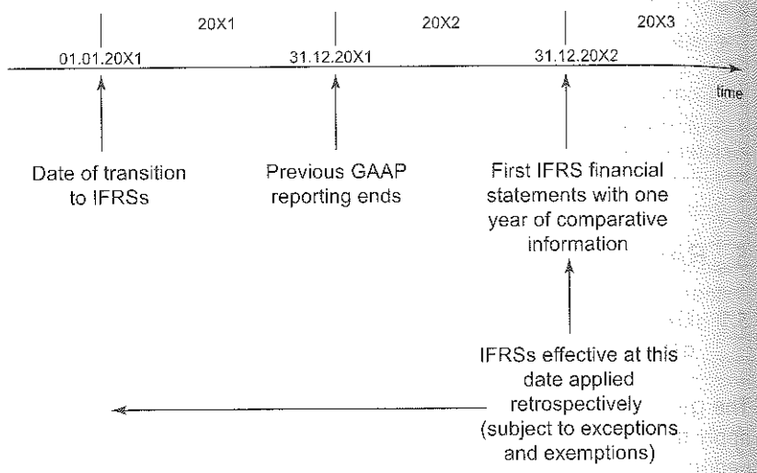
The following timeline summarises these requirements and illustrates key dates for a first-time adopter with a calendar year end that presents comparative information for one year.

IFRS adoption timeline



Subject to the exceptions and exemptions discussed in **sections 6** and **7**, respectively, in its opening IFRS statement of financial position an entity should:

[IFRS 1:10]

- recognise all assets and liabilities whose recognition is required by IFRSs;
- not recognise items as assets or liabilities if IFRSs do not permit such recognition;
- reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different asset, liability or component of equity under IFRSs; and
- apply IFRSs in measuring all recognised assets and liabilities.

5.3 Accounting policies

5.3.1 Selection of accounting policies – general

IFRS 1 requires an entity to use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies must comply with each IFRS effective at the end of its first IFRS reporting period, subject to exceptions and exemptions that are explained in **sections 6** and **7**, respectively. [IFRS 1:7]

The selection of accounting policies under IFRSs is considered in **section 3** of **chapter A5**. A first-time adopter is not bound by the accounting policy choices it made under previous GAAP, even if the previous GAAP treatment is consistent with IFRSs. In particular, in circumstances in which IFRSs permit an explicit choice, that choice is not constrained by the policy adopted under previous GAAP (e.g. whether to use the revaluation basis for a class of property, plant and equipment). However, in other cases (e.g. when there is no specific guidance in IFRSs), the factors that were relevant in selecting an appropriate policy under previous GAAP should be considered when applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

An entity may not apply different versions of IFRSs that were effective at earlier dates. [IFRS 1:8]

5.3.2 Transition provisions in other IFRSs do not generally apply

The transition provisions in other IFRSs apply to changes in accounting policies made by entities that already use IFRSs. They do not apply to a first-time adopter's transition to IFRSs except in certain specified circumstances that are explained in **sections 6** and **7**. [IFRS 1:9]

For example, an entity with a 31 March year end prepares its first IFRS financial statements at 31 March 20X3. It presents a single year of comparative figures. The entity's date of transition to IFRSs is, therefore, 1 April 20X1.

The entity applies all of those IFRSs that are effective for years beginning on 1 April 20X2 (i.e. those that are effective at the end of its reporting period) and ignores any transition provisions in those IFRSs except when IFRS 1 specifies that they should be applied. Those IFRSs should be applied in preparing the opening statement of financial position at 1 April 20X1, the comparative statement of financial position at 31 March 20X2, and the statement of financial position at 31 March 20X3 in accordance with IFRSs. The entity is permitted, but not required, to apply any new IFRSs that have been issued but are not mandatory, provided that the IFRSs in question permit early adoption (see **5.3.3**).

5.3.3 Application of new IFRSs that are not yet effective

A first-time adopter may apply a new IFRS that is not yet mandatory if the IFRS permits early adoption. [IFRS 1:8]

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Example 7.2.11E

Measurement of an asset acquired in a business combination but not recognised under previous GAAP for which recognition is required under IFRSs

Company A purchases a licence to operate a business in a particular jurisdiction for CU10 and recognises an intangible asset. Company A is subsequently acquired by Company B. Under its local GAAP, Company B does not recognise the licence as an intangible asset separately from goodwill.

