

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 ^(a)	Carrying amount of class A preference shares 31 December ^(b)	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.

1.1 Summary of IFRS 13 framework

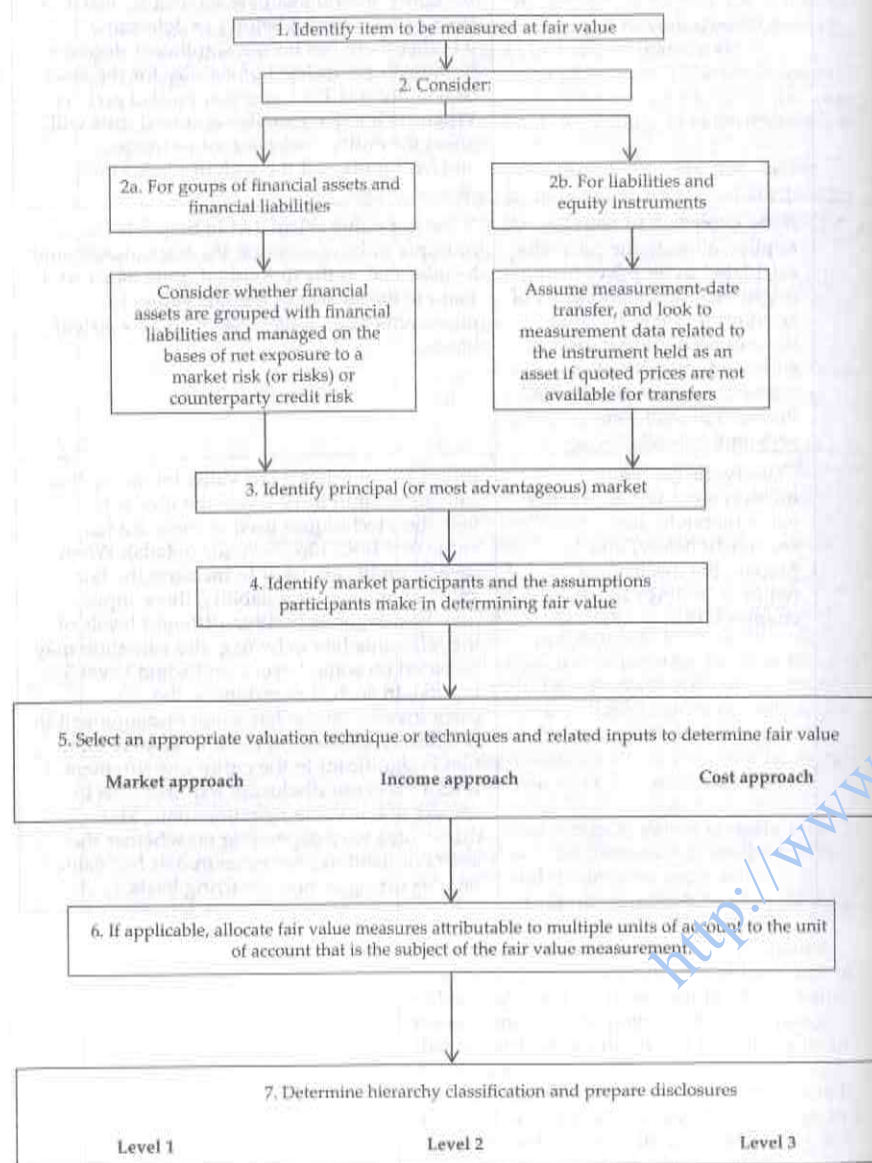
The table and flow chart below set out a step-by-step approach to applying the basic measurement principles of IFRS 13 to financial instruments. The table also provides a high level summary of some of the key concepts underlying IFRS 13 and illustrates the framework for measuring fair value. The summary does not address all of the requirements of the Standard – users should refer to the more detailed discussions later in this chapter and to the text of the Standard for a fuller understanding.

Note that Steps 2 to 4 do not necessarily occur in the order set out in the table and flow chart (i.e. they are inter-related).

