Example 5.1A

More than one business model

Entity A has a retail banking business whose objective is to collect the contractual cash flows of its loan assets. Entity A also has an investment banking business whose objective is to realise fair value changes through the sale of loan assets before their maturity.

Entity A's financial instruments held in the retail banking business qualify for amortised cost measurement even if similar financial instruments in the investment banking business do not.

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (e.g. if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see IAS 8) nor does it change the classification of the remaining financial assets held in that business model (i.e. those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information. [IFRS 9:B4.1.2A]

Example 5.1B

Assessment of business model at initial recognition

Entity B has a portfolio of loans that are held within a business whose objective is to hold to collect contractual cash flows. Entity B has disposed of some of its loans over the period but continues to regard the business that holds the remaining loans as having an objective to hold to collect contractual cash flows.

Entity B purchases a new portfolio of loans. Entity B must consider the objective of the business that acquired the loans and in doing so it considers whether the disposals of previously held loans in the period indicate a different business objective for holding financial assets.

An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

[IFRS 9:B4.1.2B]

(a) how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

(b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and

(c) how managers of the business are compensated (e.g. whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

An entity will need to reassess its business model each reporting period to determine whether the business model has changed since the preceding period. Increasing levels of sales of financial assets held within a business that previously met the amortised cost or FVTOCI criteria may be evidence that the business model has changed and, therefore, warrant reclassification of financial assets (see **section 7**).

When sales of financial assets measured at amortised cost become more frequent, but the business model is itself unchanged, the remaining assets in the business will continue to be measured at amortised cost. However, this would not be the case if the business model assessment underlying the amortised cost classification in the previous financial statements was incorrect based on the information available as of the date of the original assessment as this would be an error; in such circumstances, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would require the financial assets to be restated to be as at FVTPL or FVTOCI.

As described above, an entity may have multiple business models. At initial recognition, care should be taken in determining whether newly recognised financial assets are part of an existing business model or whether they reflect the commencement of a new business model; if they are considered to reflect the commencement of a new business model, they will be assessed separately for the purpose of the amortised cost criteria.

is permitted to prepay, or the holder is permitted to require the issuer to prepay, when the prepayment amount substantially represents an unpaid amount of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

The example included in IFRS 9:B4.1.11 illustrates the principle that the prepayment term should merely accelerate the timing of the principal that is due at maturity. Additional compensation above the principal amount often represents compensation for interest rate risk.

In the case of floating rate debt instruments the issuer and borrower are indifferent to changes in interest rates in terms of when to exercise the prepayment option as the debt instrument is continuously being reset to a market interest rate. Therefore, it is unlikely that compensation will be included for changes in interest rates other than the compensation for any contractual coupon that has accrued but not been settled.

Compensation for early termination of the contact will be common when the debt instrument has a fixed rate and market interest rates have fallen since the debt was issued. If the issuer prepays the debt early the holder will often be compensated for the interest rate risk benefit it previously had in holding debt with an interest rate higher than the interest rate that would be achieved if investing in debt at the prepayment date. The compensation may be calculated by comparing the remaining contractual coupons with the return that would be achieved by the holder investing in a debt instrument with a comparable credit rating with the same time to maturity. The interest rate differential is compared and the difference is present valued. Compensation in cases like this is often referred to as a 'make-whole' provision.

Example 5.4.4C

Borrower's option to prepay at par

Entity A lends CU10 million to Entity B at a fixed interest rate; the loan is repayable in three years. Entity B has the right to prepay the loan after the first anniversary of the loan at CU10 million plus any accrued interest.

The prepayment option written by Entity A as part of the loan to Entity B does not breach the contractual cash flows characteristics test because the right to prepay merely results in the acceleration of the payment of principal outstanding plus accrued interest since the last interest payment date.

Example 5.4.4D

Borrower's option to prepay at a premium

Entity B lends CU10 million to Entity C at a fixed interest rate; the loan is repayable in three years. Entity C has the right to prepay the loan after the first anniversary of the loan at CU10 million plus any accrued interest plus a prepayment penalty.

The prepayment option written by Entity B as part of the loan to Entity C does not breach the contractual cash flows characteristics test because the right to prepay merely results in the acceleration of the payment of principal outstanding. Compensation for accrued interest and a reasonable penalty which aims to compensate Entity B for reinvestment risk (because Entity C is more likely to prepay the loan when interest rates have fallen) would not breach the contractual cash flows characteristics test.

Example 5.4.4E

Borrower's option to prepay at a variable premium

Entity C lends CU10 million to Entity D at a fixed interest rate; the loan is repayable in three years. Entity D has the right to prepay the loan at an amount equal to the present value of the remaining contractual interest and principal payments (i.e. payments due up to including the end of Year 3) discounted by the original effective interest rate adjusted for changes in interest rates since origination if the risk-free market interest rate is lower than the equivalent risk-free market interest rate at origination. The prepayment penalty (otherwise known as a 'make-whole' provision) aims to compensate the lender for decreases in market interest rates since the loan was originated.

Because the exercise of the prepayment feature provides the lender with compensation for unpaid amounts of principal and interest on the principal amount outstanding, the prepayment feature does not breach the contractual cash flows characteristics test.

Example 5.4.4F

Lender's option to demand early repayment contingent on change in tax law

Entity F lends CU10 million to Entity G at a fixed interest rate; the loan is repayable in three years. Entity F has the right to demand early repayment at par plus unpaid accrued interest from Entity G if there is a change in tax law that has a negative impact on Entity F's post-tax internal rate of return on its lending.

Similarly, Entity G may have the right to repay the loan if a change in tax law adversely affects the post-tax cost of its borrowing from Entity F.

In either case, because the prepayment option is contingent on a change in relevant taxation that is designed to protect the borrower or lender from adverse

Example 2.1.5

Perpetual instrument with coupon step-up and dividend pusher

Bank A issues a perpetual instrument with the following terms.

- €100 million notional with annual 8 per cent interest payments for 8 years. Bank A has a call option embedded in the instrument that allows the instruments to be repurchased at the end of Year 8, and each year thereafter, for €100 million.
- If the instrument is not called by Bank A at the end of Year 8, the interest on the instrument increases to 14 per cent per annum (commonly referred to as a 'step-up' feature).
- The interest payments (both before and after the call date) are only payable if Bank A pays a dividend on its ordinary shares (commonly referred to as a 'dividend pusher'); the ordinary shares are classified wholly as equity.