Company B is subsequently acquired by Company C. Company C determines that the fair value of the licence at the date of acquisition of Company B is CU50 and recognises it as an intangible asset separately from goodwill.

Company C is subsequently acquired by Company D, but Company D does not recognise the licence as an intangible asset separately from goodwill.

The licence is therefore reported separately in the individual financial statements of Company A and in the consolidated financial statements of Company C.

Company D subsequently adopts IFRSs and chooses not to restate its acquisition of Company C in accordance with IFRS 3.

At what amount should the licence be recognised upon first-time adoption of IFRSs?

This example is similar to that discussed in **example 7.2.11C**. Although the intangible asset was not recognised in Company D's consolidated financial statements under previous GAAP, the second condition in IFRS 1:C4(b)(i) is not met and, therefore, the licence should be recognised separately in Company D's consolidated financial statements under IFRSs.

However, this example raises an additional question because there are two alternatives available on which to base the measurement of the intangible asset in Company D's consolidated financial statements (the original cost of CU10 recognised by Company A and the fair value of CU50 recognised by Company C when it acquired Company B). IFRS 1 does not provide guidance as to which of these measures should be used. In many cases, the measurement would be based on the most reliable information. If both measurements were determined to be reliable, then the most recent fair value (CU50) would be the most relevant measurement and should be used. The amount recognised (and the equivalent adjustment to goodwill) will be adjusted for amortisation of the intangible asset in accordance with IFRSs from the date of the measurement to the date of transition to IFRSs.

7.2.12 Adjustments to goodwill

7.2.12.1 Limited circumstances in which goodwill may be adjusted

As a general principle, under the optional exemption for business combinations, the carrying amount of goodwill in the opening IFRS

statement of financial position is its carrying amount under previous GAAP at the date of transition to IFRSs, adjusted only for the following items:

[IFRS 1:C4(g)]

- goodwill is increased when it is necessary to reclassify an item that was recognised as an intangible asset under previous GAAP (see **7.2.8**);
- goodwill is decreased (and, if applicable, deferred tax and non-controlling interests adjusted) when it is necessary to recognise an intangible asset that was subsumed within recognised goodwill under previous GAAP (see **7.2.11**); and
- regardless of whether there is any indication that goodwill may be impaired, IAS 36 should be applied in testing goodwill for impairment at the date of transition to IFRSs and in recognising any resulting impairment loss in retained earnings (or, if required by IAS 36, in revaluation surplus). The impairment test is based on conditions at the date of transition to IFRSs.

Goodwill should not be subject to amortisation even if it includes a subsumed intangible asset with a finite life. All goodwill should be tested for impairment at the date of transition to IFRSs.

No other adjustments to goodwill are permitted at the date of transition to IFRSs. IFRS 1 highlights the following examples for which goodwill is not adjusted:

[IFRS 1:C4(h)]

- to exclude in-process research and development acquired in that business combination (unless the related intangible asset would qualify for recognition under IAS 38 in the separate statement of financial position of the acquiree);
- to adjust previous amortisation of goodwill; or
- to reverse adjustments to goodwill that IFRS 3 would not permit, but that were made under previous GAAP because of adjustments to assets and liabilities between the date of the business combination and the date of transition to IFRSs.

Although there is no explicit prohibition in IFRS 1 on the reversal of a past impairment of goodwill, this is similar to a reversal of past amortisation which is explicitly prohibited by IFRS 1:C4(h)(ii). Also, the list of permitted adjustments to goodwill under IFRS 1:C4(g) refers only to "any resulting impairment loss" and does not envisage a profit arising from the impairment review of goodwill at the date of transition.

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The exemption cannot be applied to other classes of assets by analogy. [IFRS 1:D7] The exemption is available regardless of the IFRS accounting policy selected by the entity for ongoing reporting purposes.

