being CU84. The revised effective interest rate is 8.0%.

At 31/12/X4, the estimated recoverable cash flows remain unchanged since the last reporting period end. The fair value of the debt security is CU95. The difference between CU84 plus interest at the instrument's revised effective interest rate of 8.0% less its fair value CU95 is a fair value gain of CU4.3 and is recognised in other comprehensive income in the AFS reserve.

	CU	CU
Dr AFS asset	6.7	
Cr Interest income - profit or loss		6.7

To recognise interest income at the revised effective interest rate of 8.0%. The effective interest rate is applied to the instrument's opening fair value, not the prior period's amortised cost, because the effective interest rate was reset following the reclassification of the fair value gain from equity to profit or loss upon reversal of the impairment loss.

Example 3.5.3**Level 1 principal (or most advantageous) market**

[IFRS 13:IE19 - IE22, Example 6]

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is CU26, transaction costs in that market are CU3 and the costs to transport the asset to that market are CU2 (i.e. the net amount that would be received is CU21). In Market B, the price that would be received is CU25, transaction costs in that market are CU1 and the costs to transport the asset to that market are CU2 (i.e. the net amount that would be received in Market B is CU22).

If Market A is the principal market for the asset (i.e. the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (CU24).

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e. the net amount that would be received in the respective markets).

Because the entity would maximise the net amount that would be received for the asset in Market B (CU22), the fair value of the asset would be measured using the price in that market (CU25), less transport costs (CU2), resulting in a fair value measurement of CU23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

IFRS 13 requires entities to ensure fair value measurements reflect characteristics specific to the asset or liability. Consequently, *if* location is a characteristic of an asset, an entity should consider transport costs when measuring the fair value of the asset.

4 Measuring the fair value of non-financial assets – highest and best use

The application of IFRS 13's requirements under this heading is limited to non-financial assets. This concept is not relevant for financial assets, liabilities or an entity's own equity instruments because those items do not have alternative uses as contemplated in IFRS 13. [IFRS 13:BC63] Consequently, this topic is not dealt with in this chapter but is discussed in **section 4 of chapter A6 of Volume A** of this manual.

5 Measuring the fair value of financial liabilities and an entity's own equity instruments

5.1 Measuring the fair value of liabilities and an entity's own equity instruments – general

5.1.1 General principles

The fair value of a financial liability or an entity's own equity instruments (e.g. an equity share issued as part of the consideration in a business combination) is measured based on the assumption that the liability or equity instrument is transferred to a market participant at the measurement date. [IFRS 13:34]

For a financial liability, it is assumed that the liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. It would not be settled with the counterparty or otherwise extinguished on the measurement date. [IFRS 13:34(a)]

IFRS 13 is clear that the fair value of a liability is based on a transfer amount, i.e. the amount the reporting entity would need to pay a third party to take on the obligation, and that obligation remains outstanding and contractually unaltered before and after transfer. Fair value is therefore *not* based on the premise of settling the liability with the counterparty at the measurement date.

For an entity's own equity instrument, it is assumed that the equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date. [IFRS 13:34(b)]

IFRS 13 requires that the fair value measurement be based on an assumed transfer to a market participant even if an entity does not intend to transfer its liability or own equity instrument to a third party (e.g. because the entity has advantages relative to the market that make it more beneficial for the entity to fulfil the liability using its own internal resources) or it is unable to do so (e.g. because the counterparty would not permit the liability to be transferred to another party). [IFRS 13:BC81 & 82]

Even when there is no observable market to provide pricing information about the transfer of a liability or an entity's own equity instruments (e.g. because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (see **section 5.1.2**). [IFRS 13:35]

evidence of fair value. [IFRS 13:77] Quoted prices for the identical asset or liability are regarded as Level 1 inputs within the fair value hierarchy (see **section 10.2.1**). When a quoted price exists for an identical asset or liability, it should be used without adjustment, except in the circumstances described at **section 10.2.1**. [IFRS 13:77] When a quoted price for an asset or a liability exists in multiple active markets, it will be necessary to identify the market and price which represents fair value for the specific facts and circumstances.

Valuation techniques consistent with the market approach often use market multiples derived from a set of comparable assets or liabilities. A range of multiples may be derived, with a different multiple for each comparable asset or liability. The selection of the appropriate multiple within the range requires the exercise of judgement – with appropriate consideration of the qualitative and quantitative factors specific to the measurement. [IFRS 13:B6]

Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities. [IFRS 13:B7]

8.5 Cost approach

The 'cost approach' is defined as "[a] valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)". [IFRS 13:Appendix A] This method is often used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities. [IFRS 13:B9]

The cost approach is not generally used when measuring the fair value of financial instruments. The cost approach considers the cost to replace the service capacity of an asset, a concept that is not relevant in the context of financial instruments.

8.6 Income approach

8.6.1 Income approach – general

The 'income approach' is defined as "[v]aluation techniques that convert future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts". [IFRS 13:Appendix A]

Income approaches that are used for measuring the fair value of financial instruments include, for example:

[IFRS 13:B11]

- present value techniques (see below); and
- option pricing models, such as Black-Scholes-Merton formula or a binomial model (i.e. a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option.