Bank A has consistently chosen to pay dividends on its ordinary shares. When the perpetual instrument is issued, Bank A's cost of borrowing for a similar debt instrument is approximately 8 per cent.

Bank A does not have an indirect or a direct obligation to deliver cash or another financial asset in respect of the perpetual instrument. The instrument is therefore classified wholly as equity.

Bank A has no obligation to pay interest because it can always avoid paying interest by exercising its discretion and not paying dividends on its ordinary shares. Bank A has no obligation to exercise its right to call the instrument at the end of Year 8 because the call right is an option and Bank A can always choose not to exercise that right. Because the instrument is perpetual, there is no redemption date and, therefore, the instrument does not contain any contractual obligation to deliver cash or another financial asset.

In determining the substance of the contractual arrangement, an entity must assess whether the terms of the instrument provide the issuer with discretion as to whether to deliver cash or another financial asset. In the circumstances described, Bank A has discretion as to whether or not it wishes to pay an ordinary dividend. Even though it may be highly likely that Bank A will choose to pay ordinary dividends and, as a result, will be required to pay interest under the perpetual instrument, the high likelihood is of itself not sufficient for the instrument to be classified as a financial liability. Similarly, although it may be very likely that Bank A will pay interest on the perpetual instrument and will exercise its call option at the end of Year 8 (thus making the instrument economically equivalent to an 8-year loan), this likelihood of itself is not sufficient for the instrument to be classified as a financial liability.

2.1.6 Shares to the value of, or issuer settlement option

Some instruments may contain an obligation for the issuer to deliver a variable number of its own equity instruments such that the fair value of the entity's own equity delivered under the arrangement equals the amount of

the contractual obligation. The amount of the contractual obligation may be fixed or may fluctuate in part or in full in response to a variable other than the market price of the issuer's own equity.

Such instruments do not meet the definition of equity because the issuer is merely using its own shares as currency to extinguish its obligation. The contract therefore does not evidence a residual interest in the entity's assets after deducting all of its liabilities. [IAS 32:21]

Example 2.1.6A

Variable number of shares to the value of a fixed obligation

Entity A issues CU0.01 nominal preference shares that will pay out CU1 over three years. Entity A will pay the CU1 in its own ordinary shares so that the number of shares issued will vary to equate to CU1 in value.

The instrument is a financial liability because Entity A issues shares such that the fair value of the shares delivered is always equal to the amount of the contractual obligation (i.e. a variable number of shares).

Example 2.1.6B

Variable number of shares to the value of a variable obligation

Entity B issues an instrument for CU100 that pays no interest before maturity. At maturity, Entity B is required to deliver as many of its own equity instruments as are equivalent in value to the original issue price of CU100 plus a supplemental redemption amount depending on whether a designated share price index has increased between issuance of the instrument and the maturity date. The supplemental amount is determined as a multiple of the percentage increase in the share price index from the date of issue of the instrument to maturity and the original issue price. If the share price index has fallen over the life of the instrument, equity instruments equivalent in value to CU100 are delivered.

The instrument is a financial liability in accordance with IAS 32:11 because the instrument will be settled by delivery of a variable number of Entity B's equity instruments.

As stated in IFRS 9:B4.3.5(c) equity-indexed payments are not closely related to a debt instrument in which they are embedded. Accordingly, this feature needs to be separated out from the host contract and accounted for separately in accordance with IFRS 9:4.3.

2.1.7 Contingent settlement provisions

Financial instruments may be structured such that the obligation to deliver cash or another financial instrument arises only on the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument. The issuer does not have an unconditional right to avoid

The entries to be recorded upon settlement will depend on which of the two methods of net settlement is chosen. If net share settlement is chosen, the following entry will be made.

		CU	CU
Dr	Equity	3,750	
Cr	Swap asset		3,750

To recognise the net share settlement.

In this scenario, settlement will take place through the entity taking receipt of 150 of its own shares (CU3,750/CU25) (the market value of the entity's share on this date is CU25).

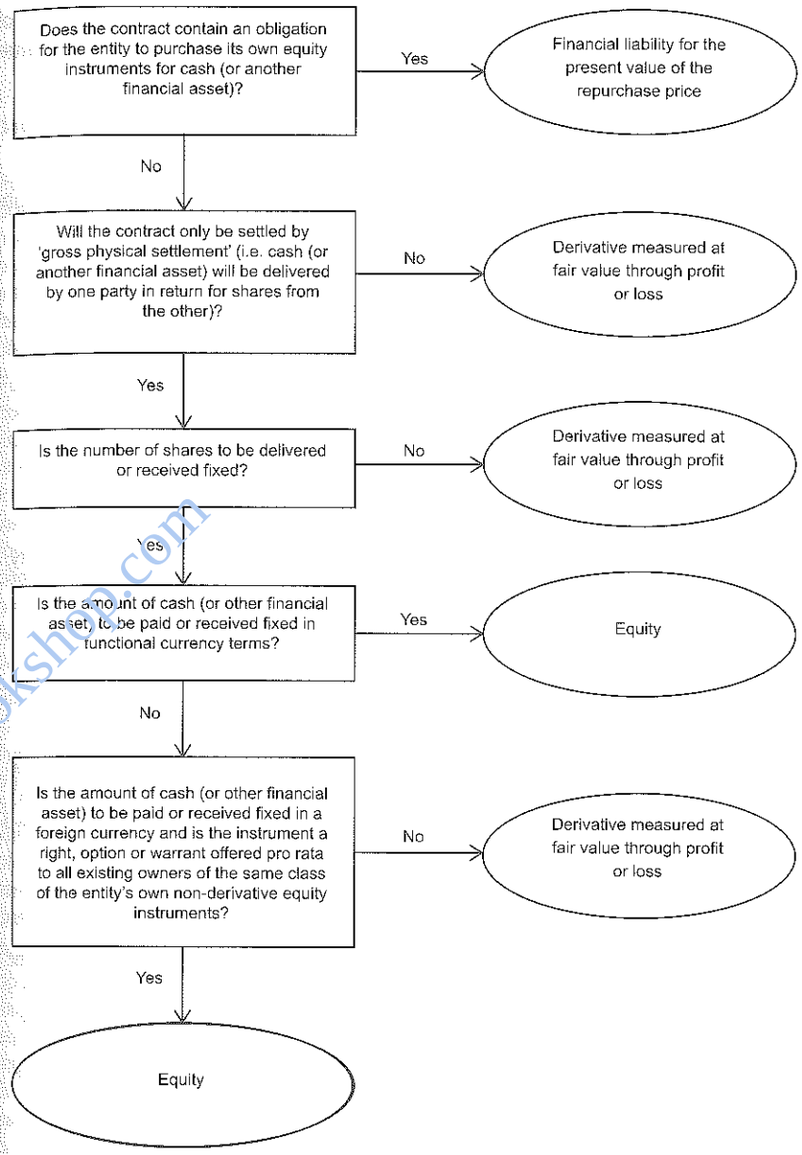
If net cash settlement is chosen, the following entry will be made at settlement of the contract.