IFRS 1:D5 provides the option to measure assets at deemed cost without specifying if the assets have been acquired, self-constructed or held under finance leases. Therefore, the exemption can also be applied to assets held under finance leases and capitalised in the financial statements. A first-time adopter may measure these items at fair value at the date of transition. However, the related finance lease liability is not measured at fair value; rather it is measured at the net present value of the lease payments in accordance with IAS 17 *Leases*.

The exemption in IFRS 1:D5 is not limited to property, plant and equipment within the scope of IAS 16. Consequently, an entity may elect to measure items of property, plant and equipment that are outside the scope of IAS 16 (e.g. certain mineral rights and reserves) at a deemed cost in accordance with IFRS 1:D5 (see also **7.5.4**). Whether mineral rights and reserves are property, plant and equipment or intangible assets is considered in **section 2** of **chapter A7**. Property, plant and equipment used in exploration activities are within the scope of IAS 16.

7.5.2.2 Details of the exemption

IFRS 1:D5 permits any asset in the designated categories to be measured at the date of transition to IFRSs at its fair value and that fair value to be used as the asset's deemed cost at that date. When this election is made, the disclosures required by IFRS 1:30 should be made in the entity's first IFRS financial statements (see **9.3.5**).

A first-time adopter may also elect to use a previous GAAP revaluation of any asset in the designated categories at, or before, the date of transition to IFRSs as deemed cost at the date of revaluation. This is, however, permitted only if the revaluation was, at the date of the revaluation, broadly comparable to:

[IFRS 1:D6]

- fair value; or
- cost or depreciated cost under IFRSs, adjusted to reflect, for example, changes in a general or specific price index.

The reference to the revaluation being 'broadly comparable' is explained in IFRS 1:BC47 as allowing a first-time adopter "to establish a deemed cost using a measurement that is already available and is a reasonable starting point for a cost-based measurement".

A previous GAAP valuation at a percentage of fair value (e.g. 80%) is not broadly comparable to fair value. IFRS 1:BC47 notes that it may

not always be clear whether a previous revaluation was intended to be a measure of fair value. For the amount to be used as deemed cost, the measurement must represent a valid estimate of fair value. A percentage of fair value is not broadly comparable to fair value and, therefore, cannot be used as the asset's deemed cost.

However, a revaluation in accordance with previous GAAP that results in a carrying amount that is similar to fair value, such as the application of a price index to a previous carrying amount, may be considered broadly comparable.

In accordance with IFRS 1:D6, the previous GAAP revaluation must be "at, or before, the date of transition to IFRSs" and this would exclude a valuation carried out at the end of the last reporting period under previous GAAP. For example, if the end of the first IFRS reporting period is 31 December 20X8 and the date of transition to IFRSs is 1 January 20X7, a valuation carried out at 31 December 20X7 under previous GAAP would not comply with IFRS 1:D6. However, it might be possible instead to use the measurement at 31 December 20X7 under the exemption in IFRS 1:D8(b) (see **7.5.3**).

Example 7.5.2.2

Accounting for previously recognised revaluation uplift

Under previous GAAP, Company G measured property, plant and equipment at a revalued amount that was broadly consistent with fair value and accumulated the difference between depreciated cost and the revalued amount within equity. Company G has elected to use the revalued amount as deemed cost under IFRS 1.

How should the revaluation uplift recognised under previous GAAP be accounted for at the date of transition to IFRSs?

IFRS 1:11 requires that the adjustments arising from first-time adoption be recognised in retained earnings or, if appropriate, another category of equity. The Standard does not specifically address the accounting for revaluation uplifts recognised under previous GAAP. The adjustment could be recognised as a separate component of equity but that is not required under IFRS 1.

If a previous GAAP revaluation is used as deemed cost under IFRS 1:D6, any revaluation uplift accumulated in equity under previous GAAP does not form part of the revaluation surplus under IFRSs. Therefore, an impairment loss arising after the transition to IFRSs cannot be offset against the amount accumulated in equity under previous GAAP but instead should be recognised in profit or loss.

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4.5.2 Share capital and reserves

4.5.2.1 Presentation when 'legal' share capital is classified as liabilities

IAS 1 requires several disclosures about share capital and reserves. These are described at **4.5.2.4** and **4.5.2.5**.