IFRS 13 describes two types of present value techniques:

- the discount rate adjustment technique (see **section 8.6.4.2**) and
- the expected cash flow (expected present value) technique (see **section 8.6.4.2**).

IFRS 13 does not specifically require that one of these present value techniques be used. The most appropriate present value technique for the measurement of fair value in a particular scenario will depend on the facts and circumstances specific to the asset or liability being measured (e.g. whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data. [IFRS 13:B12]

8.6.2 Components of a present value measurement

Present value is a tool used to link future amounts (e.g. cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all of the following elements from the perspective of market participants at the measurement date:

[IFRS 13:B13]

- an estimate of future cash flows for the asset or liability being measured;
- expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows;
- the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (i.e. a risk-free interest rate);
- the price for bearing the uncertainty inherent in the cash flows (i.e. a risk premium);
- other factors that market participants would take into account in the circumstances;
- for a liability, the non-performance risk relating to that liability, including the obligor's own credit risk.

4 January 20X3

Dr	Payable	CU1,010
Dr	Trading loss	CU2
Cr	Note Receivable A	CU1,000
Cr	Bond B	CU2
Cr	Realisation gain	CU10

In January 2007, the IFRIC (now the IFRS Interpretations Committee) issued a rejection notice on accounting for short sales of securities when the terms of the short sales require delivery of the securities within the time frame established generally by regulation or convention in the marketplace concerned. A fixed price commitment between trade date and settlement date of a short sale contract meets the definition of a derivative. Because IAS 39:AG55 and AG56 only permit a choice of trade or settlement date accounting for recognition and derecognition of financial assets traded under regular way purchases and regular way sales of long positions, the Standard would require a short sale to be recognised as a derivative until delivery of the security. The IFRIC acknowledged that an interpretation that is applied in practice is that entities choose trade date or settlement date accounting for short sales rather than treat a short sale as a derivative. Specifically, practice recognises the short sales as financial liabilities at fair value with changes in fair value recognised in profit or loss. Under the industry practice, the same profit or loss amount is recognised as would have been recognised if short sales of securities were accounted for as derivatives but the securities are presented differently in the statement of financial position. The IFRIC acknowledged that requiring entities to account for the short positions as derivatives may create considerable practical problems for entities' accounting systems and controls with little, if any, improvement to the quality of the financial information presented. For these reasons and because there is little diversity in practice, the IFRIC decided not to take the issue onto its agenda.

IAS 39 does not provide guidance on whether the trade date exemption can be applied if an entity delivers a financial instrument under a regular way contract but the delivery date is delayed, and the asset is delivered outside the normal convention for that type of contract. For example, a contract has a delivery date of t+3 days, but there is a delay in delivery and the instrument is delivered at t+5. A delay should not preclude use of the regular way exemption if the delay is outside the control of the entity.

3 Derecognition of financial assets

A financial asset is derecognised (i.e. removed from the statement of financial position), when, and only when, either the contractual rights to the asset's cash flows expire, or the asset is transferred and the transfer qualifies for derecognition.

The decision as to whether a transfer qualifies for derecognition is made by applying a combination of risks and rewards and control tests. The risks and rewards tests seek to establish whether, having transferred a financial asset, the entity continues to be exposed to the risks of ownership of that asset and/or continues to enjoy the benefits that it generates. The control tests are designed with a view to understanding which entity controls the asset (i.e. which entity can direct how the benefits of that asset are realised).

The use of both types of tests is often criticised for being a mix of two accounting models that can create confusion in application. IAS 39 addresses this criticism by providing a clear hierarchy for application of the two sets of tests: risks and rewards tests are applied first, with the control tests used only when the entity has neither transferred substantially all the risks and rewards of the asset nor retained them.

Inherent in the IAS 39 derecognition model is the notion of 'stickiness', i.e. it is more difficult to remove an asset from an entity's statement of financial position than it is to recognise that asset in the first place. Derecognition cannot be achieved by merely transferring the legal title to a financial asset to another party. The substance of the arrangement must be assessed in order to determine whether an entity has transferred the economic exposure associated with the rights inherent in the asset (i.e. its risks and rewards) and, in some cases, control of those rights.

3.1 The IAS 39 derecognition decision tree

IAS 39 provides a decision tree, reproduced below, that clarifies the hierarchy for application of the derecognition tests.

The difference in the present value calculations of the new debt in scenario 1 and new debt in scenario 2 arises because scenario 2 has an additional interest flow at current market rates and deferral of the principal by a year.

Scenario 3 – same as Scenario 2 but the yield curve is not flat in 20Y0

The yield curve remains flat until 20X9 as in scenario 2 but then falls in 20Y0 and beyond. The 6-year yield curve at 1/1/X5 (i.e. until 20Y0) is 4.85% compared to 5% in scenario 2.

Period	Cash flows New debt 4.85% x CU121.65 million	Discount factor at 10%	Present value New debt CU million
20X5	5.90	0.909	5.37
20X6	5.90	0.826	4.88
20X7	5.90	0.751	4.43
20X8	5.90	0.683	4.03
20X9	5.90	0.621	3.67
20Y0	127.55	0.564	71.99
			94.37

The difference between the present value of the existing and new debt discounted at the original effective interest rate is CU5.63 million (5.63%). Because the difference is within the '10% test', the existing debt will not be derecognised.

