

entity produces both separate financial statements and consolidated financial statements, a statement of cash flows will be required for each.

Prior to the adoption of IFRS 11 *Joint Arrangements*, an entity may have an interest in a joint venture that is accounted for using proportionate consolidation, but no subsidiaries. If the entity prepares individual financial statements (i.e. financial statements in which proportionate consolidation is applied), the statement of cash flows will include the investor's proportionate share of the cash flows of the joint venture.

### 3.1 Reporting cash flows on a net basis

Cash inflows should generally be reported separately from outflows. However, the Standard does permit the following cash flows to be reported on a net basis:

[IAS 7:22]

- receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity (such as the collection of rent on behalf of the owner of a property, funds held for customers by an investment entity, or the acceptance and repayment of demand deposits by a bank); and
- receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short (such as advances and repayments of principal amounts relating to credit card customers, purchases and sales of investments, and commercial paper or other short-term borrowings with a maturity period of three months or less).

For financial institutions, the following additional cash flows may be reported on a net basis:

[IAS 7:24]

- cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
- the placement of deposits with and withdrawal of deposits from other financial institutions; and
- cash advances and loans made to customers and the repayment of those advances and loans.

### 3.2 Exclusion of non-cash transactions

As a general principle, only transactions that require the use of cash or cash equivalents should be included in a statement of cash flows. Note,

however, that when the indirect method of presenting cash flows from operating activities is used (as discussed at 5.1.2 below), this will result in certain non-cash items appearing in the statement of cash flows as adjustments to profit or loss for the period. Investing and financing activities that do not require the use of cash or cash equivalents are always excluded from a statement of cash flows. [IAS 7:43]

Examples of investing and financing transactions that do not result in cash flows and, consequently, are excluded from the statement of cash flows, include:

- the acquisition of an asset by way of a finance lease (but the payments for lease rentals are cash flows);
- the acquisition or disposal of assets (other than cash) in return for equity securities;
- exchanges of non-monetary assets such as property, plant and equipment, and inventories;
- the issue of bonus shares to holders of the entity's equity;
- the receipt of bonus shares from another entity in which the reporting entity holds an investment; and
- the conversion of debt securities into equity securities.

The inception of a finance lease contract is one of the most commonly encountered non-cash transactions. Such a transaction, although reflected in the statement of financial position by recognising an asset and a matching liability, should not be reflected in the statement of cash flows because the reporting entity neither pays nor receives cash. It is not appropriate to show a cash outflow in respect of an asset purchase and the drawdown of a loan. A sale and leaseback arrangement, however, *will* generate cash flows and, therefore, should be included in the statement of cash flows (see 5.3.1 below).

When transactions of a non-cash nature occur, the Standard requires that they be disclosed elsewhere in the financial statements in a way that provides all of the relevant information about those investing and financing activities. [IAS 7:43] This disclosure will normally be in narrative form in the notes.

### 3.3 Exclusion of movements between items that constitute cash or cash equivalents

Movements between items that constitute cash or cash equivalents are excluded from cash flows, because these components are part of the cash management of an entity rather than part of its operating, investing or financing activities. Cash management includes the investment of excess cash in cash equivalents. [IAS 7:9]

For example, when an entity uses cash to purchase a short-term investment meeting the definition of a cash equivalent, the purchase is not shown in the statement of cash flows.

## 4 Cash and cash equivalents

Cash flows are defined as inflows and outflows of cash and cash equivalents. [IAS 7:6]

### 4.1 Cash

Cash comprises cash on hand and demand deposits. [IAS 7:6]

#### 4.1.1 Demand deposits

The term 'demand deposits' is not defined in IAS 7, but the term may be taken to refer to deposits where the reporting entity can withdraw cash without giving any notice and without suffering any penalty. A seven-day call deposit would therefore not qualify as cash, because seven days notice of withdrawal is required. The deposit could, however, be reported as a cash equivalent.

Similarly, if an entity has an account with its bank under which the entity has to give ninety days notice to the bank before it can withdraw money, the account does not meet the definition of cash because it is not a demand deposit. However, only ninety days notice is required and, therefore, it may meet the definition of a cash equivalent.

The term 'demand deposits' is not restricted to deposits with banks or financial institutions.

#### 4.1.2 Minimum average cash balances

Some entities have banking arrangements that require them to maintain a minimum average cash balance over a specified period instead of a constant minimum balance at the end of each day. It is therefore possible to have balances below the threshold for certain days as long as the average balance over the period is in excess of the minimum requirement. For such arrangements, it is necessary to consider whether the balance can be withdrawn on demand, in a way similar to demand deposits; i.e. whether the entity can withdraw the cash without giving any notice and without suffering any penalty. If these criteria are met, the cash balances will meet the definition of cash in IAS 7.

### 4.2 Cash equivalents

Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. [IAS 7:6]

#### 4.2.1 Held to meet short-term cash commitments

The Standard explains that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. [IAS 7:7] Therefore, in order to determine whether a particular investment qualifies for classification as a cash equivalent, it is necessary to look at the purpose for which it is held. Even though the investment may meet the definition set out in the previous paragraph, unless it is held for the purpose of meeting short-term cash commitments, it will not be classified as a cash equivalent.

For example, an entity purchases a two-year bond in the market when the bond only has two months remaining before its redemption date. The purchase is made for investment purposes. The bond does not qualify as a cash equivalent because, even though it meets the definition in IAS 7:6, it is not held for the purpose of meeting short-term cash commitments.

#### 4.2.2 Presumption of maturity of three months or less

The definition of cash equivalents includes the requirement that they be held for the 'short-term'. In order to qualify as such, the Standard states that the investment will *normally* have a maturity of three months or less

from the date of acquisition. [IAS 7:7] Therefore, the requirement for a three-month maturity is not part of the definition, but will nevertheless be a presumption except in very exceptional circumstances.

The Standard implicitly suggests that only in unusual cases will investments with more than three months to maturity nevertheless be free from significant risk of changes in value (arising, for example, from changes in interest rates). An entity purchasing a two-year bond in the market when the bond only has three months remaining before its redemption date could therefore classify the bond as a cash equivalent (assuming that there are no other factors causing it to be subject to a significant risk of change in value, and that the underlying purpose of holding the bond is to meet short-term cash commitments). However, the reference to three months or less 'from the date of acquisition' means that, if the entity instead purchased the same two-year bond when it had four months remaining before maturity, the entity could not classify the bond as a cash equivalent either at the date of purchase or once it has less than three months remaining to maturity (unless it could justify a departure from the three-month guideline, in which case the instrument would be classified as a cash equivalent throughout the entire four months).

The three-month limit may appear somewhat arbitrary, but the intention is to promote consistency between entities.