In straightforward cases, these disclosures will be made in respect of the amounts included in the statement of financial position caption 'issued capital and reserves attributable to owners of the parent'. However, this will not always be the case, because amounts that are legally share capital will sometimes be presented, in whole or in part, as liabilities in the statement of financial position in accordance with IAS 32 *Financial Instruments: Presentation*.

There are a number of ways in which the requirements of IAS 1 can be met. For example, it is generally acceptable to present a single line item on the face of the statement of financial position for 'issued share capital and reserves attributable to owners of the parent'. When this approach is taken, the amount presented on the face of the statement of financial position is the 'net' amount (i.e. excluding amounts that are legally share capital but presented as financial liabilities). Further details (e.g. analysing legal share capital between amounts classified as equity and liabilities) can be shown in the notes. This approach may not be appropriate in some jurisdictions; regulatory requirements or general practice may be such that entities present greater detail on the face of the statement of financial position (e.g. share capital, share premium and specified reserves).

When an expanded analysis of equity items is shown on the face of the statement of financial position (either because this is a regulatory requirement or because the entity wishes to present more detail on the face of the statement of financial position), the question arises as to which line items should be reduced by the amounts presented as liabilities.

When the amounts presented as liabilities represent the proceeds of issue of a class (or classes) of shares, the most common approach is that the amounts presented as 'share capital' and 'share premium' on the face of the statement of financial position exclude those amounts (i.e. they relate to equity shares only). Alternatively, the gross amounts for 'share capital' and 'share premium' may be presented on the face of the statement of financial position, with amounts classified as liabilities shown as a separate deduction. In such circumstances, the supplementary disclosures required by IAS 1 regarding share capital (see **4.5.2.4**) can be presented separately in the relevant notes for the 'equity' and 'liability' classes of shares. Alternatively, details about all classes of share capital may be presented in a single note, but

distinguishing separately those classes and amounts that have been presented as liabilities.

The position is more complicated when a class of shares (e.g. redeemable convertible preference shares) is accounted for as a compound financial instrument with both equity and liability components. There are several possibilities for presentation in such circumstances, including:

- the share capital and share premium could be shown on the face of the statement of financial position at their 'legal' amounts, with a separate negative reserve equal to the liability recognised; or
- the share capital and share premium could be shown on the face of the statement of financial position as those amounts that relate to equity shares, with a separate line item such as 'equity component of preference shares'; or
- the deduction for the liability might be made first from the share premium and then from share capital; or
- the deduction for the liability might be made from share capital and share premium in proportion to the allocation of the original proceeds of issue between those captions.

All of these are acceptable provided that adequate explanation is provided and that all of IAS 1's disclosure requirements are met. The key point is that the total amount presented as equity is unaffected by these choices.

4.5.2.2 Analysis of reserves

There are some specific instances when IFRSs require a separate component of equity to be maintained. For example, IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires specified exchange differences to be accumulated in a separate component of equity and IAS 16 requires a surplus on revaluation of an asset to be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. Subject to these (and other) specific requirements, there is some flexibility about which items are accounted for as separate components within equity.

See **4.5.2.5** for a discussion of the disclosure requirements regarding reserves within equity.

4.5.2.3 Meaning of 'retained earnings'

When IFRSs require amounts to be accumulated in equity, in the absence of specific requirements in IFRSs (see **4.5.2.2**), and subject to local regulatory requirements, it is generally acceptable for these amounts to be included within retained earnings.

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of IFRSs. Relevant agenda decisions should be carefully considered as indicative (but not definitive) guidance when selecting a suitable accounting policy for a transaction not specifically addressed by a Standard or an Interpretation.

In the absence of specifically applicable requirements, when an entity is making reference to and considering the applicability of IFRS requirements for similar and/or related issues, the question arises as to whether it is necessary to apply all aspects of the IFRS to the issues being analogised, or whether it could be appropriate to consider only certain aspects of that IFRS. This issue was considered by the IFRS Interpretations Committee in March 2011. The Committee observed that "when management develops an accounting policy through analogy to an IFRS dealing with similar and related matters, it needs to use its judgement in applying all aspects of the IFRS that are applicable to the particular issue".

Therefore, when analogising to the requirements of an IFRS, an entity is not necessarily bound to apply all of the requirements of that IFRS. Rather, the entity should use its judgement in determining which aspects of that IFRS are applicable to the particular issue and then apply all those aspects of the IFRS that it judges to be applicable.