The difference in the present value calculations of the new debt in scenario 2 and the new debt in scenario 3 has increased because, even though both scenarios 2 and 3 have the same maturity and notional amount, the effective interest rate on the new debt differs. Because the additional contractual interest flows on the new debt extending beyond the term of the existing debt are locking in a lower interest rate environment, this exaggerates the difference in present value calculations between the existing and new debt. If the term was to extend further, and/or interest rates were even lower, then the present value of the new debt may be greater than 10% of the existing debt which would result in derecognition of the existing debt and recognition of the new debt at fair value in accordance with IAS 39:43.

It is possible in a scenario of higher interest rates that when the term of the debt is extended beyond the term of the existing date that the '10% test' is breached and derecognition of the existing debt is required.

Example 4.1C

Debt modification: change in basis of interest

Entity C issued 5 year debt at a fixed rate of interest of 7 per cent on 1/1/X3 at par for €100 million. The debt is measured at amortised cost. On 1/1/X5, the debt is exchanged with the original lender for a new debt instrument that has floating rate, LIBOR, for the remaining three year term that is set annually in

advance. The current LIBOR rate is 4 per cent and the yield curve is flat for the next three years. Because interest rates have fallen from 7 per cent to 4 per cent, and credit spreads have remained unchanged, the fair value of the debt has risen above par. In order to put the current debt holders in the same economic position following the debt exchange, the issuer agrees to increase the notional amount of the new debt to €108.70 million.

Entity C applies the 10 per cent per cent test to the debt exchange. Entity C sums the cash flows on the new debt discounted by the original effective interest rate of 7 per cent:

- €4.3 million for three years (4 per cent x €108.70 million, as the LIBOR curve is flat at the date of exchange); and
- the principal of €108.70 million payable at the end of year 3.

The net present value of the new debt discounted using the original effective interest rate is €100 million.

Entity C then sums the remaining cash flows on the old debt of €7 million for three years and a principal of €100 million discounted by the original effective interest rate of 7 per cent, which is also €100 million.

The net present value of the old debt and modified debt discounted by the original effective interest rate are the same, i.e. €100 million. Entity C therefore does not derecognise the old debt.

For the remaining three years, Entity C applies a modified effective interest rate that consists of current LIBOR for the period plus the amortisation from €100 million to €108.70 million based on a constant yield. The internal rate of return for the amortisation is 2.82 per cent per year and represents the current discount to par on the modified debt. This is the same accounting as for a discounted floating rate bond. The amortisation for the remaining three years is as follows.

Period ending 31/12/X5: $2.82\% \times €100 \text{ million} = €2.82 \text{ million}$

Period ending 31/12/X6: $2.82\% \times €102.82 \text{ million} = €2.90 \text{ million}$

Period ending 31/12/X7: $2.82\% \times €105.72 \text{ million} = €2.98 \text{ million}$

At 31/12/X5, Entity C accrues both LIBOR for the period plus the amortisation less the LIBOR interest paid in the period. Because LIBOR is set in advance, the interest payment is €4.3 million, being 4 per cent on the modified notional of the debt of €108.70 million. The period end carrying amount is therefore €102.82 million (being €100 million + €4.3 million + €2.82 million – €4.3 million).

For illustrative purposes, the forecast LIBOR interest rate is assumed to equal to the spot LIBOR rate at the date of modification.

The period end carrying amounts for 31/12/X6 and 31/12/X7 are as follows.

Example 3.2.1**Foreign currency risk on intragroup loans**

A Sterling functional currency parent makes a 5-year US dollar denominated fixed rate interest-bearing loan to its US dollar functional currency subsidiary. The loan does not form part of the parent's investment in the US subsidiary. In the parent's separate financial statements, this loan will need to be remeasured at the end of each reporting period in accordance with IAS 21, and will give rise to an exchange gain or loss. However, there will be no corresponding foreign currency gain or loss in the subsidiary's financial statements because the loan is denominated in its functional currency.

In the consolidated financial statements, an exchange gain or loss on the intragroup balance will not be eliminated, but will be reported in profit or loss as an exchange gain or loss on a monetary item.

The parent hedges the foreign currency risk of both interest and principal by entering into a cross-currency swap with a counterparty outside of the group under which the parent receives Sterling fixed and pays US dollar fixed on the interest payment dates of the intragroup loan with a gross exchange of US dollar for Sterling at inception and Sterling for US dollar in five years' time equivalent to the US dollar notional amount of the loan.

The loan may be designated as a hedged item in both the parent's separate financial statements and in the consolidated financial statements. In the parent's separate financial statements, the cross-currency swap is expected to be fully effective as a cash flow hedge of the US dollar foreign currency risk arising on the interest and principal of the loan.

