

Entities may enter into multiple contracts with the same contractual terms for different reasons. Care needs to be taken in determining whether the contracts themselves should have the same accounting treatment or not. One subsidiary in a group may enter into contracts to buy non-financial items that are used in the group's production processes for the provision of finished goods and that are always physically delivered. A separate part of the group may enter into contractual arrangements with the same contractual terms but that are not always physically delivered (e.g. this separate business may cash settle the contracts or enter into offsetting contracts as part of a trading strategy). From a group perspective, it may be possible to differentiate the two portfolios of contracts in the two separate businesses and, therefore, account for them differently; such differentiation will only be appropriate if (1) the contracts are entered into separately and not in contemplation of each other, (2) there are no transfers between the businesses within the group, (3) the businesses are managed independently of each other, and (4) the strategies of the businesses are sufficiently different that the different settlement behaviour of each business is reasonable. In practice, it is unlikely that such a distinction is possible because different parts of a group often choose to transact with each other rather than entering separately into offsetting transactions outside the group, which would result in additional transaction costs.

2.5.6 Change of settlement terms

The terms of a contract, or the intentions of an entity, may change over time. A contract outside the scope of IAS 39 will continue to be treated as such only if it continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Example 2.5.6

Change of terms to include net settlement

Two parties enter into a contract for the delivery of a non-financial asset. There is no net settlement provision in the contract, no established market mechanism or side agreement, and no history of net settlement.

Subsequently, the parties agree to settle the contract net. From the time the decision to settle net is taken, the contract will be recognised and measured under IAS 39 because, from that time, the contract no longer continues to be for the purpose of the receipt of the non-financial asset in accordance with the expected purchase, sale or usage requirements.

2.6 Share-based payments

IAS 32, IAS 39 and IFRS 7 exclude from their scope financial instruments, contracts and obligations under share-based payment arrangements to which IFRS 2 *Share-based Payment* applies, except for contracts over non-financial items that are within the scope of IAS 39 (see section 2.5). However, the scope of IAS 32 makes it clear that treasury shares that are purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements are in the scope of IAS 32 (see section 5 of chapter C3).

2.7 Construction contract receivables

Construction contract receivables are measured and presented in accordance with IFRS 15 *Revenue from Contracts with Customers*. The financial instruments Standards do not specifically scope out these contracts and, therefore, consideration must be given as to whether such receivables are financial instruments. A right to cash or another financial asset is a critical component of the definition of a financial asset. In construction contract arrangements, the amount of work carried out by the contractor may be in excess of the amount that is billed. Where only the passage of time is required before consideration is due, IFRS 15:108 requires that a receivable is recognised in the statement of financial position. Where there is a further conditional requirement before payment is due, for example certification of work done, IFRS 15:107 requires that a contract asset is recognised in the statement of financial position. In either case the amount recognised is subject to the impairment requirements of IAS 39. An entity must consider whether the amount recognised in accordance with IFRS 15 can be contractually billed or recovered.

Example 2.7

Gross amount due from customer for contract work

Entity A has entered into a contract with Entity B for the construction of a building. The contract is within the scope of IFRS 15, and is specifically not within the scope of IFRIC 12 *Service Concession Arrangements*. Entity A has assessed that the revenue from the contract will be recognised over time in accordance with IFRS 15. At the end of the reporting period, costs incurred plus recognised profits (less recognised losses) exceed progress billings and Entity A presents a contract asset in its statement of financial position.

Under the terms of the contract, Entity A is only able to invoice Entity B when specific work performed by Entity A has been certified as completed. These invoiced amounts are recognised in the statement of financial position as a separate financial asset because they represent a contractual right to receive cash and, therefore, meet the definition of a financial asset in IAS 32:11. Until that point the contract asset is not a financial asset because it is not

the entity's intent to hold remaining investments to maturity. However, sales of HTM investments imposed by regulators due to a significant increase in *entity-specific* capital requirements applicable to a particular entity, but not to the industry, will generally 'taint' the entity's intent to hold other financial assets as HTM. Entity-specific capital requirements could only be disregarded in exceptional cases if it can be demonstrated that the sales result from an increase in capital requirements which is an isolated event that is beyond the entity's control and that is non-recurring and could not have been reasonably anticipated by the entity. [IAS 39:IG.B.17]

In consolidated financial statements, intragroup sales of HTM investments between group entities generally would not taint the HTM portfolio from a group perspective, as long as the business purpose of the transfer and the investment policies of the 'buyer' are consistent with a continued positive intention and ability to hold to maturity. The impact on each entity's stand-alone financial statements should be assessed separately; in the financial statements of the selling entity, the stated intention of holding securities to maturity will have been undermined, even though the sale was made to another entity within the consolidated group.

Note that an entity cannot apply the conditions separately to HTM financial assets held by different entities in a consolidated group, even if those group entities are in different countries with different legal or economic environments. If the consolidated entity in total across the group has sold or reclassified more than an insignificant amount of investments classified as HTM, it cannot classify any financial assets as HTM investments in its consolidated financial statements unless such sales and transfers do not taint the HTM portfolio.

As a remedy to protect the investor from the issuer's violation of a debt covenant, a contractual right of foreclosure that was negotiated at arm's length at the issuance date would not preclude an investor classifying an investment as HTM. Similarly, the exercise of such a right or foreclosure on the violation of a substantial covenant would not taint an investor's remaining HTM portfolio.

Example 3.3.2D

HTM: sale following acceptance of tender offers

Entity A, an insurance company, initially classified 100 per cent of its property liability fixed income portfolio as AFS, 50 per cent of its life fixed income securities portfolio as HTM, and 50 per cent as AFS. Entity A considered various factors in making these classifications, including its investment policy, security characteristics, liquidity needs, and asset-liability management strategy.

In a subsequent year, Entity A began receiving unsolicited tender offers from issuers with respect to its fixed income portfolio (including its HTM portfolio) prompted by a very volatile interest rate environment. Entity A accepted certain

tender offers involving the exchange of debt securities classified as HTM because these exchanges were on economically favourable terms.

As a consequence, Entity A is required to transfer 100 per cent of previously classified HTM securities to AFS because it can no longer assert it has the positive intent to hold all of these securities to maturity. The sale of a security in response to a tender offer typically is motivated not by a need for cash, but instead by the investor's desire for additional possible profit – a motive inconsistent with the HTM classification. Further, none of the exceptions for sales that do not taint HTM portfolio applies in these circumstances.