#### Example 4.2.2

##### Repurchase agreements as cash equivalents

An entity invests excess funds in short-term repurchase agreements with a term of two months. The underlying debt securities involved in the transaction have maturities in excess of three months. These repurchase agreements will be classified as cash equivalents provided that (1) there are no other factors that would subject the instruments to a significant risk of change in value, and (2) the underlying purpose for holding the repurchase agreements is to meet short-term cash commitments. The critical factor is the maturity of the repurchase agreements themselves, not the underlying debt securities.

#### 4.2.3 Foreign currency investments

Provided that the definition of a cash equivalent is met, there is no reason why an investment acquired in a foreign currency could not be classified as a cash equivalent. Indeed, the Standard refers specifically to cash and cash equivalents held or due in a foreign currency. [IAS 7:28]

#### 4.2.4 Equity investments

Equity investments will not normally meet the definition of a cash equivalent because, even when they are readily convertible to cash, the amount of that cash is generally not known and the risk of changes in value is generally not insignificant, although there are exceptions. The example of an exception given in the Standard is that of preferred shares with a specific redemption date which, when acquired, are close to maturity. The majority of equity investments will not meet the definition, however, and therefore cannot be classified as cash equivalents. [IAS 7:7]

#### 4.2.5 Gold bullion

Gold (and similar traded commodities) will not qualify as cash equivalents for the same reason as equity investments (see above). In addition, the guidance on implementing IFRS 9 *Financial Instruments* confirms that gold bullion "is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion". [IFRS 9(2010):IG.B.1] For entities that have not yet adopted IFRS 9, this text is also reflected in the guidance on implementing IAS 39 *Financial Instruments: Recognition and Measurement*.

#### 4.2.6 Bank borrowings

The definition of cash equivalents makes no reference to the inclusion of bank borrowings. Bank borrowings are generally considered to be financing cash flows. However, the Standard acknowledges that bank overdrafts repayable on demand may form an integral part of an entity's cash management, in which case they should be included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to being overdrawn. [IAS 7:8]

IAS 7 does not therefore mandate the inclusion of bank overdrafts in cash equivalents in all circumstances. But it does require their inclusion when the bank overdraft forms an integral part of the entity's cash management. IAS 7:8 also emphasises that bank borrowings are generally considered to be financing activities. Therefore, the Standard does not allow for other short-term loans (e.g. short-term bank loans, advances from factors or similar credit arrangements, credit import loans, trust receipt loans) to be classified as cash equivalents, because they are financing in nature.

## 2.5 Shares listed but not intended to be traded

### Example 2.5

#### Shares listed but not intended to be traded

The shares of Company A are listed on the Luxembourg exchange. Company A has completed a listing for marketing purposes only because its investors (which are pension funds) are restricted by their governing laws to investing in listed entities. It is not expected that these shares will be traded.

Although these shares are not expected to be traded, the entity is within the scope of IAS 33 and EPS should be presented in accordance with that Standard. The notion of 'publicly traded' requires only an ability to trade the shares publicly, not the actual trading of shares.

## 3 Definitions

### 3.1 Ordinary share

IAS 33 defines an ordinary share as an equity instrument that is subordinate to all other classes of equity instruments. [IAS 33:5] An equity instrument is defined in IAS 32 *Financial Instruments: Presentation* as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. [IAS 32:11] The Standard explains that ordinary shares participate in profit for the period only after other types of shares (such as preference shares) have participated. Ordinary shares of the same class have the same rights to receive dividends, but it is possible for an entity to have more than one class of ordinary shares. [IAS 33:6]

Entities will sometimes issue preference shares with many of the characteristics of ordinary shares. The terms of such preference shares will need to be evaluated carefully. If they share the characteristics of ordinary shares and have no preference attributed to them, such instruments should be considered as ordinary shares regardless of the legal name assigned to them (see 4.2.4 below).

### 3.2 Potential ordinary share

A potential ordinary share is defined as a financial instrument or other contract that may entitle its holder to ordinary shares. [IAS 33:5] Examples of potential ordinary shares include: [IAS 33:7]

- financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;

- options and warrants (i.e. financial instruments issued by the entity that give the holder the right to purchase ordinary shares); and
- shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

The concept of a potential ordinary share has evolved to meet the reporting needs of investors in entities that have issued certain types of convertible and other complex securities. The holders of these instruments can expect to participate in the appreciation in value of the ordinary shares resulting principally from the earnings and earnings potential of the issuing entity. The attractiveness of these instruments to investors is often based on the potential right to participate in increases in the earnings potential of the entity, rather than on fixed returns or other senior security characteristics. The value of instruments that are considered potential ordinary shares is derived largely from the value of the ordinary shares to which they relate. Changes in the value of such instruments tend to reflect changes in the value of the ordinary shares.

### 3.2.1 Derivatives over own equity

If an entity enters into a derivative over its own ordinary shares that may entitle the holder to ordinary shares, that derivative is a potential ordinary share if the settlement terms of the derivative may result in the delivery of ordinary shares of the entity. The only exception applies to forward purchase contracts and written put options over own ordinary shares when the issuer regards the shares to be delivered under the forward contract or written put option as effectively purchased upon entering into the contract (see 4.2.2.8 below). In this case only, the ordinary shares subject to the contract are deemed as acquired, resulting in a reduction in the number of shares outstanding for both basic and diluted EPS.

If, however, the settlement terms of the derivative permit only net settlement in cash or other financial assets, and/or settlement by the exchange of gross amounts of cash or other financial assets, the instrument does not 'entitle its holder to ordinary shares' and is not a potential ordinary share.

If there is a settlement choice, either by the issuer or the holder, as to whether ordinary shares will be delivered under the contract, the arrangement is still a potential ordinary share because there is the

potential for delivery of ordinary shares under the contract. However, the detailed computation of diluted EPS differs according to whether the settlement alternatives are at the option of the holder or the issuer (see 5.5.5 below).

## 4 Calculation of basic earnings per share

The objective of basic EPS information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period. [IAS 33:11] Basic EPS amounts are required to be calculated for: [IAS 33:9]

- profit or loss attributable to ordinary equity holders of the parent entity; and
- if presented, profit or loss from continuing operations attributable to those equity holders.

Basic EPS is calculated as follows. [IAS 33:10]

$$\frac{\text{Profit (loss) attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

### 4.1 Earnings numerator

The starting point for the earnings numerator (for results both from continuing operations and for the entity as a whole) is the profit or loss after tax attributable to the equity holders of the parent entity (i.e. excluding the amount attributable to non-controlling interests). [IAS 33:12]

#### 4.1.1 Non-controlling interests

The profit or loss attributable to equity holders of the parent will be readily available, because it is required under IAS 1 *Presentation of Financial Statements* to be presented in the statement of comprehensive income (or, when applicable, the separate statement of profit or loss/income statement – see 2.4) separately from the profit or loss attributable to non-controlling interests. [IAS 1:83] When applicable, however, the profit for the period from continuing operations presented in the statement of comprehensive income (which is before the allocation to non-controlling interests) will need to be adjusted

for the non-controlling interests' share of those earnings in order to arrive at the amount attributable to equity holders of the parent.