However, in the consolidated financial statements, the cross-currency swap will be less effective because the impact on profit or loss in the parent's separate financial statements and the consolidated financial statements differs and, therefore, the hedged risk differs. In the parent's separate financial statements, the impact on profit or loss will be the foreign currency risk associated with both interest and principal cash flows denominated in a foreign currency. In the consolidated financial statements, the hedged risk differs because part of the risk that resides in the parent's separate financial statements does not survive consolidation. The parent's interest income (measured at spot or an average rate) in the parent's separate financial statements and the subsidiary's interest expense (measured at spot or an average rate) in the subsidiary's financial statements should eliminate in the consolidated financial statements. Because the hedged risk differs, the hypothetical derivative will differ, and its fair value will differ from the actual derivative entered into by the parent (for detail on the hypothetical derivative method see 4.4.1 in chapter C10). The difference in the actual and hypothetical derivative will need to be determined as part of the prospective hedge effectiveness assessment to establish whether the hedge is expected to be highly effective.

3.2.2 Foreign currency risk of a highly probable forecast intragroup transaction

Foreign currency risk of a highly probable intragroup transaction qualifies as a hedged item in the consolidated financial statements provided that the following two conditions are met:

[IAS 39:80]

- the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction; and
- the foreign currency risk will affect consolidated profit or loss.

The entity can be a parent, subsidiary, associate, joint venture or branch. [IAS 39:AG99A]

In many cases, the forecast intragroup transaction does not affect consolidated profit or loss, as is the case for royalty payments, interest payments or management charges, unless there is a related external transaction. Such transactions for which there are no related external transactions do not qualify as hedged items. By contrast, in the case of forecast sales or purchases of inventories between members of the same group when there is an onward sale of the inventories to a party external to the group, there will be an effect on consolidated profit or loss (see **example 3.2.2B**). Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operation will affect consolidated profit or loss. This is because the amount initially recognised by the purchasing entity for the plant and equipment, and thus depreciated through its profit or loss, will vary with movements in foreign currency prior to the plant and equipment being recognised when the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity (see **example 3.2.2A**). [IAS 39:AG99A]

If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss recognised in other comprehensive income is reclassified from equity to profit or loss in the same period or periods during which the foreign currency risk of the external hedged transaction affects consolidated profit or loss. [IAS 39:AG99B]

Example 3.2.2A**Hedging foreign currency risk of intragroup transactions (1)**

Entity A (a Sterling functional currency entity) is expecting, with a high degree of probability, to purchase a machine from Entity B (a Euro functional currency entity) for €10m in 1 year's time. Entity A and Entity B are part of the same group and Entity A will use the machine in its production process to make goods for external sale. The cost of the machine will be capitalised and depreciated over

IAS 39:75 states that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. In practice, this prohibition is intended to preclude an entity splitting the fair value of a derivative (other than a fully proportionate share of the entire derivative) and only designating the fair value attributable to a portion of the time period during which it remains outstanding. For example, it would not be permissible to designate the portion of an interest rate swap relating to the next 5 years, when the instrument has a maturity in seven years, as a cash flow hedge of variability in interest rate risk on a debt instrument for the next five years.

The concept of being able to hedge on a partial term basis is driven by the relationship between spot rates and forward rates for any given yield curve. The spot rate today, and the anticipated spot rates in the future periods are used to construct the yield curve today. The yield curve is a reflection of the anticipated rates in the future based on an assessment today.

By dissecting a longer dated current yield curve into 'mini-curves', it is possible to isolate the fair value movements of a longer dated instrument due to movements in the shorter part of the yield curve.

Example 2.2B

Partial term hedging fixed rate debt (2)

Facts as in example 2.2A.

At issuance of the bond, Entity Q can obtain the yield curve for the stated maturity of the whole instrument, in this case, a ten year yield curve.

The ten year yield curve can be dissected into mini-yield curves.

- Spot interest rate today (t_0) for interest due in a year (t_1).
- Expected spot interest rate starting in a year's time (t_1) due at the end of that year (t_2) [one-year forward rate starting in a year].
- Expected spot interest rate starting at year 2 (t_2) due at the end of that year (t_3) [one-year forward rate starting in year 2].

If Entity Q wishes to fair value hedge for movements in the interest rate curve that matures in six years' time, it only has to consider movements in the first six years of the ten year yield curve in computing the change in the fair value of the hedged item. Because a six-year interest rate swap is priced off the six-year yield curve, in order to demonstrate hedge effectiveness, the entity discounts the six years of cash flows using the spot rates at the date hedge effectiveness is measured.

In one year's time, Entity Q will compare the change in the fair value of the derivative (with five years remaining) with the change in fair value of the hedged selected cash flows on the bond as well as the principal payment due at maturity to the extent affected by changes in the spot yield curve for the next five years, and so on.

An entity is permitted to partial term cash flow hedge a financial instrument because IAS 39 provides greater flexibility in designating portions when hedging financial instruments compared to hedging non-financial items. For hedges of non-financial items, an entity is limited to hedging all foreign currency risk or all risks in their entirety (see 3.9 in chapter C9). An entity that has a derivative with a maturity that is shorter than the timing of the cash flow exposure of the non-financial hedged item must designate all of the derivative (with the exception of the forward points in a forward contract or time value in an option) as hedging all foreign currency risk or all risks in their entirety up to the timing of the cash flow of the hedged item. Because the hedged item is non-financial, the entity cannot designate a derivative for part of the time period until the forecast transaction occurs.