In the context of open-ended funds (e.g. a mutual fund) where investors do not have an investment in equity shares in the fund, but own 'units' in the fund, and can require redemption of their share of the net assets of the fund in cash, it is difficult to argue that the possibility of unit-holders asking for redemption of their units is a non-recurring situation that could not have been reasonably anticipated.

In fact, it could reasonably be argued that the entity (e.g. the mutual fund) is "subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity" and, therefore, that HTM classification of the fund's portfolio of investments would be inappropriate.

When a large number of unit-holders require redemption of their share in the net assets of the fund, the fund could be obliged to sell assets in order to fulfil its obligation to deliver cash to the unit-holders exiting the fund. Although IAS 39:AG21 states that a "disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity", the possibility of unit-holders asking for their redemption in cash (and in large numbers), thereby forcing the sale of fund assets, does not constitute a disaster scenario but is readily possible in the course of the operation of a mutual fund and, consequential, liquidity needs have to be considered by the fund manager at any time.

A sale or transfer of a security classified as HTM for reasons other than those that are specifically permitted does not indicate that the previous financial statements were issued in error. Because the accounting for financial assets as HTM is based primarily on a representation of intent by management, the sale or transfer of a security classified as HTM does not represent an error of previously issued financial statements, provided that no evidence existed at the time the financial statements were issued demonstrating that the entity did not have the positive intent and ability to hold the security to maturity. However, such a sale or transfer may call into question the entity's intent to hold other debt securities to maturity in the future.

instruments and instruments that contain an obligation to deliver a pro rata share of net assets at liquidation described in 2.1.2.1 and 2.1.3 respectively no longer apply or start to apply, reclassification may be appropriate.

When classifying a financial instrument in consolidated financial statements, an entity should consider all of the terms and conditions agreed upon between members of the group and the holders of the instrument. For example, a financial instrument issued by a subsidiary could be classified as equity in the subsidiary's individual financial statements and as a liability in the consolidated financial statements if another group entity has provided a guarantee to make payments to the holder of the instrument.

IAS 32 defines a financial liability as any liability that is:

[IAS 32:11]

- (a) a contractual obligation:
 - (i) to deliver cash or another financial asset to another entity (e.g. a payable); or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (e.g. a financial option written by the entity); or
- (b) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative contract for which the entity is or may be obliged to deliver a variable number of its own equity instruments (e.g. an instrument that is redeemable in own shares to the value of the carrying amount of the instrument); or
 - (ii) a derivative contract over own equity that will or may be settled other than by the exchange of a fixed amount of cash (or another financial asset) for a fixed number of the entity's own equity instruments (e.g. a net-share settled written call over own shares). For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also for these purposes, the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with IAS 32:16A and 16B, 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 and are classified as equity instruments in accordance with IAS 32:16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in IAS 32:16A and 16B or IAS 32:16C and 16D.

The Standard defines an equity instrument as any contract that represents a residual interest in the assets of an entity after deducting all of its liabilities.

In May 2008, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IAS 32, *Deposits on Returnable Containers*. The IFRIC was asked to provide guidance on the accounting for the obligation to refund deposits on returnable containers. In some industries, entities that distribute their products in returnable containers collect a deposit for each container delivered and have an obligation to refund this deposit when containers are returned by the customer. The issue is whether the obligation should be accounted for in accordance with IAS 39.

The IFRIC noted that IAS 32:11 defines a financial instrument as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". Following delivery of the containers to its customers, the seller has an obligation only to refund the deposit for any returned containers. In circumstances in which the containers are derecognised as part of the sale transaction, the obligation is an exchange of cash (the deposit) for the containers (non-financial assets). Whether that exchange transaction occurs is at the option of the customer. Because the transaction involves the exchange of a non-financial item, it does not meet the definition of a financial instrument in accordance with IAS 32. In contrast, when the containers are not derecognised as part of the sale transaction, the customer's only asset is its right to the refund. In such circumstances, the obligation meets the definition of a financial instrument in accordance with IAS 32 and is therefore within the scope of IAS 39. In particular, IFRS 13:47 states that "the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid."

2.1 Contractual obligation to deliver cash or another financial asset

The key feature in determining whether a financial instrument is a liability is the existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or to exchange financial assets or liabilities under conditions that are potentially unfavourable. In contrast, in the case of an equity instrument (e.g. ordinary shares) the right to receive cash in the form of dividends or other distributions is at the issuer's discretion and, therefore, there is no obligation to deliver cash or another financial asset to the holder of the instrument. There is an exception to this rule for certain puttable instruments and instruments with

Entity A amends the terms in one of two ways in respect of conversions that take place prior to 1 March 20X6.

Scenario 1: Entity A alters the terms such that each of the 2,000 bonds converts into 300 equity shares of Entity A, instead of 250 equity shares as under the original conversion terms (assume the market value of the equity shares at the date of the amendment is CU5).

Scenario 2: Entity A states that it will pay an additional CU1 in cash in relation to each share converted.

The liability and equity components have the following carrying amounts in the statement of financial position at 31 December 20X5.

	CU
Liability component:	
– present value of two remaining interest payments of CU120,000 discounted at 9 per cent	211,093
– present value of principal amount of CU2 million due in two years' time discounted at 9 per cent	1,683,360
	1,894,453
Equity component	151,878*
Total	<u>2,046,331</u>

* The equity component remains unchanged since the allocation on initial recognition.

The following entries will be needed to recognise the amendment of the terms of the convertible bonds.

Scenario 1

Number of equity shares to be issued to bondholders under the amended conversion terms:

– number of bonds issued	2,000
– number of shares to be issued per bond on conversion	300
Total number of equity shares to be issued on conversion	<u>600,000</u>

Number of equity shares to be issued to bondholders under original conversion terms:

– number of bonds issued	2,000
– number of shares to be issued per bond on conversion	250
Total number of equity shares to be issued on conversion	<u>500,000</u>

Number of incremental equity shares to be issued to bondholders upon conversion: 100,000.

Value of incremental equity shares to be issued to bondholders upon conversion: $100,000 \times \text{CU}5 = \text{CU}500,000$

Therefore, the entry needed to record the amendment of the terms is as follows.