		CU	CU
Dr	Cash	3,750	
Cr	Swap asset		3,750

To recognise the net cash settlement.

The following decision tree summarises the classification of derivatives over own equity instruments. In making this determination, it should also be noted that:

- in consolidated financial statements, derivatives over the equity of subsidiaries are treated in the same way as derivatives over the equity of the parent entity;
- recognition of a financial liability for an obligation to purchase own equity for cash (or another financial asset) is required even if the obligation is conditional on the holder exercising its right to sell the shares to the entity and notwithstanding the fact that the contract itself may be an equity instrument (because it can be settled only through the entity delivering a fixed amount of cash in exchange for a fixed number of its own shares); [IAS 32:23] and
- a derivative over own equity when the underlying equity instrument meets the requirements for equity classification in accordance with either IAS 32:16A & 16B (puttable instruments) or IAS 32:16C & 16D (instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) of IAS 32 cannot be classified as equity. [IAS 32:22A]



The following table illustrates the application of IAS 32 to different derivatives over own equity, with different settlement mechanisms. The settlement mechanisms are described as follows.

(1) **Net cash settlement.** When one party's net gain/loss is settled in cash and no shares are exchanged.

Care is needed in determining how the carrying amount of an embedded derivative is treated when the embedded derivative is no longer closely related. This is particularly relevant when the modification occurs without cash consideration or when the cash consideration differs from the value of the embedded derivative derecognised. The carrying amount of the embedded derivative, being its fair value, at the date of modification of the contract, will be recognised in profit or loss, remain in the statement of financial position or be recognised in other comprehensive income in the period or future periods depending on the substance of the modified terms of the contract. Consideration will need to be given as to whether the pricing of the remaining contract is modified to reflect the value of the change in terms of the arrangement; whether any other goods or services are provided or received as part of the modification; or an equity transaction occurs between the entity and the counterparty.

Consideration will also need to be given to the substance of the modification when a non-closely related embedded derivative is recognised for the first time following the modification of a contract where previously the embedded derivative was closely related. The substance of the arrangement will determine whether, having recognised the derivative at fair value, the counter-entry affects profit or loss, the statement of financial position or other comprehensive income.

4 Terms of the embedded derivative and the debt host contract

The term 'debt host contract' that is applied below refers to debt instruments that are issued by an entity (and that, therefore, are financial liabilities).

The terms of the host contract must reflect the stated or implied terms of the hybrid contract (i.e. the embedded feature must be clearly present in the hybrid contract). In the absence of implied or stated terms a judgement may have to be made, but an entity cannot create cash flows that do not contractually exist.

Example 4A

Fixed versus floating debt host contract (1)

Entity A issues floating rate debt. The contract cannot be seen as fixed rate debt with an embedded interest rate swap that swaps fixed rate cash flows into floating rate cash flows. The terms of the contract do not contain any fixed cash flows, so there can be no embedded feature with fixed rate cash flows.

Example 4B

Fixed versus floating debt host contract (2)

A 5-year debt instrument has fixed annual payments, and a principal repayment at the end of the contract which is conditional on changes in the FTSE 100 index. This instrument must be treated as a host fixed rate debt contract with an embedded equity feature. It cannot be classified as floating rate debt with an embedded equity swap that has an offsetting floating rate leg. The host is a fixed rate contract because there are no variable interest rate payments in it.

Embedded non-optional derivatives must be determined so that they have a fair value of zero at inception of the contract. If this was not stipulated, it would be possible to split one instrument into an infinite number and variety of hosts with embedded derivatives. This could be done by separating embedded derivatives with terms that create leverage, asymmetry or another risk exposure that does not exist in the hybrid contract. [IFRS 9:B4.3.3 & IFRS 9 Guidance on Implementation C.1]

Embedded optional derivatives will not necessarily have a fair value (or intrinsic value) of zero at inception. The fair value of such an embedded derivative will depend on its strike price or rate. Therefore, the separation of an option from a hybrid contract should be based on the stated terms of the option feature. [IFRS 9:B4.3.3 & IFRS 9 Guidance on Implementation C.2)]

5 Determination of host contract: debt vs. equity

If a hybrid contract has both debt and equity features, a determination must be made as to whether the host contract is debt or equity. Often, this will be a relatively straightforward task because the 'majority' of the contract will behave either more like debt or more like equity.

If the host contract has no stated or predetermined maturity and represents a residual interest in the net assets of the issuer, then its economic characteristics and risks are those of an equity instrument. Any embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument. [IFRS 9:B4.3.2]

More commonly, the host contract will not represent a residual interest in an entity and, thus, the economic characteristics and risks of a financial host contract will be considered that of a debt instrument. For example, even though an overall hybrid instrument may provide for repayment of the principal linked to the market price of the issuer's ordinary shares, the host contract may not involve any existing or potential residual rights in the net assets of the issuer (i.e. rights of ownership) so would not be an equity

recognised in other comprehensive income. The foreign currency element will never affect profit or loss because no fair value amounts accumulated in equity related to equity instruments designated as at FVTOCI are permitted to be subsequently reclassified to profit or loss.

3.3.1 Financial assets and liabilities measured at FVTPL

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 and debt instruments measured at FVTOCI

For financial assets and financial liabilities measured at amortised cost as well as debt instruments measured at FVTOCI (which for the purposes of calculating foreign currency translation in profit or loss are treated as if they were amortised cost) are monetary items and so 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. Such foreign currency gains and losses are recognised in profit or loss.

As the foreign currency element recognised in profit or loss for a debt instrument measured at FVTOCI is the same as if it was measured at amortised cost, the residual foreign currency element based on the translation of the carrying value (at fair value) is recognised in other comprehensive income.