#### 4.1.2 The impact of preference shares

The profit or loss attributable to the equity holders of the parent entity will already be after deduction of dividends and other profit or loss effects relating to preference shares *classified as liabilities*. [IAS 33:13] For the purposes of calculating basic EPS, the profit or loss attributable to the equity holders of the parent entity is further adjusted for the following after-tax amounts relating to preference shares *classified as equity*: [IAS 33:12]

- preference dividends;
- differences arising on the settlement of such preference shares; and
- other similar effects of such preferences shares.

##### 4.1.2.1 Preference dividends

The after-tax amount of preference dividends to be deducted in determining the profit or loss attributable to ordinary equity holders of the parent entity is: [IAS 33:14]

- for non-cumulative preference shares classified as equity, the after-tax amount of preference dividends declared in respect of the period; and
- for cumulative preference shares classified as equity, the full after-tax amount of the required preference dividends for the period (whether or not declared). This does not include amounts paid or declared on cumulative preference shares in the current period in respect of previous periods.

For non-cumulative preference shares, dividends 'declared in respect of the period' are any dividends on the preference shares that are recognised as a liability during the current period, plus any dividends paid during the period that were not accrued at the end of the prior period. They do not include dividends declared after the end of the period that, in accordance with IAS 10 *Events after the Reporting Period*, are not recognised as a liability, or dividends accrued at the end of the prior period whether or not actually paid in the current period.

**Example 4.1.2.1****Liquidating dividends on preference shares**

Company X issued one share of Series A Non-Voting Convertible Preference Shares for CU1,000,000. The liquidation preference on this preference share is CU1,000,000, plus a 12 per cent cumulative dividend from the issue date. Company X also issued one share of Series B Non-Voting Convertible Preference Shares for CU2,000,000. The shareholder of the Series B Preference Share is entitled to a non-cumulative dividend at the rate of five per cent per annum on the liquidation preference. The liquidation preference is CU2,000,000, plus a 12 per cent cumulative dividend from the issue date. All payments on both preference shares are at the discretion of Company X and, therefore, they are both presented as equity.

In calculating 'profit or loss attributable to ordinary shareholders' for EPS purposes, Company X should not deduct the 12 per cent cumulative liquidating dividends for either the Series A or Series B shares. Although cumulative, the liquidating dividends are intended to provide a preference to the Series A and Series B preference shareholders in the event of a liquidation of Company X and, therefore, should not be adjusted in determining profit or loss attributable to ordinary shareholders until a liquidating event occurs.

**4.1.2.2 Differences arising on the settlement of preference shares**

Differences may arise on the settlement of preference shares in the following circumstances:

- when the preference shares are repurchased under a tender offer, and the fair value of the consideration paid to the preference shareholders differs from their carrying amount. Any excess of the fair value of the consideration over the carrying amount represents a return to the holders of the preference shares and is adjusted against retained earnings in the period of repurchase. This amount is deducted in calculating the earnings numerator for basic EPS. [IAS 33:16] Any excess of the carrying amount of the shares over the fair value of the consideration is added in calculating the earnings numerator for basic EPS; [IAS 33:18] and
- on early conversion of convertible preference shares, as a result of favourable changes to the original conversion terms or the payment of additional consideration. The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders, and is deducted in calculating the earnings numerator for basic EPS. [IAS 33:17]

Some entities issue classes of shares characterised as 'tracking' or 'targeted' shares to measure the performance of a specific business unit or activity of the entity (see 7.1.1 below for further description). The terms of tracking shares often allow the entity, at its option, to exchange or redeem one class of tracking shares for another class of tracking shares, such that the entity would have one less class of ordinary shares outstanding. The terms of this feature generally require a premium to be paid to the class being redeemed as a result of the transaction. In the period of redemption, profit or loss attributable to ordinary shareholders (whose shares are being used for the redemption) should be reduced by the premium over market price paid to redeem the tracking shares. The holders of the tracking shares being redeemed have received a benefit that constitutes an additional contractual return to them. **Example 4.1.2.2A** illustrates the treatment of this premium for the purpose of calculating EPS.

**Example 4.1.2.2A****Premium paid on redemption of tracking shares**

Company X has two classes of ordinary shares outstanding that separately track the results of operations of two different businesses, Company A and Company B. Company X decides to redeem all of its outstanding Company B tracking shares in exchange for Company A tracking shares. The terms of the Company B shares being redeemed provide Company X with the right to redeem the Company B tracking shares, at its discretion, by issuing its Company A tracking shares with a market price equal to a 15 per cent premium over the market price of the Company B tracking shares at the time of redemption. As such, the fair value of Company A tracking shares to be exchanged for the Company B tracking shares will exceed the fair value of the Company B tracking shares by 15 per cent on the date the redemption is announced.

When calculating basic EPS for the period in which the Company B tracking shares are redeemed, the profit or loss attributable to the Company A tracking shareholders should be reduced by the amount of the 15 per cent premium.

**Example 4.1.2.2B****Premium paid by a parent to redeem preference shares issued by a subsidiary**

Company P, a publicly traded entity, has a wholly-owned subsidiary, Company S. Company S has preference shares outstanding held by parties outside the group that are classified as equity. The preference shares are redeemable at the option of Company S (with Company P's consent) in

whole or in part, at varying dates, at CU100 per share plus accumulated and unpaid distributions to the date fixed for redemption. Consistent with the view that the subsidiary's preference shares represent a non-controlling interest in the parent's consolidated financial statements, dividends or accretions to a redemption price should be classified as income allocated to non-controlling interests in the consolidated statement of comprehensive income of the parent.

Company P decides to acquire Company S's preference shares. The premium paid by Company P to the third-party preference shareholders on the acquisition of Company S's preference shares is not recognised in the consolidated statement of comprehensive income because this represents a transaction with shareholders. Accordingly, the consolidated entity does not recognise in its statement of comprehensive income any gain or loss from the acquisition.

The premium paid to redeem Company S's preference shares should be deducted in computing profit or loss attributable to ordinary shareholders in the calculation of EPS in Company P's consolidated financial statements. The premium represents a return on investment to the holders of the preference shares and is not available to ordinary shareholders, similar to preference share dividends and accretion charges. Because dividends and accretion charges on preference shares of a subsidiary are treated as income allocated to non-controlling interests, premiums paid to redeem Company S's preference shares also should be deducted in computing profit or loss attributable to ordinary shareholders in the calculation of earnings per share in Company P's consolidated financial statements.

#### 4.1.2.3 Other effects of preference shares

The results for the period will also be adjusted for other appropriations recognised in respect of preference shares classified as equity. For example, preference shares may provide for a low initial dividend to compensate the entity for selling the shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing the shares at a premium. (These are sometimes called increasing rate preference shares.) When such shares are classified as equity, the discount or premium on issue is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating basic earnings per share. [IAS 33:15]

The following example, reproduced from Example 1 of the illustrative examples accompanying IAS 33, illustrates the required adjustments in respect of increasing rate preference shares.