For example, a derivative that matures in nine months' time could be perfectly effective as a hedge of a forecast sale or purchase of a non-financial item that is highly probable of occurring in nine months' time. If the transaction is highly probable of occurring in ten months' time, the same derivative could not be designated as a hedge of the nine month portion of time until the transaction is expected to occur as a non-financial item cannot be partial-term hedged.

2.3 Financial instruments subject to prepayment

An instrument that contains an embedded prepayment option may still be designated as a hedged item. However, the effect of the prepayment option should be considered when designating the hedged item and assessing whether the hedge relationship will be highly effective.

If the entire asset or liability is designated as being hedged, for the hedging instrument to be highly effective it may have to include an equivalent option that coincides with the prepayment option in the hedged item. Inclusion of such an option in the hedging instrument ensures that fair value of the hedging instrument is as sensitive as the hedged item to the designated hedged risk.

Alternatively, the hedging relationship could be designated for just a portion of the term of the instrument prior to the prepayment option being capable of being exercised, provided that the hedging instrument is designated for the entirety of its term. For example, if a debt instrument can be prepaid by the issuer after Year five, the investor may wish to hedge the debt instrument for a period before the prepayment option can be exercised, i.e. for the first five years only.

An investor in a prepayable asset may decide to hedge cash flows in the period in which the prepayment option is exercisable (or in the period after the date on which the option can be exercised). In order to demonstrate that the hedging instrument is expected to be highly effective in the period, the cash flows must be highly probable. For example, cash flows in the period

Entity P formally designates the hedging relationship and meets all of the hedge accounting criteria including the prospective effectiveness test.

To measure the effectiveness of the hedging relationship, Entity P compares the change in fair value of the hedging pay variable OIS, receive 5 per cent fixed interest rate swap to the changes in value of the 'hypothetical derivative', i.e. the derivative that would result in perfect hedge effectiveness for a hedge of the loan. In this instance, the hypothetical derivative is a pay 3-month EURIBOR, receive 4.9 per cent interest rate swap with quarterly payment dates. The 4.9 per cent fixed rate for the remaining 3 years is the market EURIBOR swap rate.

Note that the fixed rates on the actual hedging swap and the hypothetical swap differ because they are priced off different yield curves (i.e. OIS versus EURIBOR).

The hypothetical derivative method can be used universally for all cash flow hedge relationships where a derivative is used as a hedging instrument. This method would not be appropriate in the case of hedging foreign currency risk with a non-derivative instrument because clearly the hedging instrument is not a derivative.

The other method discussed below, the 'change in fair value' method, will have greater applicability when determining hedge effectiveness on variable rate financial assets and liabilities and the forecast issuance of fixed rate debt.

The hypothetical derivative method is referred to as Method B in IAS 39:IG.F.5.5.

Hedge ineffectiveness will arise if the timing or amount of a forecast transaction changes because the fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge will not equal the cumulative fair value on the hedging instrument from inception of the hedge.

Determining the degree of hedge ineffectiveness when the timing or amount of forecast transactions change can be a complex exercise. If an entity applies the hypothetical derivative method in assessing hedge effectiveness then this method will also be reapplied when the timing or amount of the hedged item changes. For example, if the timing of the cash flows on the derivative hedging instrument and the hedged item coincide at inception of the hedge and the derivative is deemed to be the hypothetical derivative, then only to the extent that the cash flows continue to coincide will the hedge be fully effective. If the timing of the forecast cash flows changes during the life of the hedge relationship then a new hypothetical derivative needs to be determined which will be equal to the hypothetical derivative that the entity would have determined when they entered into the hedge accounting relationship that reflects the revised timing of the forecast cash flows. Put another way, the revised hypothetical derivative is the one the

entity would have determined had it been able to foresee the revised timing of the forecast cash flows. A comparison of the cumulative gain/loss on the actual hedging instrument and the revised hypothetical derivative will determine the degree of hedge effectiveness and the amount of hedge ineffectiveness to be measured under IAS 39:96(a).

Further examples

A detailed illustration of the application of the hypothetical derivative method for a cash flow hedge of interest rate risk on a forecast issuance of debt where the timing of the forecast cash flows changes is included in 3.15 of chapter C11.

4.4.2 The 'change in fair value' method

The change in fair value method requires a computation of the change in fair value of the cash flows that would have been achieved had the variable cash flow exposure been a fixed cash exposure. For example, if an entity is hedging variable rate debt, the change in fair value method will compare the cumulative changes in the present value of the fixed cash flows that would have been achieved at inception, discounted at the new interest rate, with the fair value of the derivative that is designated as the hedging instrument.

In the instance that an entity is hedging the variable interest rate risk of a variable rate financial asset or liability, the fair value of the hedged item is generally equal to its par amount, because it is not sensitive to fair value movement when interest rates change. This method overcomes this problem by discounting the cash flows that would have been achieved had the instrument been fixed from inception.

Example 4.4.2

Change in fair value method

Facts as in example 4.4.1.