3.3.3 Hedged items and hedging instruments

IAS 21 specifically excludes from its scope the measurement of foreign currency items that are subject to hedge accounting because IFRS 9 is more specific on how to recognise gains or losses when hedge accounting is applied. 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 IFRS 9 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. [IFRS 9:6.5.8] 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)] For example, an investment in a subsidiary that is measured at cost is fair value hedged for foreign currency risk.

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 or a hedge of a net investment in a foreign operation (see **chapter B9**). [IFRS 9:B5.7.2] If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss. [IFRS 9:B5.7.4]

3.3.4 Summary of foreign currency accounting

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

Classification	Monetary or non-monetary item	Foreign currency gains and losses from remeasurement (prior to its disposal)*
Amortised cost (whether a financial asset or financial liability)	Monetary item, calculated on the instrument's amortised cost.	Profit or loss
Debt instruments held that are fair valued through other comprehensive income	Monetary item, calculated on the instrument's amortised cost.	Profit or loss (with the foreign currency element that is not based on amortised cost, being the translation on the difference between the fair value and the amortised cost is recognised in other comprehensive income along with the other fair value gains or losses)
Equity instruments held that are fair valued through other comprehensive income	Non-monetary item	Other comprehensive income
Fair value through profit or loss (whether a financial asset or financial liability)	Monetary or non-monetary	Profit or loss as part of the fair value gains and losses on the entire instrument

* Assumes that the item is not being hedged for foreign currency risk, or is not a hedging instrument in a foreign currency hedge.

3.3.5 Dual currency bonds issued

IFRS 9:B4.3.8(c) states that a foreign currency derivative that provides a stream of principal or interest payments denominated in a foreign currency and that is embedded in a host debt instrument (e.g. a dual currency

(a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.

(b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.

(c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity etc are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described above, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with IFRS 9:5.5.3 (see **5.2.1**).

5.2.5.2 *Simplified approach for trade receivables, contract assets and lease receivables*

The impairment model does not require the general approach (under which changes in credit risk since initial recognition must be monitored, see **5.2.1**) to be applied for all trade receivables, contract assets (in scope of IFRS 15 *Revenue from Contracts with Customers*) and lease receivables (resulting from transactions that are within the scope of IAS 17 *Leases*).

Instead a simplified approach can apply for these assets under which a lifetime expected loss allowance is *always* recognised (i.e. a loss allowance for 12-month expected losses is not initially or subsequently recognised). As a result there is no need to identify significant increases (or decreases) in credit risk for the purpose of measuring the impairment allowance in the statement of financial position as required under the general approach. This can make the application of the impairment model more operational. However, a consequence of always recognising a loss allowance for lifetime expected losses for assets with a term longer than 12 months is that it can give rise to a larger loss allowance and larger impairment loss on initial recognition (because lifetime expected losses for an asset with a term longer than 12 months is expected to be greater than 12-month expected losses).

In some cases the simplified approach is required and in other cases it is an accounting policy choice. For trade receivables and contract assets that do not contain a financing component (see below), it is a requirement to recognise a lifetime expected loss allowance. For other trade receivables, other contract assets, operating lease receivables and finance lease receivables it is an accounting policy choice that can be separately applied for each type of asset (but applies to all of that type of asset), as summarised below. [IFRS 9:5.5.15 & 16]

	Lifetime expected loss allowance *always* recognised
Trade receivables and contract assets that *do not contain a significant financing component*	Requirement
Trade receivables that contain a significant financing component	Accounting policy choice (for *all* such trade receivables)
Contract assets that contain a significant financing component	Accounting policy choice (for *all* such contract assets)
Operating lease receivables	Accounting policy choice (for *all* operating lease receivables)
Finance lease receivables	Accounting policy choice (for *all* finance lease receivables)

A significant financing component exists if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. [IFRS 15:60] A contract with a customer would not have a significant financing component if any of the following factors exist:

[IFRS 15:62]

(a) the customer paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer.

(b) a substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

(c) the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the

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

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

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

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

5.1.1 General principles

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

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

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

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

IFRS 13 requires that the fair value measurement be based on an assumed transfer to a market participant even if an entity does not intend to transfer its liability or own equity instrument to a third party

(e.g. because the entity has advantages relative to the market that make it more beneficial for the entity to fulfil the liability using its own internal resources) or it is unable to do so (e.g. because the counterparty would not permit the liability to be transferred to another party). [IFRS 13:BC81 & 82]

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

Consistent with the objective of fair value measurement and the prioritisation in the fair value hierarchy (see **section 10**), when measuring the fair value of a liability or an entity's own equity instrument at fair value, the entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs.[IFRS 13:36]

5.1.2 Liabilities and equity instruments held by other parties as assets

When a quoted price for the transfer of an identical or a similar financial liability or an entity's own equity instruments is not available, and the identical item is held by another party as an asset, an entity is required to measure the fair value of the financial liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date. [IFRS 13:37] This requirement could be relevant, for example, when measuring the fair value of corporate bonds or a call option on an entity's shares. [IFRS 13:35]

Determining the fair value of a financial liability or an entity's own equity instrument from the perspective of the counterparty holding the same instrument as an asset reinforces the notion that the fair value ascribed to the contract is the same irrespective of whether the entity is the issuer or the holder. This is based on the theory that fair value is based on a transaction in which the contract is transferred, as opposed, to being settled or extinguished with the holder. In all cases the fair value is based on the premise that the instrument remains outstanding and therefore is a theoretical transfer value.

In the circumstances described above, the appropriate bases for measuring the fair value of the liability or the entity's own equity instrument are listed below, in descending order of preference:

IAS 39:43 (now IFRS 9:5.1.1). The IFRIC observed that Example 3 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* deals with a similar situation. In that example, at the time when the financial liabilities are recognised as a result of a change in terms, they are recognised at their fair value.

The IFRIC observed that the change in the terms of the instrument results in the derecognition of the original equity instrument. The IFRIC noted that IAS 32:33 states that no gain or loss should be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. The IFRIC therefore concluded that, at the time when the terms are changed, the difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability should be recognised in equity.