#### Example 4.1.2.3

##### Increasing rate preference shares [IAS 33 Illustrative examples: Example 1]

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of CU100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of CU7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7 per cent a year. Thus, Entity D could have expected to receive proceeds of approximately CU100 per class A preference share if the dividend rate of CU7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at CU81.63 per share, i.e. at a discount of CU18.37 per share. The issue price can be calculated by taking the present value of CU100, discounted at 7 per cent over a three-year period.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

Year	Carrying amount of class A preference shares on 1 January	Imputed dividend <sup>a</sup>	Carrying amount of class A preference shares 31 December <sup>b</sup>	Dividend paid
	CU	CU	CU	CU
20X1	81.63	5.71	87.34	-
20X2	87.34	6.12	93.46	-
20X3	93.46	6.54	100.00	-
Thereafter	100.00	7.00	107.00	(7.00)

(a) At 7%

(b) This is before dividend payment.

#### 4.1.2.4 Contingent dividends on preference shares

##### Example 4.1.2.4

##### Contingent dividends on preference shares

Company X, a publicly traded entity, issued to Company Y convertible preference shares that earn a seven per cent dividend per year although payment is at the discretion of Company X. Conversion is at Company Y's option. Company X may elect to redeem the preference shares at any time.

reclassified to profit or loss. An entity may choose to reclassify within equity the cumulative gain or loss (which includes transaction costs), for example when the investment in equity instruments is derecognised. [IFRS 9:B5.7.1]

- (c) For financial instruments classified as at FVTPL, transaction costs are immediately recognised in profit or loss immediately on initial recognition.

Transaction costs are defined as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or a financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. [IAS 39:9]

Transaction costs are interpreted as including fees and commissions paid to agents, advisers etc., as well as levies, transfer taxes and duties. However, debt premiums/discounts, financing costs, internal administrative costs and holding costs should not be included. [IAS 39:AG13] In practice, the interpretation of this definition may require significant judgement. A particular issue arises in relation to the treatment of origination fees (see 4.1.3 below).

## 2.2 Settlement date accounting

The accounting for regular way trades is considered at 2.2 in chapter B8. When an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is recognised initially at the settlement date, but at its fair value determined at the trade date (discussed further in 3.5 below). Movements in fair value between trade and settlement date are not recognised (other than impairment losses). For assets measured subsequent to initial recognition at fair value, the change in fair value between trade and settlement date is recognised in profit or loss if the asset is measured at FVTPL and in other comprehensive income if the asset is measured at FVTOCI. [IFRS 9:5.7.4]

## 3 Subsequent measurement

### 3.1 Financial assets

The classification of financial instruments determines how they are subsequently measured. As discussed in section 5 of chapter B2, IFRS 9 requires financial assets to be classified into one of three categories: fair value through profit or loss (3.1.1 below), fair value through other comprehensive income (3.1.2 below) and amortised cost (3.1.3 below).

### 3.1.1 Financial assets at fair value through profit or loss (FVTPL)

Assets classified as at FVTPL are measured at fair value. Gains and losses that arise as a result of changes in fair value are recognised in profit or loss, except for those arising on derivatives that are designated in effective cash flow hedges or hedges of a net investment in a foreign operation. Chapter B7 contains guidance on the appropriate determination of fair value.

Gains and losses that arise between the end of the last annual reporting period and the date an instrument is derecognised do not constitute a separate 'profit/loss on disposal'. Such gains and losses will have arisen prior to disposal, while the item is still being measured at FVTPL, and should be recognised in profit or loss when they occur.

### 3.1.2 Fair value through other comprehensive income (FVTOCI)

IFRS 9 permits certain investments in equity instruments that do not meet the definition of held for trading to be designated at initial recognition as at FVTOCI. The Standard does not permit subsequent reclassification of amounts recognised in other comprehensive income and accumulated in equity to profit or loss. This means that such amounts are not reclassified when the financial asset is derecognised; it also means that assets are not required to be assessed for impairment because impairment losses would not be recognised in profit or loss. Only dividends are recognised in profit or loss when the entity's right to receive payment of the dividend is established in accordance with IAS 18. [IFRS 9:5.7.6 and IAS 18:30(c)] Because only equity instruments qualify for FVTOCI classification, there is no interest to be recognised on an effective interest basis because equity instruments are non-interest bearing.

Instead of being paid in cash, a dividend may be structured so that it is payable in shares of the issuer. This is often termed a 'stock dividend', a 'share dividend' or a 'scrip dividend'. When the dividend is payable exclusively in shares of the issuer (i.e. there is no cash or other settlement alternative), the investor does not regard the dividend as revenue in profit or loss. Rather, the receipt of additional shares in the issuer, from the investor's perspective, is in the nature of a bonus issue of shares whereby the investor's economic interest remains unchanged. The number of shares held by the investor increases, but the value of its total interest is unchanged because its economic interest is distributed over a greater number of shares (i.e. the increase in the number of shares results in a concurrent reduction in the value of each share).

When the investor is given a choice of settlement between shares of the issuer or cash (or another settlement alternative that is not shares of the issuer) then the investor treats the dividend as revenue in profit or loss when the dividend becomes unconditional from the perspective of the issuer. Between the dates the revenue is recognised and the date the holder makes its election of receiving further shares or cash (or another settlement alternative), this is likely to meet the definition of a derivative that will be required to be measured at FVTPL.

When the dividend is structured so that it is certain that all shareholders will decide to take the shares rather than cash (i.e. the cash alternative does not have substance), the dividend is in effect a pure stock dividend and should be accounted for accordingly. When the market value of the share alternative is above the cash alternative, the dividend is often referred to as an 'enhanced stock dividend'. Careful judgement will be necessary, based on the specific facts and circumstances, to determine whether a dividend involving an enhanced stock dividend is in substance a distribution to owners recognised in profit or loss or a pure stock dividend.

### 3.1.3 Amortised cost

The amortised cost classification category only applies to debt instrument financial assets that meet the specified criteria in IFRS 9:4.1.2 (described in more detail in 5.1 in **chapter B2**). Amortised cost measurement requires the application of the effective interest method, as discussed in **section 4** below.

Gains or losses resulting from fluctuations in fair value are not recognised for financial assets classified in the amortised cost category. However, impairment losses are recognised "if, and only if, one or more 'loss event' occurs after initial recognition, which has an impact on the estimated future cash flows of the financial assets that can be reliably estimated" [IAS 39:59], which is discussed further in **section 5** below. Reclassification between the amortised cost category and FVTPL category is permitted when, and only when, an entity changes its business model for managing financial assets [IFRS 9:4.4.1] (**3.4** below).