	CU	CU
Dr Expense on amendment of terms of convertible bonds (profit or loss)	500,000	
Cr Equity		500,000

To recognise the amendment of the terms of the convertible bonds.

Upon conversion, the accounting would follow the approach laid out in example 3.3A. If the instrument were not converted no further gain or loss would be recognised.

Scenario 2

The additional consideration to be paid in the event of conversion would amount to: $500,000 \times \text{CU}1 = \text{CU}500,000$

This would be recognised through the following entry upon amendment of the terms of the convertible bonds.

	CU	CU
Dr Expense on amendment of terms of convertible bonds (profit or loss)	500,000	
Cr Financial liability		500,000

To recognise the amendment of the terms of the convertible bonds.

On conversion, the accounting would follow the approach laid out in example 3.3A except that an additional entry would be required to recognise the payment of the additional cash inducement as follows.

	CU	CU
Dr Financial liability	500,000	
Cr Cash		500,000

To record the payment of the additional cash inducement.

If the instrument were not converted, an entry would be required to derecognise the inducement that the holder has not exercised.

	CU	CU
Dr Financial liability	500,000	
Cr Gain upon non-exercise of inducement (profit or loss)		500,000

To derecognise the liability for the inducement that has not been exercised.

As described in 3.3, upon conversion of a compound instrument, equity is issued and the liability component is derecognised. The original equity component recognised at inception remains in equity (although it may be

therefore considered that the question of whether the assumption in the submission is appropriate would remain open.”

IAS 39 nor any other IFRS provides a clear answer as to whether the term ‘non-financial variable specific to a party to the contract’ in the definition of a derivative is limited to the scoping out of insurance contracts or is broader. Both the IASB and the IFRS Interpretations Committee have considered this question in the past, but to date no clarifying guidance has been issued.

Given the lack of specific guidance on this topic and the IFRS Interpretations Committee’s decision to leave open the assumption made in the submission received on Greek Government Bonds, it is acceptable to adopt either of the approaches set out below as an accounting policy choice. In developing the accounting policy, entities may need to take into consideration specific requirements by local regulators, if any.

Accounting policy one

The inclusion of the term ‘non-financial variable specific to a party to the contract’ is limited to excluding insurance contracts from the definition of a derivative. Therefore, unless a contract meets the definition of an insurance contract in IFRS 4, the contract is not scoped out of the definition of a derivative if the contract is either fully (or partly, in the case of an embedded derivative) in the scope of IAS 39.

This approach is consistent with the IASB’s tentative view included in the 2007 exposure draft (see above). It is also supported by:

- IAS 39:IG.A.2 *Option to put a non-financial asset where an option to put an office building* that can be either physically settled or net cash settled is a derivative,
- IAS 39:IG.B8 *Definition of a derivative: foreign currency contract based on sales volume* where a contract based on foreign currency and sales volume is a derivative.

Accounting policy two

The inclusion of the term ‘non-financial variable specific to a party to the contract’ is broader than simply excluding insurance contracts from the definition of a derivative. Therefore, a contract (other than an insurance contract) that is either fully or partly in the scope of IAS 39 may have a non-financial variable that is specific to a party to the contract and, consequently, it may be excluded from the definition of a derivative.

This approach, in line with the agenda decision noted in the September 2012 IFRIC Update, recognises that because the IASB has not fully resolved this question different views could validly be held.

If such an approach is applied, it is then necessary to assess what is ‘specific to a party’ and which variables are considered ‘non-financial’ (as these terms are not defined by IFRSs).

For an underlying to be specific to a party to the contract the underlying must be unique to the party. For example, an entity’s real estate is non-financial that is specific to the party to the contract. However, commodities may not be specific to the party when they are readily tradable and are homogenous. An entity’s inventory of gold may not be specific to the party to the contract as it is not distinguishable from a different party holding the same commodity.

For some variables the determination of non-financial may be relatively straightforward when the variable has no financial element to it (for example, the tonnage of ore extracted from a mine or the number of units sold by a motor vehicle manufacturer). It is less straightforward whether a variable based on an amount derived from the financial statements of a party to the contract (for example, revenue, EBITDA or net assets) is ‘non-financial’. Again, the views of local regulators may need to be considered in developing a policy.

2.2 Notional amounts and payment provisions

While neither a notional amount nor a payment provision is an essential characteristic of a derivative instrument, derivative instruments usually contain a notional amount or a payment provision each of which may interact with the underlying to determine the settlement amount of the derivative instrument. A notional is often an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. A payment provision is a provision which requires a fixed payment or payment of an amount that can change (but not proportionally to a change in the underlying) as a result of some future event that is unrelated to a notional amount.

Example 2.2A

Payment provision based on interest rates

Entity ABC receives CU200 to enter into a contract that requires it to pay CU500 if 6-month LIBOR increases by 75 basis points over the next six months. Even though this contract does not have a notional amount, it contains a payment provision that does not move proportionally with the underlying.

feature meets the definition of equity for the issuer is complex and is addressed in **chapter C3**.

Example 7.8

Equity conversion feature

Entity X issues debt that is convertible into a fixed number of its ordinary shares in five years. The conversion feature represents an embedded written call option on the shares of Entity X, settled in a fixed number of shares.

For Entity X, because the conversion feature meets the definition of equity, the convertible debt is a compound instrument that should be split into its liability and equity components. Entity X will not account for the written call option as an embedded derivative because the option is an equity instrument of Entity X (see **chapter C3**).

The investor will account for the embedded purchased option separately because the equity conversion feature is not closely related to the host debt contract.

Another form of equity embedded derivative is an 'equity kicker'. These are debt instruments which provide for the lender to receive shares of the borrower for nothing, or a very low amount, if the borrower lists its shares on a stock exchange. The debt remains outstanding following the delivery of the shares. Typically, the lender is a venture capitalist. Similar to convertible debt, debt with an equity kicker carries a coupon that is lower than the rate on a comparable debt without the equity kicker.

The equity kicker meets the definition of a derivative because its value will change in response to changes in the borrower's share price, it has little initial net investment, and it is settled at a future date. This is true even though the right to receive the shares is contingent on an unrelated event. [IAS 39:IG.C.4]

For the holder, the embedded derivative is not closely related to the host debt contract and therefore will require separation at FVTPL. For the issuer, if the equity kicker fails the definition of equity for the issuer, it will also be recognised as an embedded derivative that is not closely related to the host debt contract and therefore will require separation at FVTPL.