2.2 Trade date and settlement date accounting

Under IFRS 9:3.1.2, a 'regular way' (see below) purchase or sale of financial assets can be recognised (and derecognised) using either trade date or settlement date accounting. The method used is required to be applied consistently for all purchases and sales of financial assets that belong to the same category as defined by IFRS 9. For this purpose, assets that are mandatorily measured at FVTPL form a separate classification category from assets designated as at FVTPL. [IFRS 9:B3.1.3]

A 'regular way' purchase or sale is defined as a transaction whose contractual terms "require delivery of the asset within a timeframe established generally by regulation or convention in the marketplace concerned". [IFRS 9: Appendix A] A marketplace is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable timeframe would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents. [IFRS 9 Guidance on Implementation B.28] The trade date is the date of the commitment to buy or sell the financial asset. The settlement date is the date of the delivery of the asset. If a transaction is considered 'regular way', a derivative is not recognised for the time period between the trade date and the settlement date.

When trade date accounting is applied, the entity recognises the financial asset to be received and the corresponding liability to pay for it at the trade date; on disposal, the financial asset is removed from the statement of financial position on the trade date. [IFRS 9:B3.1.5]

Under the settlement date accounting approach, the asset is recognised on the date on which it is received by the entity; on disposal, the asset is not derecognised until the asset is delivered to the buyer. When the purchase of an asset is accounted for using settlement date accounting,

between the trade date and settlement date, although the asset itself is not yet recognised, the entity is required to account for changes in its fair value, applying the same measurement basis that will be used to account for the acquired asset once it is recognised; therefore, changes in fair value are recognised in profit or loss for assets to be classified or designated as at FVTPL, in other comprehensive income (OCI) for assets to be designated as at fair value through other comprehensive income, and not recognised for assets measured at amortised cost. [IFRS 9:B3.1.6]

Example 2.2A

Trade and settlement date accounting for a purchase of an asset

The following example illustrates the amounts to be recognised for a purchase of a financial asset.

The dates and fair values that are relevant to the example are:

- trade date: 29 December 20X1 (fair value of asset 1,000);
- period end date: 31 December 20X1 (fair value of asset 1,002); and
- settlement date: 4 January 20X2 (fair value of asset 1,003).

The contracted price of the asset is set as the trade date fair value of 1,000.

TRADE DATE ACCOUNTING

Journal entries	Debt instrument measured at amortised cost	Investment in equity instruments designated as at FVTOCI	FVTPL
29/12/20X1			
	Dr Asset 1,000	Dr Asset 1,000	Dr Asset 1,000
	Cr Liability 1,000	Cr Liability 1,000	Cr Liability 1,000
Description	*To recognise the asset and payable.*	*To recognise the asset and payable.*	*To recognise the asset and payable.*
31/12/20X1			
	–	Dr Asset 2	Dr Asset 2
	–	Cr OCI 2	Cr Profit or loss 2
Description		*To recognise the increase in fair value to date.*	*To recognise the increase in fair value to date.*
04/01/20X2			
	–	Dr Asset 1	Dr Asset 1
	–	Cr OCI 1	Cr Profit or loss 1
Description		*To recognise the increase in fair value to date.*	*To recognise the increase in fair value to date.*

ownership of the transferred assets (e.g. substantially all the credit losses and the majority of interest rate risk on the loans transferred).

Interest	Fair value	Percentage of total fair value	Allocated carrying amount[1]	Sold interests	Retained interests
	CU	%	CU	CU	CU
Loans sold	900,000	85.71	840,000	840,000	–
Loans retained	100,000	9.53	93,333		93,333
IO strip	35,000	3.33	32,667		32,667
Servicing asset	15,000	1.43	14,000		14,000
Total	1,050,000	100.00	980,000	840,000	140,000

[1] The allocated carrying amount is calculated as the percentage of total fair value multiplied by the aggregate carrying amount prior to the transfer (CU980,000).

The difference between:

- the carrying amount (measured at the date of derecognition) allocated to the part derecognised; and
- the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) is recognised in profit or loss. [IFRS 9:3.2.13]

In the above example, the assets were carried at amortised cost and the amount recognised in the profit or loss is calculated as the difference between the consideration of CU900,000 and the allocated carrying amount of the derecognised asset of CU840,000.

There are likely to be instances in which allocation based on the 'relative fair value method' is difficult because it is difficult to obtain the fair value of the parts of the asset that are subject to derecognition and continued recognition. The Standard acknowledges that when an entity has a historical practice of selling parts similar to the part that is continued to be recognised, or other market transactions for such parts exist, recent prices for actual transactions would best reflect the fair value of the parts. When there are no price quotes available, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part of the asset that is derecognised. [IFRS 9:3.2.14]

3.3 Transfers that do not qualify for derecognition

When a financial asset is precluded from being derecognised in its entirety (i.e. the transferor retains substantially all of the risks and rewards of ownership), the entity continues to recognise the asset in its entirety and

recognises a financial liability for the consideration received. [IFRS 9:3.2.15] The asset and liability cannot be offset and, similarly, any income arising from the asset cannot be offset against any expense incurred on the liability. [IFRS 9:3.2.22] The asset's classification, measurement basis and income recognition does not change as a result of the transfer. This accounting treatment is often referred to as 'gross presentation' or 'secured borrowing' presentation.

Example 3.3

Transfer of receivables with credit guarantee

Entity X transfers short-term receivables to Entity Y and provides a credit guarantee to Entity Y over the expected losses of those receivables.

Entity X continues to recognise the receivables in its statement of financial position because it has retained substantially all the risks and rewards of ownership of the receivables. Entity X will recognise a financial liability for the proceeds received. The substance of the arrangement is that of a secured borrowing (i.e. short-term receivables provide security for the cash advanced by Entity Y).

When a derivative financial instrument forms part of the transfer arrangement and precludes the asset from being derecognised, the derivative is not accounted for separately because this would result in the rights to the cash flows being effectively counted twice. [IFRS 9:B3.2.14]

IFRS 9 does provide some guidance on the transferee's accounting in circumstances where the transferor continues to recognise the asset in its entirety. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor [IFRS 9:B3.2.15]. If the transferor continues to recognise the asset and, therefore, recognises a collateralised borrowing for the consideration received, then the transferee will not recognise the asset but will instead recognise a collateralised lending to the transferor. If a derivative is entered into between the transferor and the transferee as part of the arrangement, but it is not recognised by the transferor because it is an impediment to derecognition, then similarly the derivative will not be recognised by the transferee. The terms of the collateralised lending will include the cash consideration paid at the date of transfer, the contractual cash flows of the derivative, as well as the imputed repayment of principal.

3.4 Continuing involvement in the transferred assets

When an entity neither transfers, nor retains substantially all of the risks and rewards of ownership of a financial asset, and retains control of

- currency denomination;
- the guarantor (or elimination of the guarantor); or
- option features.