#	Step	Explanation
1.	Identify the 'asset' or 'liability' being measured (i.e. the unit of account) (see 3.1 below).	IFRS 13 notes that the asset or liability measured at fair value may be (1) a stand-alone financial asset or liability, (2) a group of financial assets or a group of financial liabilities, or (3) a group of assets and liabilities. The level at which fair value is measured will depend on the 'unit of account' specified in other IFRSs (typically, the level at which the asset or liability is aggregated or disaggregated for recognition or disclosure purposes). Under IAS 39, the unit of account is generally an individual financial instrument.
2a.	For financial assets and financial liabilities with offsetting market risks or counterparty credit risk, evaluate the criteria for the fair value exception and establish a policy (see section 6 below).	IFRS 13 permits an exception to the general fair value measurement requirements for financial assets and financial liabilities if an entity: <ul style="list-style-type: none"> manages the group of assets and liabilities on the basis of its net exposure to market risks or counterparty credit risk; provides information on that basis to key management personnel; and measures those assets and liabilities at fair value in the statement of financial position. In summary, the exception permits an entity to measure the fair value of the group of assets and liabilities (i.e. the portfolio) rather than the individual assets and liabilities within the portfolio. Details of the exception, including the detailed criteria for qualification, are set out in IFRS 13:48 – 56. <p>The application of this exception is an accounting policy choice in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and must be applied consistently from period to period for a particular portfolio.</p> <p>This exception does not change the unit of account (which continues to be the individual instrument determined under IAS 39), but changes the unit of measurement from the individual financial instrument to the group (portfolio) of financial instruments.</p>

#	Step	Explanation
2b.	For financial liabilities and an entity's own equity instruments, assume the financial liabilities or equity instruments are transferred to market participants at the measurement date (see section 5 below).	IFRS 13 requires that the fair value of a financial liability or an entity's own equity instrument be based on an assumed transfer to a market participant even if the entity does not intend to transfer the liability or equity instrument to a third party or it is unable to do so. <p>Under this assumption, the fair value of a financial liability should be measured on the basis that the liability would remain outstanding and the transferee would be required to fulfil the obligation; it should not be assumed that the financial liability would be settled or otherwise extinguished. Similarly, the fair value of an entity's own equity instrument should be measured on the basis that the equity instrument would remain outstanding and the transferee would take on the rights and responsibilities associated with the instrument; it should not be assumed that the instrument would be cancelled or otherwise extinguished.</p> In addition, the measurement of financial liabilities and own equity instruments depends on whether identical liabilities or equity instruments are held by other parties as assets. However, an entity must measure the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset if (a) a quoted price for an identical or similar instrument is not available and (b) the identical item is, in fact, held by another party (or by other parties) as an asset.
3.	Identify the market in which to price the financial asset or financial liability – i.e. either (1) the principal market or (2) if no principal market exists, the most advantageous market (see 3.2 below).	The principal market is "[t]he market with the greatest volume and level of activity for the asset or liability". The most advantageous market is "[t]he market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability...". <p>If there is a principal market for the financial asset or financial liability, the fair value measurement should reflect the price in that market, even if the price in a different market is potentially more advantageous at the measurement date. In the absence of evidence to the contrary, the market in which an entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal (or most advantageous) market. Therefore, an entity is permitted to use the price in the market in which it normally enters into transactions unless there is evidence that the principal (or most advantageous) market and that market are not the same.</p> <p>A market cannot be identified as the principal (or most advantageous) market unless the entity has access to that market at the measurement date.</p>

Fair value measurement framework



2 Scope

IFRS 13 applies when another IFRS requires or permits fair value measurement or disclosures about fair value measurements except in limited circumstances specified in IFRS 13:6 and 7. [IFRS 13:5] None of the exceptions in IFRS 13:6 & 7 (which are listed in chapter A6 of Volume A of this manual) applies to financial instruments in the scope of IAS 32, IAS 39, IAS 39 and IFRS 7. Consequently, all financial instruments in the scope

of IAS 32, IAS 39, IAS 39 and IFRS 7 that are measured at fair value are subject to the fair value measurement and disclosure guidance contained in IFRS 13.