7.9 Non-cash settlement of interest or principal

Debt contracts that allow for the payment of interest or principal in non-cash consideration may contain embedded derivatives that are not closely related to the host debt contract. In some cases the embedded

derivative feature may be outside the scope of IAS 39 because it results in the delivery of a non-financial item in accordance with the entity's purchase, sale or usage requirements (see 2.5 in **chapter C1**).

Example 7.9

Non-cash settlement of interest

Entity A lends Entity B, a newspaper publisher, CU10 million for 10 years. Each year instead of paying interest, Entity B agrees to give Entity A a predetermined amount of free advertising space in a newspaper. For Entity B, selling newspaper advertising space falls within its normal sale requirements and, therefore, that part of the contractual arrangement is outside the scope of IAS 39. The debt instrument, excluding the fair value of the free advertising space, is in the scope of IAS 39 and will be measured at fair value at initial recognition. The fair value of the debt instrument will be less than the proceeds borrowed reflecting the fair value of the non-cash consideration included in the loan agreement.

If the sale of advertising space did not meet the normal purchase, sale or usage requirements exemption for Entity B (e.g. because Entity B was not a newspaper publisher), then that feature would be in the scope of IAS 39. The delivery of non-cash consideration embedded in the loan meets the definition of a derivative because it has an underlying (the price of the advertising space), no initial net investment, and it will be settled at future dates. The economic characteristics and risks of the embedded derivative and debt are not closely related and, therefore, the non-cash consideration feature would be separated and measured at FVTPL.

7.10 Unit-linking features embedded in host debt instrument

A unit-linking feature embedded in a host debt instrument in the scope of IAS 39 is closely related to the host debt instrument if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in a unit of an internal or external investment fund. [IAS 39:AG33(g)]

IFRS 4:IG Example 2:2.15 provides the example of a policyholder option to surrender a contract for account value equal to the fair value of a pool of equity investments, possibly after deducting a surrender charge. The example makes reference to IAS 39:AG33(g) and states that if such a feature is embedded in a host investment contract then, if the insurer regards the account value as the amortised cost or the fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from the account value). Otherwise the embedded derivative feature would be required to be classified separately as at FVTPL. A host investment contract is described in IFRS 4:IG4 as a financial instrument that does not meet the definition of an insurance contract.

When an AFS asset is derecognised, the cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss. This reclassification of previous fair value gains and losses is frequently referred to as 'recycling'.

Example 3.1.4**Available-for-sale debt instrument**

A zero coupon bond is acquired for its fair value of CU95 on 1 January 20X0 and classified as AFS. Transaction costs arising on acquisition are CU5. The bond is due to be redeemed for CU130 on 31 December 20X4. On 31 December 20X0, the bond's fair value is CU103. On 31 December 20X1, the entity sells the bond for its fair value of CU108.

In 20X0, the entity records the following entries:

(1) Initial recognition (at fair value, including transaction costs)

	CU	CU
Dr Asset	100	
Cr Cash		100

To recognise the zero coupon bond.

(2) Interest income (calculated under the effective interest method – the rate of 5.39 per cent is calculated so as to include transaction costs as explained in section 4.1)

	CU	CU
Dr Asset	5.39	
Cr Interest income		5.39

To recognise interest income.

(3) Fair value adjustment (such that the asset is stated at its fair value of CU103)

	CU	CU
Dr Other comprehensive income	2.39	
Cr Asset		2.39

To record the remeasurement of the asset to fair value.

In 20X1, the entity records the following entries:

(1) Interest income (calculated under the effective interest method)

	CU	CU
Dr Asset	5.68	
Cr Interest income		5.68

To recognise interest income.

(2) Fair value adjustment (such that the asset is stated at its fair value of CU108)

	CU	CU
Dr Other comprehensive income	0.68	
Cr Asset		0.68

To record the remeasurement of the asset to fair value.

(3) Sale of asset

	CU	CU
Dr Cash	108	
Cr Asset		108

To record the disposal of the asset.

(4) Reclassification to profit or loss of fair value losses previously recognised in other comprehensive income and accumulated in equity

	CU	CU
Dr Profit or loss	3.07	
Cr Other comprehensive income		3.07

To reclassify losses previously recognised in other comprehensive income and accumulated in equity.

3.1.4.1 Available-for-sale financial asset exchanged for another available-for-sale financial asset

If an AFS asset is derecognised, with the consideration received being another AFS asset, the fair value gain or loss previously recognised in other comprehensive income should nonetheless be reclassified to profit or loss. Because the original asset has been derecognised, the deferred gain or loss is not attributable to the new asset and does not remain in equity. [IAS 39:IG.E.3.1]

Example 3.1.4.1A**Available-for-sale equity instrument – group restructuring (1)**

Entity A has a directly-held wholly-owned subsidiary, Entity B. Entity A accounts for its investments in subsidiaries in accordance with IAS 39 in its separate financial statements as permitted by IAS 27(2008):38(b) and IAS 27(2011):10(b). Entity A designates its investment in Entity B as an AFS investment in its separate financial statements and, therefore, measures its investment at fair value with fair value gains/losses recognised in other comprehensive income.

As part of a group reorganisation, a new holding entity, Entity C, is created whose shares are issued to Entity A in return for Entity A's investment in Entity B. Entity C has no other assets or liabilities or transactions other than the issue of shares to Entity A and the acquisition of shares in Entity B. At the date of the

It is not acceptable to set aside additional provisions or reserves in excess of the amount of impairment or bad debt losses that are recognised under IAS 39. [IAS 39:IG.E.4.6]

5.3 Assets carried at cost

Unquoted equity instruments (and derivatives that result in physical delivery of unquoted equity investments) whose fair value cannot be reliably measured are measured at cost (see 3.1.6). For such instruments, if there is objective evidence of an impairment (as discussed in section 5.1), the amount of the impairment loss is measured as the difference between carrying amount and the present value of estimated future cash flows discounted at the current rate of return for a similar financial asset. [IAS 39:66]

Once an impairment loss has been recognised on a financial asset recognised at cost, a reversal of that impairment is not permitted.