Applying the change in fair value method, Entity P will determine the fixed rate that would have been achieved on 3-year fixed rate loan that is priced off EURIBOR.

The entity will discount the fixed cash flows that would have been achieved on a 3 year fixed rate loan at the new EURIBOR interest rate curve. The cumulative present value of these cash flows will be compared with the fair value of the interest rate swap that is priced off the overnight indexed swap rate. The change in fair value method will recognise ineffectiveness due to the different basis of interest rates between the hedging instrument and the hedged item.

The change in fair value method is referred to as Method A in IAS 39:IG.F.5.5.

Potential sources of ineffectiveness include non-occurrence of the forecast transaction and changes in the date of sale. Any ineffectiveness will be recognised in profit or loss.

On 30 June 20X2, the fair value of the currency forward is negative £100,000 because the forward rate has changed, reflecting the fact that the Euro has strengthened against Sterling.

On 31 December 20X2, the transaction occurred as expected. The fair value of the forward is negative £111,111 because the Euro continued to strengthen against Sterling.

The required entries are as follows.

4 January 20X2

No entries are required because the forward was entered into 'on-market' and therefore had a fair value of zero at inception. Normally, there will be margin to be posted, associated with trading on a currency exchange, but this has been ignored for illustration purposes only. There may also be fees if the foreign exchange contract is an over-the-counter (OTC) transaction.

30 June 20X2

	£	£
Dr Other comprehensive income	100,000	
Cr Forward		100,000

To recognise the forward contract at fair value, reflecting that the forward contract is fully effective in hedging the forward rate of the forecast transaction.

31 December 20X2

	£	£
Dr Other comprehensive income	11,111	
Cr Forward		11,111

To recognise the change in fair value of the forward contract. The forward contract remains fully effective in hedging the forward rate of the forecast transaction.

	£	£
Dr Forward	111,111	
Cr Cash		111,111

To recognise the cash paid in settling the forward contract.

	£	£
Dr Cash	2,777,778	
Cr Sales		2,777,778

To recognise the receipt of €4m from the sale of confectionery translated at the spot rate of €1.44:£.

	£	£
Dr Sales	111,111	
Cr Other comprehensive income		111,111

To recognise the cumulative effective portion of the hedging instrument included in other comprehensive income that is reclassified from equity to profit or loss when the sale occurs.

The net effect of reclassifying the amount from equity to profit or loss when the sale occurred is equivalent to recognising in profit or loss the sale translated at the contracted rate inherent in the forward (i.e. €4,000,000/€1.5:£).

Translation of sale at spot rate at 31 December 20X2	£2,777,778
Reclassified from equity to profit or loss at 31 December 20X2	(£111,111)
	<u>£2,666,667</u>

Note: for the purposes of illustration only, the forward contract has not been discounted.

3.3 Basis adjusting the acquisition of a non-financial item

The following example illustrates the entries for a cash flow hedge of a non-financial item where a policy of basis adjustment is adopted.

Example 3.3

Basis adjusting forecast acquisition of a non-financial item

On 4 January 20X2, Entity D has a forecast purchase of 100,000 kg of cocoa on or about 31 December 20X2 from a Brazilian supplier, Entity B. Entity D has a Sterling functional currency, and Entity B has a US dollar functional currency. On 4 January 20X2, Entity D designates the cash flow of the forecast purchase as a hedged item and enters into a currency forward to buy US\$180,000 based on the forecast payment (100,000 kg at US\$1.8 per kg). The forward contract locks in the value of the US dollar amount to be paid at a rate of US\$1.8:£1. At inception of the hedge, the derivative is on-market (i.e. fair value is zero). The terms of the currency forward and the forecast purchase match each other, and the entity designates the forward foreign exchange risk as the hedged risk.

Potential sources of ineffectiveness include non-occurrence of the forecast transaction and changes in the date of purchase. Any ineffectiveness will be recognised in profit or loss.

On 30 June 20X2, the fair value of the currency forward is positive £10,000 because the forward rate has changed, reflecting the fact that the US dollar has strengthened against Sterling.

	£	£
Dr Other comprehensive income (cash flow hedging reserve)	456	
Dr Interest expense (profit or loss)	1,259	
Cr Retranslation gain (profit or loss)		1,715

To recognise the reclassification of the effective portion of CCS from equity to profit or loss.

	£	£
Dr Debt	2,353	
Cr Cash		2,353

To recognise the payment of interest on US\$ debt converted at the spot rate.

Similar entries would be recorded for the remaining term of the hedging relationship (20X3 -20X6). Interest expense totalling £20,676 is recognised over the term of the hedging instrument and net profit or loss impact is as if Entity A had issued Sterling LIBOR + 106bp debt at inception. The CCS is fair valued at the end of each reporting period (after interest payments have been made because all interest payments are deemed to have taken place on last day of year which is also the reset date for the swap) with amounts recognised in other comprehensive income (and taken to the cash flow hedge reserve in equity). The amount of the CCS is reclassified from equity to profit or loss at the end of each reporting period to offset the amount recognised for retranslation of the US\$ debt to Sterling spot rates and finally to offset the translation loss on repayment of principal at maturity of the debt.