### 3.1.4 Hedged items

IAS 39 includes specific requirements to be applied when accounting for a financial asset that is a hedged item. These requirements are discussed in detail in **chapters B9** and **B10**.

### 3.1.5 Instruments whose fair value is 'unreliable'

If IFRS 9 requires a financial instrument to be measured at fair value, there is no exception from measurement on that basis is permitted. In all cases fair value is deemed to be reliable.

### 3.1.6 Negative fair value

If the fair value of a financial instrument previously recognised as a financial asset falls below zero, it becomes a financial liability and is measured as discussed in **3.2** below.

## 3.2 Financial liabilities

Financial liabilities are measured at amortised cost using the effective interest method (see **section 4** below), with the following exceptions: [IFRS 9:4.2.1]

- financial liabilities at FVTPL (see **3.2.1** below);
- financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies (see **3.2.2** below)
- written financial guarantee contracts not designated as at FVTPL that are not accounted for under IFRS 4 *Insurance Contracts* (see **2.3.3** of **chapter B1**);
- commitments to provide a loan at a below-market interest rate (see **3.5** of **chapter B1**); and
- hedged items (see **3.2.3** below).

### 3.2.1 Financial liabilities at fair value through profit or loss (FVTPL)

Financial liabilities at FVTPL, which include those classified as held for trading and derivative liabilities that are not designated as effective hedging instruments, and those designated as at FVTPL, are measured at their fair value with gains and losses recognised in profit or loss. Fair value measurement is described in detail in **chapter B7**.

A consequence of including a financial liability in this category is that the effect of an entity's own credit risk will be reflected in the entity's performance (i.e. profit or loss, or other comprehensive income). For example, if an entity that has elected to measure its issued debt at fair value experiences financial difficulties, it is likely to recognise a gain in

other comprehensive income or, in some specified, exceptional cases, in profit or loss (see 7.1.2.5 in **chapter B3**) reflecting the instrument's worsening creditworthiness.

### 3.2.2 *Financial liabilities arising on the transfer of a financial asset*

A liability may arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using the 'continuing involvement' approach. The approach required for measuring such liabilities is discussed in **chapter B8**.

### 3.2.3 *Hedged items*

IAS 39 includes specific requirements to be applied when accounting for a financial liability that is a hedged item. These requirements are discussed in detail in **chapters B9** and **B10**.

## 3.3 Foreign currency

When a financial asset or liability is a monetary item foreign exchange gains and losses should be recognised in profit or loss in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Monetary items are defined as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. [IAS 21:8]

### 3.3.1 *Financial assets and liabilities measured at fair value through profit or loss*

For financial assets and liabilities that are measured as at FVTPL, the requirement to recognise foreign currency gains or losses is straightforward because all gains and losses are recognised in profit or loss as part of the fair value gain or loss. The fair value is determined firstly in the foreign currency in which the item is denominated and that foreign currency amount is subsequently translated into the entity's functional currency using the closing rate. The accounting treatment is the same irrespective of whether the item is monetary or non-monetary.

### 3.3.2 *Amortised cost*

For financial assets and financial liabilities measured at amortised cost (which will only include monetary items), foreign currency gains or loss are calculated by determining the amortised cost in the foreign currency in which the item is denominated and the foreign currency amount is

subsequently translated into the entity's functional currency using the closing rate. This approach applies to both financial assets and financial liabilities that are measured at amortised cost. Foreign currency gains and losses are recognised in profit or loss.

### 3.3.3 *Exceptions*

IAS 21 specifically excludes from its scope the measurement of foreign currency items that are subject to hedge accounting because IAS 39 is more specific. If a financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IAS 39, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under IAS 21. [IAS 39:89] This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates. [IAS 21:23(b)]

Foreign currency gains or losses on monetary items are recognised in profit or loss except if the monetary item is designated as a hedging instrument in either a cash flow hedge (see 2.2 in **chapter B9**) or a hedge of a net investment (see 2.3 in **chapter B9**). [IFRS 9:B.5.7.2]

IFRS 9 allows investments in equity instruments not held for trading to be designated as at FVTOCI. When the investment is denominated in a foreign currency, the fair value is determined first in the foreign currency in which the item is denominated and then the foreign currency amount is translated into the functional currency using the closing rate. The gain or loss recognised in other comprehensive income will include the part that relates to foreign currency translation. The foreign currency element will never affect profit or loss because, under IFRS 9, no amounts accumulated in equity related to equity instruments designated as at FVTOCI are permitted to be subsequently reclassified to profit or loss.

### 3.3.4 *Summary of foreign currency accounting*

A summary of how foreign currency is treated for the various financial asset classifications in IFRS 9 is set out in the following table.

range of 10–11 years. Bank S would like to hedge the interest rate exposure on the CU100 million bond portfolio. It performs a sensitivity analysis and determines that the fair value exposure with respect to movement in interest rate risk only of all of the items individually respond within a range of 95 to 105 per cent of the overall change in price of the portfolio as a whole.

Bank S can designate an interest rate swap as a hedge of interest rate risk of the portfolio as a whole because all of the items within the portfolio share the same risk exposure, and the change in value of the items within the portfolio is expected to be approximately proportional to the change in value of the portfolio as a whole.

It is unlikely that a pool of shares could be grouped together and hedged as a portfolio. For example, it would not be possible to hedge a portfolio of shares that equate to the FTSE 100 index with a FTSE 100 total return swap. Although on an aggregated basis the hedge may be highly effective, it is clear that the individual equity securities that make up the portfolio do not share the exposure to risk, in that the fair value of each individual equity share does not move proportionally to the changes in value of the overall FTSE 100 index. [IAS 39:IG.F.2.20]

### 3 Hedging instruments

The basic requirements governing the qualification of hedging instruments are discussed in detail in **section 4** in **chapter B9**. This section provides additional guidance beyond the basic requirements, incorporating less common, more complex scenarios.

- Section 3.1 Hedging more than one risk
- Section 3.2 Hedging with more than one derivative
- Section 3.3 Written options and combinations of options
- Section 3.4 Purchased options
- Section 3.5 Dynamic hedging strategies
- Section 3.6 'All-in-one' hedges
- Section 3.7 Splitting a derivative to exclude embedded financing
- Section 3.8 Rollover hedging strategies
- Section 3.9 Forwards versus futures
- Section 3.10 Deal contingent derivatives
- Section 3.11 Internal hedges

#### 3.1 Hedging more than one risk

A hedging instrument is often designated as hedging one risk only.

However, a hedging instrument can be designated as hedging more than one risk provided that:

[IAS 39:76]

- (i) the risks being hedged can be clearly identified;
- (ii) the effectiveness of the hedge can be demonstrated; and
- (iii) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

IAS 39 allows the use of one instrument to hedge more than one risk. Cross-currency interest rate swaps are commonly used to swap foreign currency variable rate debt back into functional currency fixed rate debt, or to swap foreign currency fixed into functional currency variable (see 4.4.1 in **chapter B9** for further guidance).