The most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, accounting literature and accepted industry practices may also be considered, provided that they do not conflict with the above sources. [IAS 8:12]

Example 3.1.2

Selection of accounting policy for combinations of entities under common control – requirement to restate comparative information

Entities S1 and S2 are two subsidiaries of holding company H. Following a decision by H to reorganise the legal structure of the group, S1 acquires S2 (i.e. H now holds an indirect interest in S2 in place of the direct interest it held before the reorganisation). The acquisition of S2 by S1 is considered a combination of entities under common control and, under paragraph 2(c) of IFRS 3 *Business Combinations*, is excluded from the scope of that Standard.

This is the first time that S1 has entered into a transaction of this nature and, therefore, it is required to develop a new accounting policy. In the absence of specific IFRS literature on the topic, S1 has applied the requirements of IAS 8:10 to 12 and, in its consolidated financial statements, has chosen to account for the transaction at S2's carrying amounts at the date of the transaction (i.e. as a pooling of interests).

Is S1 obliged to restate the comparative periods in its consolidated financial statements as if S1 had acquired S2 at the beginning of the earliest period presented?

No. Even if S1 has developed its accounting policy by reference to a pronouncement of another standard-setting body that requires restatement of comparatives when the pooling-of-interests method is applied, S1 is not bound to apply all of the requirements of that pronouncement.

However, the decision-usefulness of the restated comparative information should be considered by management when developing its accounting policy and, if the failure to restate comparative information would be detrimental to the users of the financial statements, restatement should be considered. In addition, S1 should consider local regulatory requirements that may require (or prohibit) restatement of comparative periods for such transactions.

3.1.3 *Accounting policies to be applied consistently*

Accounting policies should be applied consistently for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If this is the case, an appropriate accounting policy should be selected and applied consistently to each category. [IAS 8:13]

IFRS 10 *Consolidated Financial Statements* requires that consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. [IFRS 10:19] There is no such requirement for the individual or separate financial statements of a parent and its subsidiaries.

In practice, most subsidiaries will choose to apply accounting policies that are applied by their parent because this will simplify the consolidation process. Also, the factors that determine the most appropriate policy for the group will often also determine that the same policy is the most appropriate for the subsidiary.

3.2 Changes in accounting policies

3.2.1 *Circumstances in which a change in accounting policy is permitted*

An accounting policy can be changed only if the change:

[IAS 8:14]

- is required by an IFRS; or
- results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

It is important that changes in accounting policies are only made if one of the criteria in IAS 8:14 is met; otherwise comparability over time within the financial statements will be lost. [IAS 8:15]

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8.9 Changes in valuation techniques

Once a valuation technique has been selected, it should be applied consistently. A change in a valuation technique or its application (e.g. a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is only appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. [IFRS 13:65]

IFRS 13 provides the following examples of events that might appropriately lead to a change in valuation technique:

[IFRS 13:65]

- new markets develop;
- new information becomes available;
- information previously used is no longer available;
- valuation techniques improve; or
- market conditions change.

If a valuation technique does not use unadjusted quoted prices, and in a subsequent period a quoted price in an active market becomes available, the quoted price should be used because IFRS 13:77 states that "a quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available", with limited exceptions.

Depending on the particular circumstances, a change from a valuation technique that uses unadjusted quoted prices to a different valuation technique (such as a discounted cash flow technique) may be appropriate when:

- quoted prices for an identical asset or liability are no longer available; or
- quoted prices are available, but the market is no longer active. Note, however, that prices from relevant observable transactions must be considered in determining fair value even if the market is not active (see **9.5**); or
- the entity no longer has access to the market in which the prices are quoted. The entity must be able to access the market in order to use a quote from that market without adjustment to reflect the lack of access, but the entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date (see **section 3.3** for further details); or
- quoted prices are no longer based on relevant observable market data and do not reflect assumptions that market participants would

make in pricing the asset at the measurement date. As discussed at **9.7**, an entity cannot necessarily assume that a price provided by an external source is representative of fair value at the measurement date.