3.8 Cash flow hedging foreign currency risk of fixed rate debt

The following example illustrates the entries for a cash flow hedge of foreign currency risk on fixed rate debt using a cross-currency interest rate swap.

Example 3.8

Cash flow hedging the foreign currency risk of issued fixed rate debt with a cross-currency swap that receives fixed foreign currency and pays fixed functional currency

On 1 January 20X2, Entity A, a Sterling functional currency entity, issues a 4 per cent annual fixed coupon debt instrument denominated in US dollars (US\$) with a notional amount of US\$100,000, that will mature on 31 December 20X6 at par, and therefore the effective interest rate is 4 per cent. At 1 January 20X2,

the spot rate on the US\$/£ is 1.75/1 so the notional of US\$100,000 is equivalent to £57,143. On 1 January 20X2, Entity A also enters into a cross-currency swap ('CCS') to exchange interest payments and principal at redemption on the same terms as the above debt and designates the CCS as a cash flow hedge of the variability of the Sterling functional currency equivalent cash flows on the debt. The terms are such that on each interest payment date (assume interest is paid annually on 31 December each year for both the debt and the cross-currency swap), Entity A will receive 4 per cent on a notional of US\$100,000 and pay 6 per cent based on a notional of £57,143. Because the currency, notional, coupons and interest payment dates match on both the cross-currency swap and the debt, Entity A expects that the hedge relationship will be highly effective.

Date	Spot rate US\$/£	Carrying amount of US\$ debt in £ after interest settlements	Cross-currency swap fair value £ after interest settlements	Net cash settlement on the swap translated at spot rate £ (£ 6% – US\$ 4%)	Net interest on the swap translated at average rate £ (£ 6% – US\$ 4%)
1/1/X2	1.75	57,143	0	0	0
31/12/X2	1.7	58,824	2,560	1,076	1,110
31/12/X3	1.6	62,500	7,723	928	1,004
31/12/X4	1.5	66,667	9,513	762	848
31/12/X5	1.8	55,556	(1,452)	1,207	1,004
31/12/X6	1.7	58,824	1,681	1,076	1,143

Entity A's documentation of the hedge is as follows.

Risk management objective and nature of risk being hedged	Cash flow hedge of the variability in functional currency equivalent cash flows associated with the foreign currency debt due to changes in forward rates.
Date of designation	1 January 20X2
Hedging instrument	Cross-currency swap to receive US\$ 4 per cent, pay £6 per cent interest annually based on notional of US\$100,000 over the term of the instrument and exchange US\$100,000 for £57,143 at maturity.
Hedged item	Changes in the £ functional currency equivalent cash flows relating to the changes in foreign currency forward rates related to the debt and to the annual interest payments.

In addition, an entity should disclose:

[IFRS 7:11]

- (a) the methods used to comply with the requirements in (c) above; and
- (b) if the entity believes that the disclosure it has given to comply with the requirements in (c) above does not faithfully represent the change in the fair value of the financial asset attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

The maximum exposure to credit risk for a derivative is its carrying amount. [IFRS 7:BC50] The Standard is not clear whether the maximum exposure to credit risk for loans and receivables can also equal the carrying amount, which is fair value, when an entity designates those assets as at FVTPL.

The information to be disclosed regarding the maximum exposure to credit risk depends on whether exposure to credit loss is viewed as a 'cash loss' or a loss that will be recognised in the statement of comprehensive income. Credit risk is defined as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation". [IFRS 7:Appendix A] If the maximum exposure to credit risk is viewed as a cash loss, then the amount to be disclosed would be the amount owed (e.g. if the fair value of the debt is CU70 and the amount owed is CU100, then the maximum 'cash loss' is CU100). If, however, the maximum exposure to credit risk is viewed as a loss that will be recognised in the statement of comprehensive income, then the carrying amount (i.e. the fair value of the assets in this instance) will be the amount that is required to be disclosed.

While either approach is supportable, an entity must apply a consistent policy in disclosing the maximum exposure to credit risk for loans and receivables designated as at FVTPL.

Example 4.1.2

Entity A acquired at the beginning of the prior period a portfolio of 9 per cent non-amortising unsecured long-term loans with five years remaining to maturity. The loans meet the definition of loans and receivables. Entity A chooses to designate the loans as at FVTPL. The loans were acquired for CU905 million when the effective interest rate was 10 per cent, consisting of 8 per cent interest rate and 2 per cent credit spread. The par amount of the loans is CU1 billion. At the date of acquisition, Entity A entered into a credit default swap with a financial institution to provide credit protection on the loans with a notional of CU500 million. The credit default swap had an initial fair value of zero and remains outstanding at the end of the reporting period.

At the end of the reporting period:

- the fair value of the loans is CU896 million (prior year: CU852 million);
- interest rates for the remaining maturity are 8 per cent and credit spreads are 2.5 per cent (prior year: 9 per cent and 3 per cent respectively); and
- the fair value of the credit default swap is CU35 million (prior year: CU46 million).

The items to be disclosed in accordance with IFRS 7:9 are as follows.