Example 4.1B

Debt modification: change in notional, interest, term

Entity P borrowed CU100 million on 1 January 20X0 at a fixed interest rate of 10 per cent per annum for 10 years. Entity P incurred no issue costs. Interest on the loan is payable annually in arrears. The original effective interest rate is 10 per cent. At the end of 20X4, Entity P is offered a number of alternatives to refinance its issued debt with effect from 1 January 20X0. The current market interest rate including a credit premium for Entity P's credit risk (which has remained unchanged) is 5 per cent for the remaining time to maturity of its existing debt, i.e. half the contractual cash flows on the original debt issued at the start of 20X0.

All proposed new borrowings are with the same counterparty and are used to buy back existing debt with the issue and buy back being in contemplation of one another. Assume for illustrative purposes only, the yield curve is flat at 1 January 20X5.

The fair value of the outstanding debt at 31 December 20X4 is determined as follows.

Period	Cash flows 10% x CU100m	Discount factor at 5%	Present value CUm
20X5	10	0.952	9.52
20X6	10	0.907	9.07
20X7	10	0.864	8.64
20X8	10	0.823	8.23
20X9	110	0.784	86.19
		Fair value	121.65

Scenario 1 – new borrowing at current market interest rate of 5% with notional amount equal to the amount needed to buy back the outstanding debt at market price

Entity P determines the present value of remaining cash flows on its existing debt at the original effective interest rate and compares this with the cash flows on the new debt also discounted at the same original effective interest rate.

The new debt has a notional amount of CU121.65 million and an interest rate of 5% and matures in 20X9.

Period	Cash flows Existing debt CUm	Cash flows New debt 5% x CU121.65m	Discount factor at 10%	Present value Existing debt CUm	Present value New debt CUm
20X5	10	6.08	0.909	9.09	5.53
20X6	10	6.08	0.826	8.26	5.03
20X7	10	6.08	0.751	7.51	4.57
20X8	10	6.08	0.683	6.83	4.15
20X9	110	127.73	0.621	68.31	79.31
				100.00	98.59

The difference between the present value of the existing and new debt discounted at the original effective interest rate is CU1.41million (1.41%). Because the difference is within the '10% test' the existing debt will not be derecognised.

Scenario 2 – same as Scenario 1 but term of new debt is extended by one year (assuming yield curve is flat)

The new debt has a notional amount of CU121.65 million and an interest rate of 5% and matures in 20Y0.

Period	Cash flows New debt 5% x CU121.65m	Discount factor at 10%	Present value New debt CUm
20X5	6.08	0.909	5.53
20X6	6.08	0.826	5.03
20X7	6.08	0.751	4.57
20X8	6.08	0.683	4.15
20X9	6.08	0.621	3.78
20Y0	127.73	0.564	72.10
			95.16

The difference between the present value of the existing and new debt discounted at the original effective interest rate is CU4.84 million (4.84%). Because the difference is within the '10% test', the existing debt will not be derecognised.

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

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

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

reclassification from equity to profit or loss when the hedged risk of the hedged item affects profit or loss; and

(ii) the shares would be recognised at fair value, being US$15 (Dr Shares US$15, Cr Cash US$10, Cr Derivative asset US$5).

If the share price subsequently rose or fell, and thus affected profit or loss, there would be no basis for determining how much of the gain recognised in other comprehensive income should be reclassified to profit or loss.

If the entity had expected to designate the equity instrument as at FVTOCI, the equity instrument would still not have been an eligible hedged item in an all-in-one cash flow hedge because fair value changes of the equity share would not impact profit or loss. A cash flow hedge must result in the hedged risk impacting profit or loss.

If at recognition of the equity investment an entity elects to measure it at FVTOCI, that equity investment would, subsequent to initial recognition, be an eligible hedged item in a fair value hedge in accordance with IFRS 9:6.5.3.

2.1.10 Splitting a derivative to exclude embedded financing

It is not possible to split the embedded financing from a non-optional derivative that has a fair value other than zero at the time of designation and account for it as a separate amortising loan whilst designating the zero fair value derivative as the hedging instrument.

If a non-optional derivative, such as a forward contract or swap, has a fair value other than zero at inception of the hedge, future changes in its fair value are affected by that starting value. The derivative includes an embedded financing element that contributes to its fair value movements and causes them to differ from the changes in fair value of the hedged item when the hedged item does not have an equal and opposite financing element.

IFRS 9 does not prohibit non-zero fair value non-optional derivatives being designated as hedging instruments as long as the hedge relationship meets the hedge effectiveness requirements (see IFRS 9:B6.4.15). In fact, IFRS 9:B6.5.28 allows hedging instruments to be designated part way through their lives and, therefore, it could be quite common for a derivative to have a starting value on designation other than zero.

However, the fact that a derivative is in or out of the money at inception of a hedging relationship will likely cause some hedge ineffectiveness over the term of the hedge. This is particularly the case for cash flow hedges because the 'hypothetical derivative' is deemed to be on-market at the date of designation, which for a non-optional derivative would have a fair value of zero (see **5.4.1**). This ineffectiveness arises because the embedded financing element is economically similar to a fixed rate

amortising loan embedded in the derivative and this 'loan' will change in fair value as interest rates move. By the time the derivative matures, the loan will have been fully eliminated along with the derivative.

In assessing hedge effectiveness, an entity should use a method that captures the relevant characteristics of a hedging relationship including potential sources of hedge ineffectiveness. An entity would also need to consider the appropriate hedge ratio at inception of the hedge and on an on-going basis.

2.1.11 Internal derivatives

In a group that has a central treasury function, a group entity or division that wishes to enter into hedging transactions uses their central treasury function rather than using an external group counterparty. The central treasury function then aggregates all its internal positions and enters into external transactions to offset the internal ones on a net basis thereby taking advantage of any natural offsets and hedging the exposures of the group in a cost efficient way.

At a group level, if the central treasury function enters into external derivatives these can be used as hedging instruments of exposures that exist at the group level (including eligible net positions, see **section 4**).