5.4 Available-for-sale financial assets

If a decline in the fair value of an AFS financial asset has been recognised in other comprehensive income under the requirements discussed in 3.1.4, and there is objective evidence of an impairment (as discussed in 5.1.1 for debt instruments and 5.1.1 and 5.1.2 for equity instruments), the cumulative loss that had been recognised in other comprehensive income is reclassified from equity to profit or loss. The amount of cumulative loss is the difference between the acquisition cost (net of principal repayments and amortisation for debt instruments) and the current fair value, less any impairment loss previously recognised in profit or loss. [IAS 39:67 & 68] Any portion of the cumulative net loss that is attributable to foreign currency movements that had been recognised in other comprehensive income in the case of a non-monetary item, e.g. for equity instruments, is also reclassified from equity to profit or loss. [IAS 39:IG.E.4.9]

5.4.1 Impairment measurement – equity instruments

An impairment of an AFS equity investment does not establish a new deemed cost for that investment. The test of whether there has been a “significant or prolonged decline in the fair value of an investment in an equity instrument below its cost” is with reference to the original cost on initial recognition (not the carrying amount after the previous impairment) and ‘prolonged’ should be evaluated against that period in which the fair value of the investment has been below original cost at initial recognition. IAS 39 does not allow entities to consider only the period since the last impairment loss was recognised in profit or loss nor does it allow entities to segregate different loss events in order to evaluate the significance and duration of each event separately. Therefore, once an impairment loss is recognised in profit or loss, any

further decline in value must be recognised immediately in profit or loss. [IAS 39:IG.E.4.9] This was confirmed by the IFRIC (now the IFRS Interpretations Committee) in April 2005.

If an investment in an equity instrument is reclassified from FVTPL to AFS, consideration should be given as to whether “cost” is the original acquisition cost at initial recognition or the fair value at the date of reclassification. Prior to the IAS 39 amendment on reclassifications of financial assets, cost always meant ‘acquisition cost’ because it was not possible to reclassify an equity investment from one fair value measurement category to another and, therefore, the amount recognised in equity always represented the difference between the acquisition cost of the equity investment and its fair value. For an investment in an equity instrument reclassified from FVTPL to AFS, the amounts in equity will be the difference between the fair value at the date of the reclassification and the fair value at the end of the reporting period. The IAS 39 amendment on reclassifications introduced IAS 39:50C which states that the fair value at the date of reclassification “becomes its new cost”. The requirements to assess impairment were not applicable prior to reclassification because any impairment is automatically included in profit or loss for assets carried at FVTPL. Therefore, subsequent to reclassification, in assessing whether the fair value of an equity investment is significantly below its cost it is appropriate to compare the fair value at the end of the reporting period with the fair value at the date of reclassification. Similarly, in assessing whether there has been a prolonged decline in fair value below cost, it is appropriate to look at how long the equity investment’s fair value has been below the ‘new cost’ established at the date of reclassification.

It is unlikely that an entity could apply a portfolio approach for assessing impairment of AFS equity securities. Equity securities are issued by different entities and they are unlikely to have similar risk characteristics because their exposure to equity price risk will differ.

If an entity holds an investment in a fund that invests in equity securities, and the investment is classified as an AFS investment, the investor should assess impairment based on a comparison of cost and fair value of the investment in the fund, not by looking through the fund to the individual equity securities held by the fund.

5.4.2 Impairment reversals – equity instruments

Once an entity has recognised an impairment loss on an AFS equity investment, it is not permitted to recognise a reversal through profit or loss. [IAS 39:69] This approach differs from the approach for debt instruments where reversal is permitted (see 5.4.4).

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:

[IFRS 13:38]

- (a) using the quoted price in an active market (see below) for the identical item held by another party as an asset, if that price is available;
- (b) if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset; and
- (c) if the observable prices in (a) and (b) above are not available, using another valuation technique, such as:
 - (i) an income approach (e.g. a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see 5.1.2); or
 - (ii) a market approach (e.g. using quoted prices for similar liabilities or equity instruments held as assets; see **section 8.4**).

An active market is defined as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis". [IFRS 13:Appendix A]

A quoted price of a liability or an entity's equity instrument held by another party as an asset should be adjusted only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument. An entity should ensure that the price of the asset does not reflect the effect of a restriction preventing the sale of an asset. [IFRS 13:39]

The Standard provides the following examples of factors that might indicate that the quoted price of the asset should be adjusted.

[IFRS 13:39]

- The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. For example, the liability or equity instrument may have a particular characteristic (e.g. the credit quality of the issuer) that is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.
- The unit of account for the asset is not the same as for the liability or equity instrument. For example, for liabilities, in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is not for the combined package, the objective is to measure the fair value of the issuer's liability, not the fair value of the combined package. In such circumstances, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement.

from the perspective of a market participant that holds the identical item as an asset at the measurement date. The value should only be adjusted for factors specific to the asset that are not applicable to the fair value measurement of the liability. IFRS 13:39 provides a number of examples of such factors (see 5.1.1).

In addition, if an entity uses a quoted price for a similar item in its valuation technique, the entity may need to make adjustments to reflect differences in risk, including liquidity differences. For example, the item being measured may be in shorter supply (relative to demand) than the similar item for which a quoted price exists. In this situation, a liquidity risk premium exists for the item being measured that should be factored into the fair value measurement as an adjustment to the quoted price of the similar item.

An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy, if the adjustment uses significant unobservable inputs. [IFRS 13:84] See 10.3.3.2 for further discussion.

IFRS 13 provides the following examples of Level 2 inputs for particular assets and liabilities.

[IFRS 13:B35]

- **Receive-fixed, pay-variable interest rate swap based on the London Interbank Offered Rate (LIBOR) swap rate** A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
- **Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency** A Level 2 input would be the swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for Year 10 would not be significant to the fair value measurement of the swap in its entirety (but see **example 10.2.2** for circumstances when observable data is not available for substantially the full term of the agreement).
- **Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate** A Level 2 input would be the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.

- **Three-year option on exchange-traded shares** A Level 2 input would be the implied volatility for the shares derived through extrapolation to Year 3 if both of the following conditions exist:
 - (i) prices for one-year and two-year options on the shares are observable
 - (ii) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option.