A decrease in the volume or level of activity in a market does not necessarily mean that the market is no longer active (see **10.2.1.1** for a discussion of active vs. inactive markets) and, consequently, that a change in the valuation technique is warranted.

In selecting another valuation technique, when appropriate, an entity should maximise the use of relevant observable inputs (e.g. quoted prices for a similar asset or liability with adjustments as appropriate) and minimise the use of unobservable inputs.

If there is a change in the valuation technique used or its application, any resulting difference should be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; however, the disclosures generally required under IAS 8 regarding a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application. [IFRS 13:66]

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9 Inputs to valuation techniques

9.1 Definition of inputs

Inputs are defined as "[t]he assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

(a) the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and

(b) the risk inherent in the inputs to the valuation technique". [IFRS 13:Appendix A]

Inputs may be observable or unobservable. [IFRS 13:Appendix A] Valuation techniques used to measure fair value are required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs (see **section 8**). [IFRS 13:67]

Valuation inputs that are observable are more reliable than those that are unobservable (sometimes referred to as 'entity-specific' because these inputs are derived by an entity rather than by the 'market').

6.5 Revaluation of assets by class

6.5.1 Revaluation to be made for entire class of assets

When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs is required to be revalued. [IAS 16:36] Items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and valuations at different dates. [IAS 16:38] This is intended to prevent the distortions caused by the selective use of revaluation, also referred to as 'cherry-picking', so as to take credit for gains without acknowledging falls in the value of similar assets.

6.5.2 Definition of a 'class' of assets

A class of property, plant and equipment is defined as a grouping of assets of a similar nature and use in an entity's operations. [IAS 16:37] The following examples of separate classes are cited:

- land;
- land and buildings;
- machinery;
- ships;
- aircraft;
- motor vehicles;
- furniture and fixtures;
- office equipment; and
- bearer plants.

Bearer plants were added to the examples in IAS 16:37 as part of the June 2014 amendments which brought bearer plants within the scope of IAS 16 (see **2.6**).

The examples cited as separate classes are not intended to be prescriptive or comprehensive. In practice, it is not uncommon for some of these classes to be combined. For example, when motor vehicles are not significant to an entity, motor vehicles and machinery may be combined in a plant and machinery class. For similar reasons, office equipment may be included in the furniture and fixtures class.

6.5.3 Disclosure of classes

As discussed in **11.2**, detailed disclosures are specified for each class of property, plant and equipment. This should be borne in mind when distinguishing classes, because multiple classes could lead to voluminous disclosures.

6.5.4 Revaluation on a rolling basis

The requirement to revalue entire classes of assets is a potentially onerous requirement because, for some reporting entities, a class of assets could comprise a large number of items. For this reason, IAS 16:38 allows a class of assets to be revalued on a rolling basis, provided that revaluation of the class of assets is completed within a short period of time and that the revaluations are kept up to date.

No further guidance is provided as to how a 'short period' should be interpreted for the purposes of IAS 16:38 although, given the drafting of the Standard, it is presumably less than a financial year. The general approach of IAS 16:38 is, however, to require simultaneous valuations so as to avoid the reporting of amounts that are a mixture of costs and values as at different dates. Accordingly, it would seem appropriate:

- for all such valuations to take place in the same accounting period (and in the same interim period when an entity presents interim financial statements); and
- for the acceptable length of the period to take into account how stable fair values are, so that greater volatility requires a shorter period over which to perform valuations.

6.6 Assets for which fair value cannot be reliably measured

Even when an entity has selected the revaluation model for its property, plant and equipment, only those assets whose fair value can be measured reliably are carried at revalued amounts. [IAS 16:31]

IAS 16 provides no guidance as to the circumstances in which it is appropriate to conclude that the fair value of an item of property, plant and equipment cannot be measured reliably, nor does it address the appropriate accounting for those assets whose fair value cannot be measured reliably.

However, IAS 40 *Investment Property* contains useful guidance on the circumstances in which it is appropriate to conclude that the fair value of an item of property, plant and equipment cannot be measured reliably. Under that Standard, the exception is allowed when, and only when, comparable market transactions are infrequent and alternative

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for Government Grants and Disclosure of Government Assistance (see **section 5** of **chapter A36**).