However, in the consolidated financial statements, intragroup derivatives cannot be hedging instruments because these are not external to the reporting entity and they are eliminated on consolidation. These intragroup derivatives may be used in the entity's individual financial statements because, from the individual entity's perspective, such derivatives are with an external third party. [IFRS 9:6.2.3]

Example 2.1.11A

Hedge accounting in the group versus individual financial statements

Entity A has a 100 per cent owned subsidiary, Entity B. The group treasury policy requires that only Entity A enters into derivatives with external parties. If Entity B wishes to enter into a foreign currency forward it notifies Entity A. Entity A enters into a forward with a bank (Forward 1), and then enters into an equal and opposite forward contract with Entity B (Forward 2). Entity B is not party to any contractual arrangement with the bank.

From a consolidated perspective, only the forward contract with the bank, Forward 1, can be a designated hedging instrument. In Entity B's individual financial statements, however, Forward 2 may be designated as a hedging instrument. This would be true even if Entity A had not entered into Forward 1 with the bank.

In Entity A's individual financial statements, there will be two equal and opposite derivatives. These must be presented separately in its statement of financial

than the contractual fixed rate coupons on the bond, the entity can designate as the hedged item a portion of each coupon cash flow equal to the fixed receipts of the swap. The fixed receipts of the swap and the cash flows on the designated portion of the bond will match and the hedge is likely to meet the hedge effectiveness requirements.

If interest rates have risen since the bond was issued, the coupons on the bond may be lower than the contractual fixed receipts on the interest rate swap. The entity can designate the bond as hedged for the benchmark interest rate portion of its fair value interest rate risk, provided that the benchmark rate is less than the effective interest rate of the hedged item, calculated based on the assumption that the entity had issued the bond on the date the hedge is designated. [IFRS 9:B6.3.23]

This is achieved by designating as the hedged risk both the contractual coupon payments and an amount of discount which is included in the difference between the current fair value of the bond and the amount repayable at maturity. A hedge designated in this way is likely to exhibit ineffectiveness because the fixed cash flows of the swap will have a different profile from the fixed cash flows of the hedged item; the fixed interest cash flows of the swap are composed of equal payments, while the hedged interest cash flows on the bond comprise lower contractual payments and a discount to par. The different cash flow profiles will result in different changes in fair value in response to changes in interest rates.

To minimise ineffectiveness, an entity may need to enter into a swap with a fixed leg rate equal to or lower than the contractual coupons on the bond. Such a swap does not have a zero fair value at inception because it is not entered into at market interest rates. When the upfront payment on the swap is structured to be equivalent to the discount on the bond, the swap will be more effective at hedging the bond than an on-market swap with nil fair value.

Example 3.17B

Fair value hedging fixed rate debt when interest rates have moved since issue

Entity F originated a four-year 5 per cent fixed rate loan of CU10,000 on 1 January 20X2, with a maturity date of 31 December 20X5. Of the 5 per cent coupon, 0.4 per cent represents credit spread (i.e. the market rate of interest was 4.6 per cent). Interest is receivable annually. The effective interest rate of Entity F's loan at inception is 5 per cent.

Scenario 1: Interest rates fall between 1/1/20X2 and 31/12/20X2

One year later, interest rates have fallen. At 31 December 20X2, the loan has a fair value of CU10,251. Entity F wishes to protect its loan asset against an

increase in interest rates by entering into a fair value hedge of interest rate risk. The current market rate of interest is now 3.5 per cent, rather than 4.6 per cent.

Entity F enters into a receive-variable rate, pay-fixed rate of 3.5 per cent interest rate swap on 31 December 20X2 with a maturity of 31 December 20X5 to hedge its fair value interest rate exposure. The swap is on-market, i.e. it has a fair value of zero at inception.

The benchmark interest rate of 3.5 per cent is lower than the contractual cash flows of the loan and, therefore, Entity F is permitted to designate as the hedged item a portion equal to the benchmark rate (e.g. LIBOR).

Scenario 2: Interest rates increase between 1/1/20X2 and 31/12/20X2

One year later, interest rates have increased. At 31 December 20X2, the loan has a fair value of CU9,081. Entity F wishes to protect its loan asset against a further increase in interest rates by entering into a fair value hedge of the interest rate risk. The current market rate of interest is now 6 per cent, rather than 4.6 per cent.

Entity F enters into a receive-variable rate, pay-fixed rate of 6 per cent interest rate swap on 31 December 20X2 with a maturity of 31 December 20X5 to hedge its fair value interest rate exposure. The swap is on-market, i.e. it has a fair value of zero at inception.

If Entity F had originated the loan when the hedging swap was entered into, it would not have originated the loan at 5 per cent, but at 6.4 per cent, i.e. at the benchmark interest market rate plus the appropriate margin given the counterparty's credit rating, i.e. the (6 per cent + 0.4 per cent). The benchmark interest rate of 6 per cent is lower than the effective interest rate of this 'hypothetical loan' and, therefore, Entity F is permitted to designate as the hedged item a portion equal to the benchmark rate (e.g. LIBOR) that is higher than the contractual fixed rate received on the asset.

Items with contractually specified risk components and negative margins can be designated as hedged items, however, the presence of negative margins will often limit the range of variability due to embedded floors in the contract that prevent the cash flows of the contract becoming negative. Hence if such risks are hedged with derivatives that do not contain a corresponding embedded cap to limit the cash flows on the derivative, hedge ineffectiveness may arise.

Example 3.17C

Hedging a variable rate financial liability with negative margin

[IFRS 9:B6.3.24]

If a variable-rate financial liability bears interest of (for example) three-month LIBOR minus 20 basis points (with a floor at zero basis points), an entity can designate as the hedged item the change in the cash flows of that entire liability

allocated specifically to those 10 future interest periods and, accordingly, is released to profit or loss in those future periods.

Example 6.5.3B

Change in timing of forecast sale of a non-financial item

Entity S designates a derivative as a hedging instrument in a cash flow hedge of a forecast sale of silver. The hedging relationship meets all of the conditions for hedge accounting.

In a subsequent period, S determines that the forecast transaction is expected to occur in an earlier period than originally anticipated.

The change in timing of the forecast transaction does not affect the validity of the designation. Entity S can conclude that the transaction is the same as the one that was designated as being hedged. However, the change in timing of the hedged transaction may affect the assessment of hedge effectiveness going forward because the hedging instrument must continue to be designated for the whole of its remaining period to maturity. Also, the amount recognised in other comprehensive income up to this point will need to be adjusted to be the lower of the cumulative gain or loss on the derivative from inception of the hedge and the cumulative change in fair value of the future cash flows of the forecast transaction.