#### 3.1.1 Hedging multiple hedged items

IAS 39 provides limited guidance on how to assess hedge effectiveness when an entity uses a single hedging instrument to hedge multiple hedged items. There are many instances where an entity could use a single derivative financial instrument to hedge one risk (say foreign currency risk) or multiple risks (say foreign currency risk and interest rate risk) where those risks reside in more than one hedged item.

IAS 39:IG.F.1.13 provides an example of an entity hedging two hedged items for the same risk. The example describes a Japanese Yen functional currency entity that has a 5-year floating rate US\$ liability and a 10-year fixed rate £-denominated note receivable and chooses to hedge both items with a single foreign currency forward contract where it will receive US\$ and pay £ in five years. Because the principal amounts of the asset and liability when converted into Japanese Yen are the same, the entity designates the dual foreign currency forward contract as hedging foreign currency risk for both items. Even though foreign currency risk is defined by reference to the entity's functional currency, and the foreign currency forward contract does not have a cash flow in the functional currency (i.e. Japanese Yen), the foreign currency forward contract may still be designated as hedging *both* foreign currencies as the exposure to both currencies has been eliminated by the forward. Put another way, if the entity entered into a receive US\$ pay Japanese Yen forward, and a receive Japanese Yen pay £ forward, each forward could have been designated separately as hedging the foreign currency risk of the liability and asset respectively, the

fair value of the two Japanese Yen legs would offset each other perfectly. In a single forward to receive US\$ pay £, the receive Japanese Yen leg and the pay Japanese Yen leg do not exist but this does not create hedge ineffectiveness because the fair value of both legs offsets to zero. However, in assessing and measuring hedge effectiveness with a single forward contract, the entity will need to impute the two notional Japanese Yen legs into the hedge designation in order to determine the hedge effectiveness of the two hedges of foreign currency risk. Imputing the two notional cash flows for assessing hedge effectiveness is permitted because doing so does not create any additional cash flows as both notional cash flows offset each other perfectly.

In July 2007, the IFRIC (now the IFRS Interpretations Committee) issued a rejection notice on hedging multiple risks with a single derivative financial instrument. The IFRIC recognised that IAS 39's interpretative guidance does result in an entity needing to impute a notional leg as a means of splitting the fair value of the derivative into multiple components in order to assess hedge effectiveness. The IFRIC considered that this was acceptable in assessing hedge effectiveness because this conclusion did not conflict with IFRS 9:IG.C.1 which prohibits an entity from recognising embedded derivatives that result in the *recognition* [emphasis added in the July 2007 IFRIC Update] of cash flows that do not contractually exist. The IFRIC's rejection notice highlights that, should any entity need to split notionally a derivative for assessing hedge effectiveness when that derivative is hedging multiple risks, then the process of splitting should not result in any new cash flows or any new risks arising which were not evident in the contractual terms of the derivative.

#### Example 3.1.1A

##### Hedging a net investment in a foreign operation and interest rate risk of issued debt

Parent P, a € functional currency entity, has issued a €100 million denominated fixed rate debt. Parent P consolidates Subsidiary S, a US dollar functional currency foreign operation with opening net assets of US\$300 million. Parent P's objective is to hedge:

- (i) the foreign currency risk of part of its foreign operation (being the € equivalent of US\$150 million net assets); and
- (ii) the fair value due to changes in interest rates on its issued debt (being interest rate risk on €100 million).

In order to minimise transaction costs, Parent P enters into a single derivative to Receive € fixed on €100 million, Pay US\$ 3m-US\$ LIBOR on US\$150

million with the fair value of the cross-currency interest rate swap equal to zero at the transaction date (i.e. the derivative is on-market).

Parent P designates in the consolidated financial statements the cross-currency interest rate swap as a hedge of the foreign currency risk of Subsidiary S's net assets equal to US\$150 million and the fair value interest rate risk on €100 million of its €-denominated debt.

In order to assess hedge effectiveness for net investment hedge and fair value hedge, Parent P notionally splits the derivative into the following:

- (i) Receive fixed €100m, Pay 3m-EURIBOR on €100m (notional derivative 1); and
- (ii) Receive 3m-EURIBOR on €100m, Pay 3m-US\$ LIBOR US\$150m (notional derivative 2).

Parent P fair values the two notional derivatives at inception and both have a fair value of zero so the sum of the fair values equals the fair value of the actual contractual derivative. Each period, the notional derivatives are fair valued in order to assess and measure hedge effectiveness and to ensure that the sum of these fair values equals the fair value of the actual contractual derivative entered into.

#### Example 3.1.1B

##### Hedging cash flow variability of both an asset and liability

Entity B, a Sterling functional currency entity, has issued 3m-LIBOR £200 million denominated debt and has an investment in an inflation-linked bond that receives 3% + UK CPI on a notional of £200 million (the inflation linkage is considered a closely related embedded derivative). The asset and liability have the same five year maturity.

Entity B's objective is to hedge the cash flow variability on both its asset and its liability. In order to minimise transaction costs, the entity enters into 5-year Receive 3m-LIBOR £200 million Pay 3% + UK CPI £200 million and designates this basis swap as a hedge of the cash flow variability of both its assets and its liability.

In order to assess hedge effectiveness, Entity B notionally splits the derivative into the following:

- (i) 5-year Receive 3m LIBOR £200 million, Pay 6% £200 million (notional derivative 1); and
- (ii) Receive 6% £200 million, Pay 3% + UK CPI £200 million (notional derivative 2).

Entity B fair values the two notional derivatives at inception and both have a fair value of zero so the sum of the fair values equals the fair value of the actual contractual derivative. Each period, the notional derivatives are fair

valued in order to assess and measure hedge effectiveness and to ensure that the sum of these fair values equals the fair value of the actual contractual derivative entered into.

#### Example 3.1.1C

##### Hedging cash flow variability of both a foreign currency sale and purchase

Entity C, a Euro functional currency entity, has forecast sales in US dollars and forecast purchases in Japanese Yen. Entity C enters into a series of foreign currency forward contracts under which it receives a fixed amount of Japanese Yen and pays a fixed amount of US dollars every month. The fair value of each forward contract is zero at inception as the terms are on-market at that date. Entity C's objective is to hedge the variability in functional currency cash flows of its US dollar sales and Japanese Yen purchases.

In order to assess hedge effectiveness, Entity C notionally splits the derivative into the following:

- (i) receive fixed amount of Japanese Yen, pay fixed amount of Euro (notional derivative 1); and
- (ii) receive fixed amount of Euro, pay a fixed amount of US dollars (notional derivative 2).

Entity C fair values the two notional derivatives at inception and both have a fair value of zero so the sum of the fair values equals the fair value of the actual contractual derivative. Each period the notional derivatives are fair valued in order to assess and measure hedge effectiveness and to ensure that the sum of these fair values equals the fair value of the actual contractual derivative entered into.