In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established. [IFRS 13:B35]

10.2.3 Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability. [IFRS 13:86 & Appendix A]

Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available (e.g. when there is little, if any, market activity for the asset or liability at the measurement date). However unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, so as to achieve the general fair value measurement objective (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). [IFRS 13:87]

Unobservable inputs should reflect, among others, assumptions that market participants would make about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability (or similar assets or liabilities) and the entity has determined that the transaction price or quoted price does not represent fair value – see **sections 9.5 to 9.7**). [IFRS 13:88]

Unobservable inputs should be developed using the best information available in the circumstances, which might include an entity's own data. In developing unobservable inputs, an entity's own data, should be adjusted if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (e.g. an entity-specific synergy).

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 that asset, the entity continues to recognise the asset to the extent of its continuing involvement. Continuing involvement represents the extent to which the transferor continues to be exposed to the changes in the value of the transferred asset. A corresponding liability is also recognised and measured in such a way that the *net* carrying amount of the asset and the liability is:

[IAS 39:31]

- the amortised cost of the rights and obligations retained, if the asset is measured at amortised cost; or
- the fair value of the rights and obligations retained, if the asset is measured at fair value.

The liability that is recognised at the date of transfer will not necessarily equate to the proceeds received in transferring the asset which would ordinarily be the case if the asset continued to be fully recognised and the proceeds received were recognised as a collateralised borrowing. In some cases, the liability appears to be the 'balancing figure' that results from applying the specific guidance for continuing involvement accounting. IAS 39 acknowledges that measuring the liability by reference to the interest in the transferred asset is not in compliance with the other measurement requirements of the Standard. [IAS 39:31]

This requirement for consistent measurement of the asset and the associated liability means that the entity is not permitted to designate the liability as at FVTPL if the transferred asset is measured at amortised cost (see 7.2 in chapter C3).

The entity cannot offset the asset and the associated liability. Any subsequent changes in the fair value of the asset and the liability are measured consistently and are not offset. [IAS 39:33] Any income on the asset to the extent of the entity's continuing involvement and any expense incurred on the associated liability are not offset. [IAS 39:32]

When an entity transfers assets, but retains a guarantee over the transferred assets that absorb future credit losses, and that guarantee (as well as other continuing involvement) results in the transferor neither transferring nor retaining substantially all the risks and rewards of ownership, the transferor must recognise the guarantee as part of its continuing involvement.

Assuming, for illustrative purposes only, that the guarantee represents the transferor's only continuing involvement in the transferred asset, then:

- the transferred asset at the date of transfer will be measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay; and
- the associated liability is measured initially at the amount in (ii) above plus the fair value of the guarantee.

The initial fair value of the guarantee is recognised in profit or loss when (or as) the obligation is satisfied in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers Revenue* and the carrying amount of the asset is reduced by any impairment losses. [IAS 39:AG48(a)]

Example 3.4A

Continuing involvement: guarantee over first default losses

Transferor X transfers an asset to Transferee Y. The carrying amount at the date of transfer is CU100, which is also the asset's fair value at that date. Transferee Y pays CU105. Transferor X provides a guarantee to Transferee Y to pay for the first default losses up to a value of CU8. The fair value of the guarantee at the date of transfer is CU5. Expected future losses on the asset are CU12. Transferor X considers that substantially all the risks and rewards of ownership have neither been transferred, nor retained. Transferee Y does not have the practical ability to sell the assets, i.e. Transferor X controls the asset.

Transferor X determines its continuing involvement as the extent to which it continues to be exposed to the changes in the value of the transferred asset, i.e. the lower of:

- the carrying amount of the asset (CU100); and
- the maximum amount of the consideration received in the transfer that Transferor X could be required to repay ('the guarantee amount') (CU8).

Transferor X recognises its continuing involvement in the asset at CU8, and derecognises the part of the asset transferred, i.e. CU92. The associated liability is initially measured at CU13, being the guarantee amount (CU8) plus the fair value of the guarantee (CU5). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis.

The following entries would be recorded at the date of transfer.

	CU	CU
Dr Cash	105	
Cr Financial asset		92
Cr Financial liability		13

To record the transfer of the asset and recognition of the liability associated with the guarantee.

If the put option is exercised by the holder at the end of Year 3, the whole instrument is extinguished and, therefore, is derecognised. Due to the unwinding of the discount on the financial liability recognised in profit or loss, the carrying amount of the financial liability will equal the exercise price of the put option and, therefore, the put option will be settled with no gain or loss.

If the put option is not exercised by the holder at the end of Year 3, the instrument remains outstanding and the written put option is extinguished because it has not been exercised by the holder and is, therefore, derecognised. The financial liability is derecognised at its closing carrying amount and reclassified to equity. In this instance, the terms of the instrument have not changed but the written put option ceases to be a financial liability and starts to be recognised as equity. No gain or loss is recognised on derecognition of the financial liability in this case because the holder has chosen not to exercise its put right to redeem the instrument but rather chose to retain the instrument and have an entitlement to a fixed coupon payable at the discretion of the issuer which is classified as equity.

4.1 Exchange or modification of a financial liability

Often entities will seek to renegotiate debt instruments for a variety of reasons. Sometimes the entity will be seeking more favourable terms from the lender. Sometimes the borrower may be in financial difficulty and need to alter the contractual terms of the liability such as the maturity of the instrument or the coupon on the instrument.

When the existing borrower and lender exchange instruments with terms that are substantially different, the exchange is accounted for as an extinguishment of the original liability and recognition of a new liability. Similarly, modification of the terms of a liability is accounted for as an extinguishment of the original liability and recognition of a new liability where the modification is substantial. [IAS 39:40]

The terms are deemed to be substantially different if the net present value of the cash flows under the new liability, including any fees paid and received, is at least 10 per cent different from the net present value of the remaining cash flows of the existing liability, both discounted at the original effective interest rate of the original liability. Similarly, modification is deemed to be substantial if the net present value of the cash flows under the modified terms, including any fees paid or received, is at least 10 per cent different from the net present value of the remaining cash flows of the liability prior to the modification, both discounted at the original effective interest rate of the liability prior to the modification. [IAS 39:AG62]

IAS 39:AG62 is clear that *fees paid* are included as part of the cash flows of the new or modified liability when performing the 10 per cent test. However, it is not clear whether this relates only to fees paid to the lender or whether this also includes fees paid to third parties (e.g.

third party legal fees). In the absence of further guidance, inclusion or exclusion of third party fees could be justified.