4.7 Exchanges of assets

When an intangible asset is acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, the cost of the asset received is measured at fair value (even if the entity cannot immediately derecognise the asset given up), unless either:

[IAS 38:45]

- the exchange transaction lacks commercial substance; or
- the fair value of neither the asset received nor the asset given up is reliably measurable.

In either of these circumstances, which result in the acquired asset not being measured at fair value, its cost is measured at the carrying amount of the asset given up. [IAS 38:45]

Whether or not a transaction has commercial substance is determined by considering the extent to which the entity's future cash flows are expected to change as a result of the transaction. An exchange transaction is considered to have commercial substance if:

[IAS 38:46]

- the configuration (i.e. risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; *or*
- the entity-specific value (reflecting post-tax cash flows) of the portion of the entity's operations affected by the transaction changes as a result of the exchange; *and*
- the difference arising in either of the two circumstances outlined is significant relative to the fair value of the assets exchanged.

As set out in **4.2**, no intangible asset can be recognised unless its cost can be measured reliably. In an exchange transaction that has commercial substance, if an entity is able to measure reliably the fair value of either the asset received or the asset given up, the fair value of the asset given up should be used to measure cost, unless the fair value of the asset received is more clearly evident. Fair value can be measured reliably if either (1) the variability in the range of reasonable fair value measurements is not significant for that asset, or (2) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. [IAS 38:47]

4.8 Internally generated intangible assets

4.8.1 *Additional recognition criteria for internally generated intangible assets – background*

Inherently, it is more difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in identifying whether and when there is an identifiable asset that will generate future economic benefits, and in determining the cost of the asset reliably. Therefore, IAS 38 includes additional recognition criteria for internally generated intangible assets which expand on the general recognition criteria. It is assumed that these additional criteria are met implicitly whenever an entity acquires an intangible asset.

Example 4.8.1

Development costs paid to an external party

Company A pays Company B, an external party, to develop an asset that would meet the requirements of IAS 38 for recognition as an internally generated intangible asset in Company A's financial statements (see **4.8.5.1**). Company B is performing only development work; all the associated research has already been performed, and the costs expensed, by Company A.

Company A should recognise an internally generated intangible asset for these development costs under IAS 38. Whether Company A incurs the costs directly via an internal development function or outsources the development process to an external party does not influence how Company A should account for the asset in its financial statements.

Therefore, because the expenditure meets the requirements for the recognition of an internally generated intangible asset under IAS 38, Company A should recognise the asset as an internally generated intangible asset in its financial statements. If the asset being developed did not meet the requirements for recognition of an internally generated intangible asset under IAS 38, the costs would be considered research expenditures and would be expensed as incurred. Similarly, if Company B was paid by Company A to perform both research and development activities, the research element would be expensed as incurred, but the development element would be capitalised provided that it met the requirements of IAS 38.

4.8.2 *Items that should not be recognised as internally generated intangible assets*

The Standard prohibits the recognition of internally generated goodwill as an asset. [IAS 38:48]

Some other internally generated items are specifically identified in IAS 38 as not capable of being distinguished from the cost of developing the business as a whole and therefore are prohibited from being capitalised as internally generated intangible assets. These are internally generated:

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the lessee an additional three months to return or to acquire the asset. The extension option must be exercised prior to the end of the main lease term.

Entity X enters into 'residual value guarantee' contracts with Entity A, a third party. Under these contracts, Entity A will purchase the assets from Entity X at the end of each lease term at a predetermined price. Entity A receives a fee in return for providing the residual value guarantee.

When an extension option is exercised by the lessee, ownership of the asset is transferred to Entity A at the end of the main lease term for the predetermined price. During the extension period, Entity X passes the rental income to Entity A. At the end of the extension period, Entity A sells the asset either in the market or to the lessee. Rental income received by Entity A during the extension period is considered incidental to Entity A's principal activities, which are the provision of residual value guarantee contracts and selling the assets acquired.

In order to determine how to recognise the assets in the period from acquisition at the end of the main lease term to the point of sale, Entity A must establish how the assets are used in the business, i.e. whether they represent inventories or property, plant and equipment.