If the hedge is highly effective, the effective gains/losses on the series of forward contracts will initially be recognised in other comprehensive income and will be reclassified to profit or loss when the sales and purchases affect profit or loss. It should be noted that the timing of the impact to profit or loss of the two hedged items may differ. This is because purchases would normally result in recognition of inventory and the sale of the inventory acquired in Japanese Yen could occur in a period after the sales in US dollars. The entity must allocate the fair value gains/losses accumulated in equity to the two individual hedge relationships so it can determine the appropriate amount to be reclassified to profit or loss when the purchase or sale affects profit or loss.

Judgement is required in determining what is an appropriate split when allocating the fair value of derivatives to multiple hedged items for assessing hedge effectiveness. It would not be appropriate to create multiple notional derivatives which introduce notional legs over risks which did not exist in the contractual derivative or are not specific to the entity entering into the transaction, for example the

entity's functional currency. Taking **example 3.1.1A** above, the notional legs introduced are in the functional currency of the entity, the Euro, which is a reference point that is specific to the entity; the frequency of reset of EURIBOR on the notional leg is equal to the frequency of reset on the US\$-LIBOR leg of the actual derivative. Taking **example 3.1.1B** above, the notional legs introduced are the Sterling fixed rate for a 5-year interest rate swap priced off the Sterling 5-year LIBOR curve. In both examples, it would be unacceptable to impute notional legs which, although they could offset each other, would introduce an unrelated risk (say equity prices or an unrelated currency).

If a single hedging instrument is designated as a hedge of more than one risk, the hedge accounting criteria must be satisfied in respect of all the designated hedged risks. If the criteria are not met in respect of one of the risks being hedged, no hedge accounting treatment is allowed for the period. If one designation fails to meet the effectiveness test or no longer exists, continuing hedge accounting would result in split accounting for the hedging instrument, treating one part as a hedge and the other as a trading instrument which is not permitted.

## 3.2 Hedging with more than one derivative

Two or more offsetting derivatives, or proportions thereof, can be jointly designated as a hedging instrument if none of them are a written or net written option. [IAS 39:77] Further, when hedging foreign currency risk, two or more non-derivatives (or proportions) or a combination of non-derivatives and derivatives can be viewed in combination. Common situations where two or more offsetting derivatives are designated in combination as a hedging instrument are:

- when an entity issues fixed rate debt, swaps the entirety of the debt instrument to floating, and then re-fixes some of the instrument's cash flows;
- when an entity uses a combination of long and short foreign currency forward contracts to hedge its net investments in a foreign operation (e.g. when it manages foreign currency risk on the net assets of the foreign operation where the value of those net assets changes on a frequent basis); and
- when an entity uses a combination of a basis swap and a floating to fixed interest rate swap if there is not enough liquidity directly to

## 6 Offsetting financial assets and financial liabilities

### 6.1 General principle

IAS 32 requires that a financial asset and a financial liability should be offset as a net amount in the statement of financial position when, and only when, both of the following conditions are satisfied:

- the entity currently has a legally enforceable right to set off the recognised amounts of the asset and liability; and
- the entity intends to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In the case of a transfer of a financial asset that does not qualify for derecognition under IFRS 9, the entity should not offset the transferred asset and the associated liability (for further details on derecognition refer to 3.3 in chapter B8). [IAS 32:42]

When offset is applied, the entity has the right to pay or receive a single net amount in relation to the two instruments, and intends to do so; therefore, in effect, the entity only has a single financial asset or financial liability. If the conditions for offset are not met, the two financial instruments are presented separately. Whether or not a financial asset and a financial liability are offset, they should be measured in accordance with the normal measurement principles with respect to financial assets and financial liabilities.

It should be noted that offsetting a financial asset and a financial liability (and the consequent net presentation in the statement of financial position) is different from derecognition of those financial instruments. In contrast to offsetting, derecognition of a financial asset or a financial liability not only removes the financial instrument from the statement of financial position, but also may give rise to a gain or loss on derecognition. [IAS 32:44] Offset does not result in the asset or liability being removed from the statement of financial position, but in net presentation of the asset and liability as either a net asset or a net liability. A gain or loss does not arise because of the offsetting requirements, although it may arise because of the measurement requirements applicable to the asset or liability, respectively.

In December 2011 the IASB issued amendments to IAS 32 *Offsetting Financial Assets and Financial Liabilities*. Concurrently the IASB introduced new offsetting disclosures by amending IFRS 7 which is described in 6.8 below. The amendments to IAS 32 introduce further application guidance

which was intended to address inconsistencies in applying some of the offsetting criteria. This included clarifying the meaning of 'currently has a legally enforceable right of set-off' and that some gross settlement systems may be considered equivalent to net settlement. [IAS 32:BC78] These amendments are reflected in the sections below.

The amendments to IAS 32 are effective for annual periods beginning on or after 1 January 2014 and must be retrospectively applied. An entity that early applies the IAS 32 amendments must state this fact and also early apply the IFRS 7 amendments at the same time. [IAS 32:97L]

### 6.2 Legal right of offset

The first part of the offset criteria is that the reporting entity 'currently has a legally enforceable right to set off the recognised amounts' [IAS 32:42]

IAS 32 defines the right of offset as a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. Because the right is specifically a legal right, the circumstances that give rise to such a right will vary from one legal jurisdiction to another. Thus, for each relationship between the two parties (the debtor and the creditor), it will be necessary to consider the particular laws applicable to it. [IAS 32:45]

The amendments to IAS 32 acknowledge that a right of set-off may be currently available or it may be contingent on a future event (for example, the right may be triggered or exercisable only on the occurrence of some future event, such as the default, insolvency or bankruptcy of one of the counterparties). Even if the right of set-off is not contingent on a future event, it may only be legally enforceable in the normal course of business, or in the event of default, or in the event of insolvency or bankruptcy, of one or all of the counterparties. [IAS 32:AG38A]

The Standard makes clear the characteristics that a currently legally enforceable right to set-off the recognised amounts should have. The right of set-off:

[IAS 32:AG38B]

- (a) must not be contingent on a future event; and
- (b) must be legally enforceable in all of the following circumstances:
  - (i) the normal course of business;
  - (ii) the event of default; and
  - (iii) the event of insolvency or bankruptcy

of the entity and all of the counterparties.