If the hedged transaction is no longer expected to occur, then the cumulative amounts in other comprehensive income are reclassified from equity to profit or loss. [IFRS 9:6.5.12(b)]

Example 6.5.3C

Change in timing of forecast debt issuance

Entity D is hedging the forecast issuance of £100 million of 10-year, fixed rate debt using a rate lock agreement (a derivative). Entity D designates the rate lock agreement as a hedge of the variability in the total cash flows arising on the forecast debt issuance. Entity D expects to issue the debt in the second quarter of 20X0. Entity D's credit rating is BB. In the first quarter of 20X0, the spreads between government and corporate bond rates widen significantly. As a result, Entity D does not expect to issue its bonds in the second quarter. Entity D's advisers believe that the markets may stabilise in the first quarter of 20X1. Entity D will now make a decision on the type of funding in the first quarter of 20X1 and, therefore, closes out its rate lock agreement. At the time of closure, the fair value of the lock agreement is negative.

Entity D should recognise the entire loss in profit or loss because the forecast debt issuance is not expected to occur.

If Entity D had instead designated the highly probable forecast interest cash flows occurring over the 10-year period from the second quarter of 20X0 (rather than interest cash flows on the specific debt issuance), and still regarded the

forecast interest cash flows from the second quarter of 20X1 to be highly probable, part of the original hedge relating to the cash flows no longer expected to occur (i.e. up to the second quarter of 20X1) would be discontinued and amounts deferred in the cash flow hedge reserve in respect of these cash flows would be reclassified to profit or loss. However, the amounts deferred in the cash flow hedge reserve in respect of the remaining 9-years of hedged cash flows would continue to be deferred in the cash flow hedge reserve if the hedged cash flows are still expected to occur.

6.5.4 *Reclassification from equity to profit or loss after a business combination*

Following a business combination, when the acquiree has applied cash flow hedging and recognised gains or losses in other comprehensive income prior to the acquisition, the acquirer will not be able to reclassify those gains and losses to consolidated profit or loss. This is because the pre-acquisition reserves of the subsidiary do not exist in the consolidated financial statements of its new parent. Thus, the group can only hedge account for the specific relationship prospectively from the date of acquisition and designation at the group level. Only those amounts recognised in other comprehensive income subsequent to the acquisition (i.e. the cash flow hedge reserve that was recorded post-acquisition) will ultimately be reclassified from equity to consolidated profit or loss.

Given that the hedge relationship is new from the perspective of the group, the hypothetical derivative used to measure post-acquisition fair value changes of the hedged item will be determined at acquisition with nil fair value. The difference between the actual hedging instrument and the hypothetical derivative will result in hedge ineffectiveness.

6.5.5 *Further illustrations of cash flow hedges*

Detailed illustrations of cash flow hedges are included in **chapter B10** in the following sections.

- **3.1** Cash flow hedging a forecast sale for foreign currency risk
- **3.2** Basis adjusting the acquisition of a non-financial item
- **3.3** Cash flow hedging variable rate interest with an interest rate swap
- **3.4** Cash flow hedging foreign currency risk of floating rate debt
- **3.5** Cash flow hedging foreign currency risk of fixed rate debt
- **3.6** Cash flow hedging foreign currency risk of zero coupon debt
- **3.7** Cash flow hedging foreign currency risk of the principal only on interest-bearing debt

Date		Cash	Derivative	Debt	Equity	Profit or loss
	Reclassify amounts from equity				(1,585)	1,585
	Settlement of interest on the debt and net settlement of derivative	(3,500)	2,085	1,415		
31/12/X1	Accrue interest on debt			(915)		915
	Change in fair value of derivative		(203)		199	4
	Reclassify amounts from equity				(2,085)	2,085
	Settlement of interest on the debt and net settlement of derivative	(3,500)	2,585	915		
30/06/X2	Accrue interest on debt			(865)		865
	Change in fair value of derivative		(7)		5	2
	Reclassify amounts from equity				(2,135)	2,135
	Settlement of interest on the debt and net settlement of derivative	(3,500)	2,635	865		
	Settlement of debt	(100,000)		100,000		
		(15,177)	0	0	0	15,177
	Key				**A**	**B**

A Nets to zero reflecting that all amounts in the cash flow hedge reserve in equity have been reclassified to profit or loss to offset the interest accrual.

B Reflects the total interest expense from the debt and derivative. This amount equals the total interest expense that would have been incurred had the entity issued fixed rate debt with a par of £100 million paying interest at 7 per cent, at £102,323 (i.e. at a premium).

Journal entries in the financial statements are provided below for illustrative purposes.

1 January 20X0

		£ '000s	£ '000s
Dr	Derivative	2,323	
Cr	Cash		2,323

To recognise the derivative.

		£ '000s	£ '000s
Dr	Cash	100,000	
Cr	Debt		100,000

To recognise the issue of debt.

30 June 20X0

		£ '000s	£ '000s
Dr	Interest expense	3,365	
Cr	Debt		3,365

To recognise the accrual of interest on the debt.

		£ '000s	£ '000s
Dr	Derivative	1,501	
Cr	Equity (cash flow hedge reserve)		1,501

To recognise the change in fair value of the derivative.

		£ '000s	£ '000s
Dr	Equity (cash flow hedge reserve)	352	
Cr	Interest expense		352

To recognise the reclassification from equity to profit or loss.

		£ '000s	£ '000s
Dr	Debt	3,365	
Cr	Derivative		135
Cr	Cash		3,500

To recognise the settlement of interest on the debt and net settlement of interest on the derivative.

Similar entries would be recorded for the remaining term of the hedge relationship.

3.4 Cash flow hedging foreign currency risk of floating rate debt

The following three examples illustrate the entries for a cash flow hedge of foreign currency risk on floating rate debt using a floating - floating cross currency interest rate swap. In the first example (**example 3.4A**) the cross currency swap is designated as the hedging instrument in its entirety and the foreign currency basis spread element of the swap gives rise to ineffectiveness. In the second and third examples the foreign currency basis spread element is excluded from the designation of the hedging instrument. In the second example (**example 3.4B**) the excluded element is recognised directly in profit or loss on a fair value basis. In the final example (**example 3.4C**), the entity has elected, in accordance with IFRS 9:6.5.16 to apply IFRS 9:6.5.15 and recognise the excluded element in OCI (to the extent it relates to the hedged item). Because the hedged item is a period related item, the excluded element is amortised from OCI to profit or loss on a rational basis over the period during which the hedge adjustment for the included element could affect profit or loss.