(a) Maximum exposure to credit risk at the end of the reporting period

If maximum exposure to credit risk is viewed as being loss that will be recognised in the statement of comprehensive income, then the amount to be disclosed would be CU896 million (prior year: CU852 million), being the fair value of the loans at the end of the reporting period.

If the maximum exposure to credit risk is viewed as being equal to a cash loss, then the amount to be disclosed would be CU1 billion (prior year: CU1 billion), being the amount owed by the borrower at the end of the reporting period.

Note: the entity cannot offset the loans and the credit default swaps because there is no right of set-off and the financial instruments are with a different counterparty.

(b) Amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk

The credit default swap provides credit protection for half of the loans. On a fair value basis, the maximum protection is equivalent to 56 per cent (prior year: 59 per cent) and on a cash loss basis is equivalent to 50 per cent (prior year: 50 per cent).

(c) Amount of change, during the period and cumulatively, in the fair value of loans that is attributable to changes in credit risk

The cumulative change in fair value due to credit risk of the loans is a CU16 million loss (prior year: CU27 million loss). The change in fair value due to credit risk for the period is a CU11 million gain.

(d) Change in the fair value of any related credit derivatives

The cumulative change in fair value of the credit default swap is a CU35 million gain (prior year: CU46 million gain). The change in fair value of the credit default swap for the period is a CU11 million loss.

4.1.3 Financial liabilities at FVTPL

When an entity has designated financial liabilities as at FVTPL, IFRS 7:10 requires extensive disclosures and, in particular, disclosures about credit-worthiness. These disclosures have been included to help alleviate concerns that users may misinterpret the profit or loss effects of changes in the issuer's credit risk. The perceived 'anomaly' of recognising gains in profit or loss when the entity's credit rating deteriorates should be mitigated by disclosure of the changes in fair value attributable to credit risk.

4.2.3 Fee income and expense

IFRS 7 requires disclosure of fee income and expense, other than those amounts that are included in determining the effective interest rate, that arise from financial assets or financial liabilities that are not at fair value through profit or loss. [IFRS 7:20(c)(i)] Such items include:

[IAS 39:AG8C]

- (a) fees charged for servicing a loan;
- (b) commitment fees to originate a loan when the loan commitment is outside the scope of IAS 39 and it is unlikely that a specific lending arrangement will be entered into; and
- (c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

In addition, disclosure is required of trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions. [IFRS 7:20(c)(ii)] This information indicates the level of such activities and helps users to estimate possible future income of the entity. [IFRS 7:BC35]

The extent of disclosure required under IFRS 7:20 (c)(i) will depend on the type of business. Lenders are likely to be subject to a significant level of disclosure. Examples of fees will include annual membership fee income for credit cards (payable irrespective of whether the card holder uses the card); interchange fees received each time a credit card is used; merchant service commission fees for processing debit and credit transactions; fees for withdrawing cash on a credit card; overdraft fee income received irrespective of whether the borrower utilises the overdraft facility etc. Many fees with respect to specific borrowing and lending will meet the definition of a transaction cost and, therefore, will form part of the effective interest rate (and, thereby, will not be subject to separate disclosure).

4.2.4 Interest on impaired financial assets

IFRS 7 requires interest income on impaired financial assets to be disclosed. The interest income is determined using the rate of interest used to discount the future cash flows for the purposes of measuring the impairment loss. [IFRS 7:20(d)]

The requirements of IFRS 7:20(d) merit careful consideration in the context of financial assets impaired on a portfolio basis (see 5.2.4 in chapter C6).

If a loan within a portfolio is not individually assessed as being impaired, but is impaired on a collective basis prior to the loan being individually identified, and all cash flows with respect to the impaired loan are not recoverable, then no interest income will be disclosed in accordance with IFRS 7:20(d). In such circumstances, following the impairment loss, there is no interest income on the loan as the loan is fully impaired (because no cash flows are expected).

In contrast, the entity may determine that an impairment loss is required in circumstances where some, but not all, cash flows on unidentified loans are not recoverable. For disclosure of interest income on impaired financial assets, the entity should use the effective interest rate that was used to discount the cash flows in determining the impairment loss. Even though the loans that are impaired are not yet identified, the entity is still required to disclose the amount of interest on the portfolio of loans that is impaired.

If an impairment loss is recognised in the period but is reversed prior to the end of the period, an entity should still disclose the interest that arose during the part of the reporting period that the loan was impaired. Because interest will be recognised throughout the instrument's life, the entity will need to isolate the period immediately following the impairment event and prior to the impairment loss being reversed and determine the interest that was recognised during that period.

4.2.5 Impairment losses

IFRSs require disclosure of the amount of any impairment loss for each class of financial asset. [IFRS 7:20(e)]

4.3 Other disclosures

4.3.1 Accounting policies

IAS 1.117 requires disclosure of the measurement bases used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, these would normally include:

[IFRS 7:B5]

- (a) for financial assets or financial liabilities designated as at fair value through profit or loss:
 - (i) the nature of the financial assets or financial liabilities that have been designated as at fair value through profit or loss;
 - (ii) the criteria for so designating financial assets or financial liabilities on initial recognition; and