The nature and extent of the right of set-off, including any conditions attached to its exercise and whether it would remain in the event of default or insolvency or bankruptcy, may vary from one legal jurisdiction to another. Consequently, it cannot be assumed that the right of set-off is automatically available outside of the normal course of business. For example, the bankruptcy or insolvency laws of a jurisdiction may prohibit, or restrict, the right of set-off in the event of bankruptcy or insolvency in some circumstances. [IAS 32:AG38C] The reference to default, insolvency or bankruptcy are broad and are intended to describe scenarios where an entity will not or cannot perform under the contract. [IAS 32:BC81]

The laws applicable to the relationships between the parties (for example, contractual provisions, the laws governing the contract, or the default, insolvency or bankruptcy laws applicable to the parties) need to be considered to ascertain whether the right of set-off is enforceable in the normal course of business, in an event of default, and in the event of insolvency or bankruptcy, of the entity and all of the counterparties (as specified in IAS 32:AG38B(b)). [IAS 32:AG38D]

The amendments to IAS 32 in this area arose following feedback on the exposure draft that revealed inconsistencies in the application of this criterion. In amending IAS 32 the IASB made clear that where set-off only arises if a contingent event occurs it is not acceptable to offset financial assets and financial liabilities. Even where the right to set-off is not dependent on a contingent event the right to set-off must apply in all circumstances, i.e. not just in the normal course of business but also in bankruptcy, default or insolvency. This means that the right must apply in cases where the reporting entity (or counterparty) ceases to operate as a going concern.

Uncertainties about the amount to be paid (and/or received) under the set-off arrangement do not preclude an entity from currently having a legally enforceable right to set-off. Similarly, the passage of time is not considered a contingent right that would prevent offsetting. [IAS 32:BC83]

For example, if a receivable and payable are contractually due on the same date and there is an enforceable right to set-off on that date, the fact there is no right to enforce net settlement (and potentially simultaneous settlement) prior to that date does not prevent offset as prior to that the receivable and payable are not due. However, in order for the offset criteria to be met the reporting entity must be able to demonstrate that there is a currently enforceable right to set-off the

recognised amounts on the settlement date which would apply in all circumstances, i.e. in the normal course of business or in the case of default, insolvency or bankruptcy of either party.

If the right of set-off is not exercisable during a period when amounts are due and payable, then the entity does not meet the offsetting criterion as it has no right to set off those payments. [IAS 32:BC84] For example, a right to set-off the recognised amount that only applies say at the reporting period end, but not throughout the reporting period(s) would not meet the offset criterion.

Similarly, a right of set-off that could disappear or that would no longer be enforceable after a future event that could take place in the normal course of business or in the event of default, or in the event of insolvency or bankruptcy, such as a ratings downgrade, would not meet the currently legally enforceable criterion in IAS 32:42(a). [IAS 32:BC84]

In some circumstances, the debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right to offset. [IAS 32:45]

Legal rights do not need to be established in a single document between the three parties. For example, a debtor might obtain set-off rights separately from the third party and from the creditor. In establishing the validity of the legal right to set-off, it is necessary to understand the terms of the particular contracts, as well as the context within which set-off is to be applied. The legal right to set-off could, inter alia, be evidenced with reference to a legal opinion, or be established by statutory or regulatory provisions which have been clearly demonstrated as applicable to and governing the particular transaction.

Assessing whether the entity has a legal right to set off the recognised amounts is independent from assessing how the reporting entity intends to settle the arrangement. The requirement to have a currently legally enforceable right to set off the recognised amounts in effect means that the reporting entity can enforce settlement of the net amount and can do so in all situations (i.e. the exercise of this right is not contingent on a future event). The Board clarified in the Basis for Conclusions that the ability to exercise this right 'is assured' [IAS 32:BC86]. This right must exist and be assured irrespective if the

entity does not intend to settle the net amount, but instead (as permitted by IAS 32) intends to settle the asset and liability simultaneously (see 6.3 below).

For a discussion of considerations surrounding master netting agreements refer to 6.6 below.

### 6.3 Intention to settle on a net basis, or to realise the asset and settle the liability simultaneously

The second part of the offset criteria is that the reporting entity 'intends to settle on a net basis, or to realise the asset and settle the liability simultaneously'. [IAS 32:42]

The existence of the legal right of offset (while it affects the entity's rights and obligations and may affect its credit exposure) is not sufficient in itself for offsetting. When there is a legal right, and an entity intends to exercise the right of offset (i.e. to settle net), or to settle simultaneously, the entity is, in effect, exposed to a net amount, which reflects the timing of the expected cash flows and the risks to which those cash flows are exposed and, therefore, presentation of the financial instruments on a net basis is appropriate. [IAS 32:46]

The intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting a financial asset and a financial liability. This is due to the fact that the legal rights and obligations pertaining to the individual financial assets and financial liabilities are not altered. [IAS 32:45]

Intention may be demonstrated through management representations that are not contradicted by past experience or other relevant circumstances (e.g. normal business practices, requirements of financial markets, circumstances that limit the ability to settle net) and also may take into account reference to the entity's risk management policies, if appropriate. There is no requirement for an assessment of the counterparty's intent, however, if the counterparty was able to restrict the reporting entity's right to enforce the set-off of the recognised amounts this prevents the reporting entity from meeting the offset criteria.

#### Example 6.3

##### Offset: unmatched payments and receipts

Assume that the legal right of offset exists in the following scenario.

Company X owes Company Y four payments of CU10 million each at the end of each calendar quarter (31 March, 30 June, 30 September, 31 December), totalling CU40 million. As part of another contract, Company Y owes Company X two payments of CU15 million at 30 June and 31 December, totalling CU30 million.

The intention to settle simultaneously can only be demonstrated in respect of the 30 June and 31 December cash flows. At the beginning of the year, Company X will, therefore, reflect a financial liability of CU20 million (being the 31 March and 30 September payments) and a separate financial asset of CU10 million (representing the difference between the CU10 million payable and CU15 million receivable from Company Y on 30 June and 31 December). Although Company X's net position over the whole year is a financial liability of CU10 million, because it cannot demonstrate the intention to settle net or simultaneously for all payments, the criteria for offset are not satisfied in respect of those unmatched payments and separate presentation is required. Company Y correspondingly has an asset of CU20 million and a liability of CU10 million.

It is common for entities to have amounts on deposit with a financial institution and simultaneously have a drawn-down borrowing facility, sometimes referred to as an 'overdraft', with the same financial institution. The entity has a separate financial asset and a financial liability with the same counterparty. It is usually not possible to achieve offset for the asset and the liability because, in most cases, the entity cannot assert that the asset will be used to settle the liability. The asset will rise and fall as the entity places further cash on deposit or withdraws cash to settle other obligations. Although the asset at the reporting date could be used to settle the overdraft, the entity cannot claim offset because the entity does not have the intention at the reporting date to settle the overdraft liability with the deposit asset. Rather, the entity's intention is to use the deposit asset at the reporting date, and potentially draw down more borrowings if needed to meet its working capital needs.

The amendments to IAS 32 clarified when simultaneous settlement of gross amounts can meet the second part of the offset criterion in IAS 32:42. This will be the case where the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle. For example, a gross settlement system that has all of the following characteristics would meet the net settlement criterion in IAS 32:42(b):

- (a) financial assets and financial liabilities eligible for set-off are submitted at the same point in time for processing;