The measurement requirements in IFRS 13 apply when measuring the fair value of:

- financial instruments that are measured at fair value in the statement of financial position; and
- financial instruments for which the fair value is disclosed, even if the item is not measured at fair value in the statement of financial position (e.g. financial instruments not measured at fair value but for which fair value is required to be disclosed under IFRS 7:25). [IFRS 13:BC25]

Some financial instruments are measured at fair value on an ongoing basis (IFRS 13 refers to this as 'fair value on a recurring basis') and some (e.g. financial assets meeting the criteria for amortised cost measurement in IAS 39:46 – see section 3 in chapter C2) are measured at fair value only on initial recognition or for disclosure purposes. IFRS 13 applies in all of these circumstances (subject to the exceptions in IFRS 13:6 & 7).

2.1 Application of IFRS 13 to receivables and payables measured at initial recognition using present value techniques

All recognised financial instruments that are within the scope of IAS 39, including receivables and payables, are required to be measured at fair value on initial recognition. This requirement applies irrespective of how the instrument is subsequently measured. In the case of receivables and payables measured at amortised cost subsequent to initial recognition, because fair value generally cannot be observed directly, present value techniques are used to estimate fair value at initial recognition. Accordingly, IFRS 13 (including the guidance in IFRS 13:B12 – B30 regarding the use of present value techniques to measure fair value) applies to such initial measurements.

Note, however, that IFRS 13's disclosure requirements do not apply to fair value measurements at initial recognition (see IFRS 13:91 & BC184).

2.2 Application of IFRS 13 to financial assets measured at amortised cost that are determined to be impaired

When a financial asset measured at amortised cost is determined to be impaired, the impairment loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (see IAS 39:63).

For measurement in the statement of financial position IFRS 13 does not generally apply when an impaired financial asset is measured using this approach. The recognition of an impairment loss using the approach described results in the financial asset being remeasured at the present value of expected future cash flows discounted at the original effective interest rate. This amount may not be equivalent to fair value because a fair value measurement would incorporate a current market discount rate. Accordingly, the measurement and disclosure requirements of IFRS 13 do not generally apply to an impaired financial asset measured at amortised cost.

However, as a practical expedient, IAS 39:AG84 allows the impairment of a financial asset measured at amortised cost to be measured on the basis of the instrument's fair value using an observable market price. When this approach is adopted, it results in the financial asset being measured at fair value and, consequently, the requirements of IFRS 13 do apply.

In addition, IFRS 7:25 requires an entity to disclose the fair value of each class of financial assets and financial liabilities. Consequently, the fair value of financial assets measured at amortised cost is required to be disclosed. The amount disclosed should be measured in accordance with IFRS 13 and the disclosures required under IFRS 13:97 should be provided.

2.3 Application of IFRS 13 to a hedged item in a fair value hedge

Hedged items in a fair value hedge are not measured at fair value in the statement of financial position. The hedged item may be accounted for under an IFRS that specifies a measurement basis other than fair value (e.g. a debt instrument measured at amortised cost under IAS 39). In such circumstances, under the fair value hedge accounting rules, the underlying carrying amount of the hedged item is adjusted for relevant changes in the fair value of the hedged risk.

The hedged risk could be (i) changes in the fair value of the hedged item (see **example 2.3A** below) or (ii) changes in a portion of the fair value of the hedged item specific to a hedged risk (see **example 2.3B**). In both cases, the fair value hedge adjustment applied to the hedged item results in a 'hybrid' carrying amount for the hedged item.

In such circumstances, the fair value measurement principles in IFRS 13 should be used in determining the amount of the fair value hedge adjustment (i.e. the amount of the relevant changes in the fair value of the hedged risk).

When the relevant IFRS requires disclosure of the fair value of a hedged item that is not measured at fair value in its entirety in the statement of financial position:

- the measurement requirements of IFRS 13 apply to the amount disclosed as fair value; and
- the disclosure requirements of IFRS 13:97 apply.

Example 2.3A

Application of IFRS 13 to a hedged item in a fair value hedge (1)

On 1 January 20X1, Company A (which is not a broker-dealer) measures oil inventories of 100,000 barrels under IAS 2 *Inventories* at its cost of US\$60 per barrel (US\$6 million). The spot price for oil is US\$65 per barrel. At that date, Company A enters into and designates oil futures contracts to sell 100,000 barrels of oil at US\$65 per barrel as a fair value hedge of its oil inventories. The fair value of the oil futures contracts on 1 January 20X1 is zero. The oil futures contracts are measured at fair value at subsequent reporting dates in accordance with IAS 39.

