

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;

1.1 Summary of IFRS 13 framework

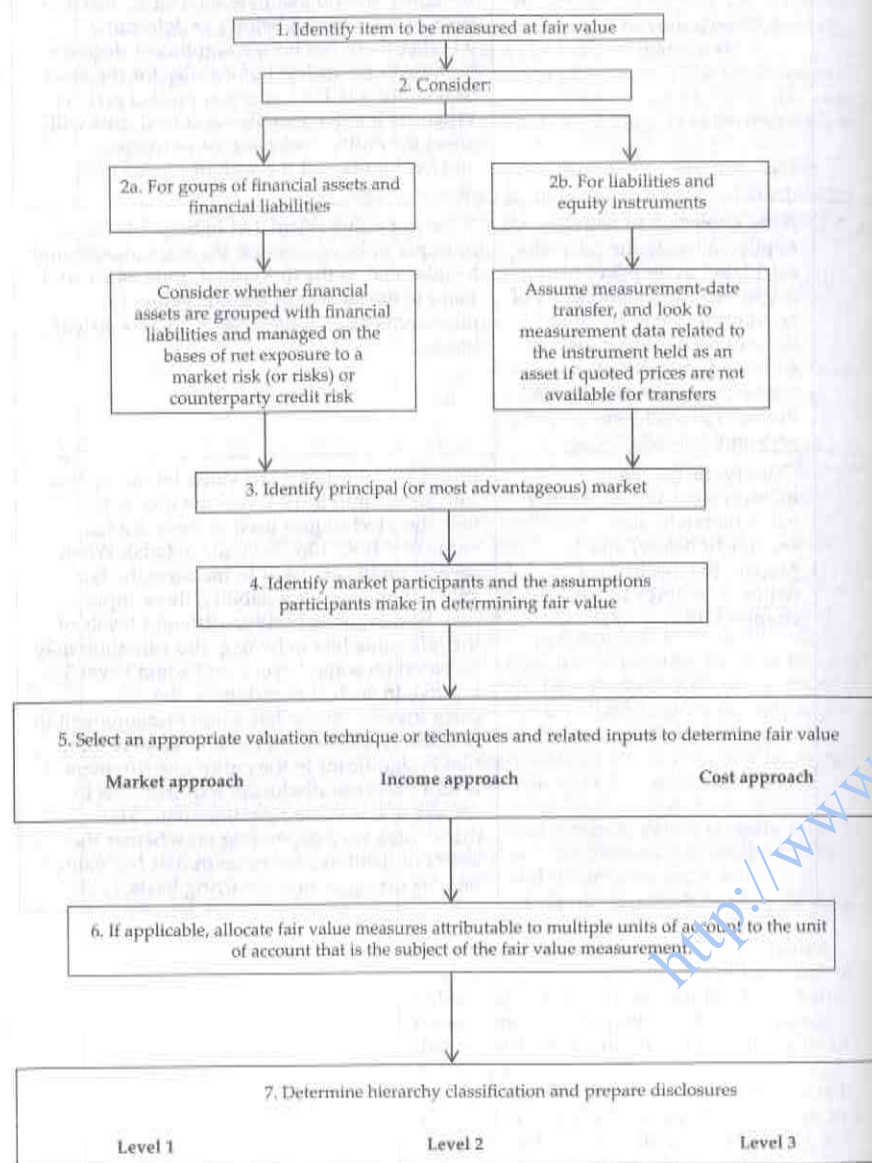
The table and flow chart below set out a step-by-step approach to applying the basic measurement principles of IFRS 13 to financial instruments. The table also provides a high level summary of some of the key concepts underlying IFRS 13 and illustrates the framework for measuring fair value. The summary 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