Excluding third-party fees from the calculation is justified based on a view that the 10 per cent test under IAS 39:AG62 is intended to compare the cash flows between the borrower and the lender before and after the modification or exchange. Some of these cash flows may be referred to as 'fees' but, in substance, they are indistinguishable from the other cash flows of the modified debt instrument. Furthermore, inclusion of directly attributable cash flows in the calculation can be justified by analogy to the definition of transaction costs to be included in the initial carrying value of a financial asset or liability which includes, according to IAS 39:AG13, fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Accordingly, third party fees should be considered to form part of the cash flows of the modified debt instrument.

On the other hand, fees paid to another party are distinguishable as payments for services other than lending and therefore it can be justified that such fees should not form part of the cash flows used for the purpose of the 10 per cent test.

An entity should adopt an accounting policy, to be applied consistently, to either include or exclude directly attributable fees payable to a third party other than the lender from calculation of the 10 per cent test.

When performing the 10 per cent test described above, the entity must exclude from the original effective interest rate the effects of hedge accounting (whether fair value hedging or cash flow hedging). For example, if the issuer is fair value hedge accounting, the interest rate risk portion of its issued fixed rate debt, the effective interest rate on this debt will reflect current floating rates at the date of exchange. Because the terms of the original debt are fixed, not floating, the original effective interest determined at initial recognition of the debt prior to any hedge accounting, should be the rate that is used in applying the 10 per cent test.

The above treatment for fair value hedge accounting is consistent with applying the original effective interest rate at initial recognition had the issuer designated the debt as at FVTPL. Designating the debt as at FVTPL for subsequent measurement does not negate the issuer determining the original effective interest rate at the date the instrument was initially recognised for the purposes of applying the 10 per cent test.

operations, net investment hedging may be applied. The amendment is effective for annual periods beginning on or after 1 January 2016 (with earlier application permitted).

In the separate financial statements of the investor, an investment in a subsidiary associate or joint venture may alternatively be recognised either at cost or in accordance with IAS 39 (i.e. as an AFS asset or at FVTPL). [IAS 27:10(b)] In such circumstances, the carrying amount will not be equivalent to the net investment in that operation (as defined by IAS 21) and, therefore, net investment hedging cannot be applied.

However, as an alternative, the investor may wish to apply fair value hedge accounting for the foreign exchange risk of its investment in its foreign operation if the investment is not measured at FVTPL under IAS 39. For example, if an investor makes an investment in a foreign operation that meets the definition of a subsidiary, and the investor recognises the investment at cost in its separate financial statements, the investing entity will be exposed to a risk that will affect profit or loss (i.e. the foreign currency risk that arises upon disposal of the foreign subsidiary). If the investing entity has a foreign currency derivative, or a foreign currency denominated liability that was used to fund the investment in the foreign operation, that instrument could be designated as a hedging instrument in respect of a portion of the foreign currency risk of the investment in the subsidiary equivalent to the notional on the hedging instrument. In order to qualify for this treatment, the entity must be able to determine that foreign currency risk with respect to the investment in the subsidiary exists of an amount equal to at least the notional of the hedging instrument. For the entity to make this claim, it must either be able to measure the fair value the investment in local currency terms or, at a minimum, be able to determine that the fair value in local currency terms is not below the notional of the hedging instrument. Applying fair value hedge accounting would result in the gain or loss on the hedging instrument being recognised in profit or loss along with the associated movement in the foreign currency risk on the designated portion of the investment in the subsidiary.

It is worth noting that this approach is very different from applying net investment in a foreign operation hedge accounting at a consolidated level where both the hedging instrument and the foreign exchange translation on the net assets of the foreign operation are recognised in other comprehensive income. Additionally, it should be noted that fair value hedge accounting cannot be applied in the consolidated financial statements to an equity method investment or an investment in a consolidated subsidiary. [IAS 39:AG99] Fair value hedge accounting for such items can only be applied in the separate financial statements of the investor.

2.3.1 Hedging net investments with loans

In the absence of hedge accounting, foreign exchange gains and losses on retranslating the net assets of a foreign operation are recognised in other comprehensive income and taken to a separate component of equity (in accordance with IAS 21), while those on the loan are recognised in profit or loss. This creates a mismatch in foreign currency translation. When net investment hedge accounting is applied, this mismatch is eliminated because the gains and losses on the loan, to the extent effective, are recognised in other comprehensive income.

When the hedging instrument in a net investment hedge is a foreign currency denominated non-derivative financial liability (e.g. a foreign currency denominated loan), it is always the spot retranslation risk that is the hedged risk (as opposed to the forward rate) because it is only the spot rate that is recognised from retranslating the foreign currency non-derivative liability.

2.3.1.1 Loan is less than or equal to the net assets of subsidiary

Example 2.3.1.1

Loan is less than or equal to the net assets of subsidiary

Entity A, a UK entity with a Sterling functional currency, has a US subsidiary with a US dollar functional currency, Entity B. To finance this subsidiary, Entity A has a US\$50 million US dollar loan with a third-party bank. Entities A and B have the same 31 December year end and the net assets of Entity B at 31 December 20X1 and 31 December 20X2 are US\$70 million.

The loan is designated as a hedging instrument of the first US\$50 million of net assets of Entity B. The designation is spot retranslation risk only. The hedge is determined to be highly effective. The US\$/£ spot rate on 31/12/X1 is 1.6 and on 31/12/X2 it is 1.7.

On 31/12/X2, the following entries are recorded.

	£ million	£ million
Dr Loan	1.84	
Cr Other comprehensive income		1.84

To recognise the foreign exchange gain on the loan. This is the difference between US\$50 million translated at 1.6 and 1.7.

	£ million	£ million
Dr Other comprehensive income	2.57	
Cr Net assets		2.57

To retranslate the net assets. This is the difference between US\$70 million translated at 1.6 and 1.7.

5.1.5.2 Own credit risk

Changes in own credit risk (non-performance risk) will affect hedge effectiveness assessment in the same way as changes in counterparty credit risk described in 5.1.5.1.

5.1.6 Clean versus dirty prices

'Clean' prices are prices that exclude any interest accruals. 'Dirty' prices include interest accruals.

Although the carrying values recognised in the statement of financial position are dirty prices, clean prices can be used when assessing whether a hedge is expected to be highly effective.

When a retrospective test of hedge effectiveness is performed using dirty prices for a hedge of a debt instrument with an interest rate swap, ineffectiveness will be observed if the test is performed between interest payment dates. The swap's value will include a net interest accrual being the net of the interest receivable on the receive leg and the interest payable on the pay leg. The loan's value will include a gross interest accrual. The accrued interest component of the swap's value will therefore be far smaller than that of the debt causing hedge ineffectiveness.