At 31 December 20X1, the spot price for oil is US\$63 per barrel. Assume, for simplicity, that Company A did not purchase or sell any oil in the period. The IAS 2 measurement of the oil inventories is unchanged, because the current spot price of US\$63 per barrel is higher than the carrying amount of \$60 per barrel (i.e. cost). However, as a result of the fall in the spot price from US\$65 to US\$63 per barrel, the fair value of the oil futures contract on 31 December 20X1 is an asset of US\$200,000. For illustrative purposes, assuming Company A has a perfectly effective fair value hedge, the carrying amount of the inventories is therefore adjusted by US\$200,000, resulting in an adjusted carrying amount of US\$5.8 million (i.e. US\$6 million less the fair value hedge adjustment of US\$200,000).

This adjusted carrying amount of US\$5.8 million is not the fair value of the inventories, and IAS 2 does not require that the fair value of the inventories

Example 3.3A**Use of assumptions that market participants would use**

Entity F uses a discounted cash flow model to measure the fair value of a financial asset. Entity F has obtained information about the assumptions that market participants would use to measure the fair value of the asset. However, Entity F believes that some of those assumptions are not appropriate.

Entity F is not permitted to rely on its own internal data rather than use the assumptions that market participants would use. A fair value measurement is a market-based measurement and not entity-specific. IFRS 13:22 requires that the fair value of an asset or a liability should be measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

When using a discounted cash flow model to measure the fair value of a financial asset, Entity F should incorporate relevant observable inputs whenever available. Any unobservable inputs used in the fair value measure (e.g. estimated future cash flows or risk adjustments incorporated into the discount rate) should be based on management's estimate of assumptions that market participants would use in pricing the asset in a current transaction at the measurement date. If market data from transactions involving comparable assets indicate, for example, that a significant liquidity discount applies at the measurement date to compensate for the difficulty in selling assets under current market conditions, Entity F should incorporate that information in its cash flow model (e.g. through an adjustment to the discount rate) even if management's internal data would not result in such a liquidity adjustment.

Example 3.3B**Use of assumptions that market participants would use**

Entity A uses a discounted cash flow model as a valuation technique to measure the fair value of its investment in the debt securities of Entity X. No quoted price for identical securities is available. Entity A's valuation technique requires assumptions about default rates as inputs. Default rate assumptions can be readily derived from current relevant observable market data: for example, actively traded credit default swaps (CDSs) on publicly traded bonds of Entity X, or asset swap spreads (the differential between the bond yield and the LIBOR curve expressed in basis points) or issuer spreads on the basis of recent notes issuances.

In applying its valuation technique to measure fair value, Entity A should maximise the use of relevant observable inputs. Therefore, it cannot rely solely on its own historical default data for issuers with a credit quality similar to that of Entity X or on its own default assumptions, even if the

default assumptions are 'stressed' (e.g. by changing the inputs to other reasonably possible alternative assumptions). Instead, Entity A should use the relevant default rate assumptions that are observable in the market.

Example 3.3C**Fair value measurement of loans and receivables – requirement to consider the credit standing of the borrower**

Entity A (a lender) has a loan receivable from Entity B (a borrower). When measuring the fair value of the loan receivable, Entity A should take into account the credit standing of Entity B.

A lender is required to take into account a borrower's credit standing when measuring the fair value of a loan receivable in accordance with IFRS 13.

IFRS 13:22 states that "[a]n entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest".

Market participants would incorporate the effect of a borrower's credit standing into the valuation of a loan receivable because the borrower's credit standing can be indicative of the amount that will be collected on the loan. Therefore, Entity A should make appropriate adjustments to the fair value measurement of its loan and receivable to reflect Entity B's credit standing.

These requirements are relevant when Entity A measures the loan receivable at fair value on initial recognition and/or at subsequent reporting dates. They are also relevant when Entity A measures the receivable at amortised cost at subsequent reporting dates because, subject to limited exceptions, IFRS 7 requires that the fair value of financial instruments be disclosed at each reporting date. The amount disclosed should be measured in accordance with IFRS 13 and the disclosures required under IFRS 13:97 should be provided.

3.3.1 Identifying market participants when no apparent exit market exists

IFRS 13:21 requires that, even when there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement should assume that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability (see 3.2.1 above).

variability in its debt due to changes in 3m LIBOR. Entity A intends to cash flow hedge the variability in interest rates on its borrowings even though the interest on the borrowings is capitalised under IAS 23.

Entity A can apply cash flow hedge accounting of the interest rate risk on its variable rate borrowings but the gain/loss on the derivative that is recognised in other comprehensive income is reclassified from equity to profit or loss when the interest component of the qualifying asset affects profit or loss.

Entity A will apply the following steps in order.

- (i) Capitalise the variable rate interest on the borrowing in accordance with IAS 23.
- (ii) Determine the effectiveness of the cash flow hedge and recognise any ineffectiveness in profit or loss. Recognise the effective gain/loss on the derivative in other comprehensive income.
- (iii) The amount recognised in other comprehensive income will be reclassified from equity to profit or loss when the hedged risk affects profit or loss. The hedged interest that is capitalised as part of the qualifying asset will affect profit or loss when the qualifying asset is amortised, impaired or is sold. The net effect in profit or loss from this reclassification is that the impact in profit or loss will be equivalent to the entity borrowing at fixed rates and capitalising fixed borrowing costs.

If an entity does not apply hedge accounting and, therefore, the derivatives are classified as at fair value through profit or loss, it is not appropriate for the entity to capitalise part of the derivative as part of the borrowing costs under IAS 23. All gains/losses on non-hedging derivatives must be immediately recognised in profit or loss.

2.7 Hedging non-financial items

As described in 3.9 in chapter C9 a non-financial asset or liability may qualify as a hedged item in limited circumstances. More complex aspects of hedging non-financial items are described below.

2.7.1 Hedging foreign currency risk of non-financial asset held at cost

If an entity is hedging foreign currency risk, this risk must be separately measurable. A non-financial asset that was purchased in a foreign currency cannot be hedged for foreign currency risk because foreign currency risk is not evident in that non-financial item. However, the foreign currency risk associated with a forecasted sale of that non-financial item could qualify as a hedged item.

It is important to distinguish between hedging foreign currency risk of a non-financial item and hedging foreign currency risk in relation to the forecast sale or purchase of that non-financial item.

Example 2.7.1 below illustrates that it is not possible to hedge the foreign currency risk of a non-financial item because the foreign currency risk is not evident and not separately measurable. However, if an entity is purchasing or selling a non-financial item in a foreign currency, it is a fixed amount of foreign currency that will be needed to buy or will be received from selling that non-financial item, and a qualifying foreign currency exposure therefore exists.

Example 2.7.1

Hedging a non-financial item: held at cost

Entity A, a Sterling functional currency entity, acquires some plant and machinery in US\$ from Entity B, an unrelated third party US dollar functional currency entity. In the financial statements of Entity A, the plant and machinery will be translated at the US\$:£ exchange rate at the date of the purchase (i.e. at historical rate).

If Entity A used US dollar borrowing to finance the purchase of the plant and machinery, these US dollar borrowings cannot be used as a hedging instrument in a fair value hedge of the foreign currency risk of the plant and machinery because the hedged item does not contain any separately measurable foreign currency risk.

If Entity A was to demonstrate that the disposal of the plant and machinery in US dollars was highly probable, then the US dollar denominated debt could be used as a hedging instrument against the forecast sale in US dollar provided that the timing of the future cash flows on the debt coincided with the timing of the future cash flow on the disposal.

Non-derivatives can be used as hedging instruments only when hedging foreign currency risk. This is discussed further in 4.1 in chapter C9.