It is important to note that excluding accrued interest in an effectiveness test does not eliminate the ineffectiveness that can be caused by the first fixing of the swap. When an interest rate swap fixes in advance, the interest rate on the floating leg of the swap is fixed until the next reset date. Therefore, between reset dates, as market interest rates change, this fixed portion of the floating leg builds up value. The build-up of value between reset dates is not mirrored in the fair value movements of the hedged debt. This ineffectiveness is not eliminated by excluding accrued interest from the hedge effectiveness testing.

When measuring the actual results of the hedge (see 5.2) the dirty value of the instruments must be used.

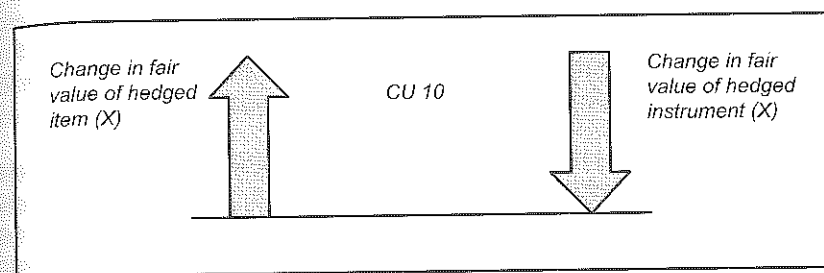
5.1.7 Frequency of hedge effectiveness assessment

Effectiveness must be assessed, at a minimum, at inception and at the end of each reporting period, including interim reporting periods. [IAS 39:AG106]

5.1.8 Ratio analysis and regression analysis

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

A perfect hedge relationship might be illustrated as follows.



For each CU10 change in value of the hedged item, there is an equal and opposite (CU10) change in value of the hedging instrument (i.e. in this example, the hedging instrument is perfectly negatively correlated with the risk it hedges). The negative sign results from the offsetting effect between the derivative and the hedged item.

Correlation is a term that originates from probability theory and relies on statistical analysis, but it is often estimated from historical data. It is a measure of the extent to which two variables move in relation to one another. The correlation can range from perfectly negative through totally uncorrelated to perfectly positive. Quantitatively, it is expressed as a value ranging from -1 (perfectly negatively correlated) to 1 (perfectly positively correlated).

5.1.8.1 Ratio analysis

Ratio analysis establishes, as a percentage, the extent of effectiveness of the hedging instrument in offsetting the hedged item for the designated risk over a defined period of time, i.e. the degree to which the changes in fair value of the hedging instrument and the hedged item are negatively correlated. It is relatively simple to compute and is well suited for measuring the effectiveness of short term hedges (where there may be insufficient data to perform a statistical test, such as regression) and is also used to measure the level of actual offset.

5.1.8.2 Regression analysis

Regression analysis is a statistical measurement technique for determining the validity and extent of a relationship between an independent and dependent variable. It is more complex than ratio analysis and is explained in more detail in 4.6 in chapter C10.

5.2 Measuring hedge ineffectiveness

Section 5.1 considers the various ways in which hedge effectiveness can be assessed. These techniques are used to support the entity's claim that a hedge relationship has been highly effective in the period, and will continue to be so for future periods. Consistent application of these techniques in

on 31 December each year for both the debt and the cross-currency swap). Entity A will receive US\$ LIBOR + 100 bp on a notional of US\$100,000 and pay Sterling LIBOR + 106 bp based on a notional of £57,143. Because the currency, notional, coupons and interest payment dates match on both the CCS and the debt, Entity A expects the hedge relationship to be highly effective.

Date	Spot rate US\$/£	Carrying amount of US\$ debt in £ after interest settlements	Cross-currency swap fair value £ after interest settlements	Net cash settlement on the swap translated at spot rate £ (£ LIBOR + 106 bp) – (US \$ LIBOR + 100 bp)	Net interest payment on the swap translated at average rate £ (£ LIBOR + 106 bp) – (US \$ LIBOR + 100 bp)
1/1/X2	1.75	57,143	0	0	0
31/12/X2	1.7	58,824	1,743	1,225	1,259
31/12/X3	1.6	62,500	5,520	1,389	1,476
31/12/X4	1.5	66,667	9,670	1,870	1,952
31/12/X5	1.8	55,556	(1,624)	1,282	1,042
31/12/X6	1.7	58,824	1,681	1,228	1,321

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

Risk management objective and nature of risk being hedged	Cash flow hedge of the variability in functional currency equivalent interest and principal cash flows associated with the foreign currency debt due to changes in forward rates.
Date of designation	1 January 20X2
Hedging instrument	Cross-currency swap to exchange US\$100,000 for £57,143 at maturity and receive US\$ LIBOR + 100bp, pay £ LIBOR + 106bp interest annually over the term of the instrument.
Hedged item	The cross-currency swap is designated as a hedge of the variability in functional currency equivalent interest and principal cash flows associated with the foreign currency debt due to changes in forward rates.

Assessment of hedge effectiveness	The critical terms of the derivative match (exchange of principal at maturity and annual interest payment), accordingly there is an expectation of high effectiveness. The entity will assess counterparty credit risk and probability of cash flows under the swap occurring every period.
Measurement of hedge effectiveness	Hypothetical derivative method. The actual hedging instrument is the same as the hypothetical cross-currency swap with exactly matching terms and therefore, no ineffectiveness is anticipated.

The following table illustrates the accounting entries for the transaction during its life in Sterling. Dr or (Cr) as indicated.

Date		Cash	CCS	Debt	Cash flow hedge reserve	Interest expense	Translation loss (gain)
1/1/X2	Issue debt	57,143		(57,143)			
31/12/X2	Fair value of CCS (before interest settlements)		518		(518)		
	Net settlement of CCS (at spot rate)	(1,225)	1,225				
	Accrue interest on debt (at average rate)			(2,319)		2,319	
	Retranslate debt to spot			(1,715)			1,715
	Reclassify amounts from cash flow hedge reserve				456	1,259	(1,715)
	Settle interest on the debt (at spot rate)	(2,353)		2,353			
31/12/X3	Fair value of CCS (before interest settlements)		2,388		(2,388)		