2.7.2 Hedging all risks except foreign currency

IAS 39 is clear that hedges of a non-financial instrument are possible for all risks or just foreign currency risk. Therefore, by deduction, it is possible to hedge all risks except foreign currency risk, assuming all other hedge accounting criteria are met. IAS 39:IG.E.3.4 on the interaction between IAS 39 and IAS 21 supports this assertion. For financial instruments, fair value is firstly determined in the currency

in which the contract is denominated, and translation of the contract into the functional currency of the entity is secondary. If it can be clearly demonstrated that the exposure to fair value of the non-financial instrument excluding foreign currency risk can be identified and measured, and hedged for all risks except foreign currency risk, such exposure is a permissible hedging designation.

Example 2.7.2

Hedging a non-financial item: all risks except foreign currency

Entity O has an anticipated purchase of 1,000 barrels of oil in six months that is highly probable of occurring. The purchase price will be the market price at the date of purchase and will be priced in US dollars. Entity O's functional currency is the Australian dollar.

Entity O purchases oil futures on 500 barrels of oil to fix the price at US\$60 for those 500 barrels. The duration (and other terms) of the forecast transaction and the futures contracts match so that Entity O believes the hedge will be highly effective over its term.

Entity O has two risk exposures: foreign currency risk and fair value risk.

The oil futures hedge price risk only. Entity O does not co-terminously hedge its exposure to the US dollar on the purchase contract.

The oil futures can be designated as a hedge of the forecast purchase of oil (provided that the other hedge accounting criteria are satisfied). A forward purchase of oil (a non-financial asset) does not have inherent foreign exchange risk. The foreign exchange risk arises from the fact that the reporting entity's functional currency is not the US dollar, not from the market price risk inherent in a forward purchase of oil.

2.7.3 Hedging income tax

IAS 39 does not prohibit an entity from hedging the cash flow variability arising from income tax where income tax affects profit or loss. However, IAS 32:AG12 makes clear that income taxes are not financial liabilities or assets as they are not contractual, because they result from statutory requirements. Accordingly, for hedging purposes, income tax is a non-financial item. Designating a non-financial item is more restrictive than hedging a financial item because the entity can only designate all risks in their entirety or just foreign currency risk. Because income tax varies due to the underlying net income upon which the tax is based, it will likely prove difficult to achieve hedge accounting because the notional amount of the derivative would need to change continuously to correspond with the

taxable portion of the net income of the entity. In most cases, this will prove to be too complex to achieve.

In some cases, the variability in net income is more easily determinable, e.g. in a special purpose entity which has a limited amount of transactions, assets and liabilities. In such cases, it may be possible to designate a derivative hedging instrument as a hedge of the cash flow variability of income tax that will affect profit or loss.

As with all cash flow hedges, IAS 39 does not prescribe where gains and losses on derivatives designated as hedging derivatives should be presented. It has become customary, and is useful to the users of the financial statements, for the hedging effects of derivatives to be presented in the statement of comprehensive income in the same line as the item that they hedge. Therefore, although the hedging gain or loss is clearly not an income tax as defined by IAS 12, an argument can be made for including the effects of derivatives that an entity has entered into as hedges of its income tax liability in the income tax line in the statement of comprehensive income.

When an entity chooses to present derivative gains or losses relating to designated tax hedging derivatives within the income tax line, this accounting policy choice should be applied consistently from period to period. Furthermore, appropriate separate disclosure of the amount attributable to hedging gains/losses should be made in the notes.

2.8 Designation of groups of items

It is possible to group together similar assets or similar liabilities and hedge them as a group, but only if the individual items within the group share the same risk exposure that is designated as being hedged. The change in fair value attributable to the hedged risk of each item in the group must be approximately proportional to the change in fair value attributable to the hedged risk of the entire group. [IAS 39:83]

IAS 39 does not provide specific guidance as to what is approximately proportional. It is reasonable to assume that while it is not expected that the items within a portfolio have exactly the same sensitivity to the hedged risk, the items must show a high degree of similarity for a given movement in the hedged risk.

Investments in debt instruments that have different credit ratings and different maturities can be combined and hedged as a portfolio. In order to

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 C9 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 IAS 39: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:

- the foreign currency risk of part of its foreign operation (being the € equivalent of US\$150 million net assets); and
- 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:

- Receive fixed €100m, Pay 3m-EURIBOR on €100m (notional derivative 1); and