In the circumstances described, Entity A acquires the assets at the end of the main lease term to profit from selling them in the market. In accordance with IAS 2:6, the assets are classified as inventories because they are assets "held for sale in the ordinary course of business".

The assets acquired do not represent property, plant and equipment, in accordance with IAS 16 *Property, Plant and Equipment*, because they are not held primarily for rental by Entity A to others and are not expected to be used during more than one period.

Example 2.1B

Classification and measurement of pipeline fill

Company A operates a pipeline to transport crude oil. Company A does not produce or distribute crude oil; it merely provides the use of its pipeline to the buyer and seller in a contract for a usage fee. The seller and buyer independently negotiate the sales price, and either the buyer or the seller pays a fee to Company A for transporting the oil purchased/sold through its pipeline.

The pipeline needs to be full of oil at all times to be operational. Therefore, during initial construction of the pipeline, Company A purchases oil to fill the pipeline. Once the pipeline is operational, Company A charges a fixed fee for its transportation services and, in effect, swaps crude oil pushed into the pipeline by a seller for crude oil of the same grade and quality delivered to the customer at the exit point of the pipeline. Company A bears the risk of loss due to theft or line loss in excess of the maximums allowed under the contract. Such losses are rare and normally arise as the result of a pipeline spill that is covered by insurance.

The pipeline fill meets the definition of an asset and should be recognised at cost when acquired. The pipeline fill does not meet the definition of property, plant and equipment under paragraph 6 of IAS 16. Rather, it should be classified as inventories in accordance with IAS 2:6 because it is held "in the form of materials or supplies to be consumed in the production process or in the rendering of services".

Because an accounting transaction does not take place at the time of each swap of crude oil, no step-up in the value of inventories is recognised. The pipeline fill is measured at the lower of cost and net realisable value throughout the term of the pipeline's operations in accordance with IAS 2:9.

See **example 9.4.1** in **chapter A14** (or, for entities that have not yet adopted IFRS 15 *Revenue from Contracts with Customers*, **example 6.2.1E** in **appendix A1**) for a discussion of retention of title clauses.

The classification of spare parts, stand-by equipment and servicing equipment as inventories or property, plant and equipment is addressed at **3.2** in **chapter A7**.

IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* addresses the classification of costs relating to production stripping activity in a surface mine as inventories or as a non-current asset – see **section 10** of **chapter A7**.

Supplies purchased during the research phase of a project, for example in the pharmaceutical industry, will not meet the definition of inventories prior to a decision to proceed with commercial production. Nevertheless, such supplies may qualify for recognition as an asset (see **example 4.8.4** in **chapter A9** for further dicussion).

2.2 Inventories excluded from the scope of IAS 2

IAS 2 applies to all inventories, except:

[IAS 2:2]

- financial instruments (addressed by IAS 32 *Financial Instruments: Presentation* and either IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement* – see **Volume B** and **Volume C**, respectively); and
- biological assets related to agricultural activity and agricultural produce at the point of harvest (addressed by IAS 41 *Agriculture* – see **chapter A38**).

For entities that have not yet adopted IFRS 15 *Revenue from Contracts with Customers*, IAS 2:2 also refers to the exclusion from the scope of IAS 2 of work in progress arising under construction contracts,

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2.2 Executory contracts

Executory contracts are contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent. [IAS 37:3] Executory contracts do not fall within the scope of IAS 37 unless they are onerous (see **3.9.2**).

Examples of executory contracts include:

- employee contracts in respect of continuing employment;
- contracts for future delivery of services such as gas and electricity;
- obligations to pay local authority charges; and
- most purchase orders.

Example 2.2

Executory contract

On 1 January 20X0, Company A enters into a contract with Company B for the manufacture and delivery of 100 units of component Q at five different dates in the future, i.e. 500 units are to be delivered in total. Payment is due on delivery of the units.

On 1 January 20X0, the contract between Company A and Company B is executory because neither party has performed any of its obligations; Company B has not manufactured or delivered any of the units, nor has Company A paid for any of them.

By 1 March 20X0, Company B has produced and delivered 200 of the units and Company A has paid in full for those 200 units. At this date, the contract between Company A and Company B continues to be executory because both parties have partially performed their obligations to an equal extent.

By 1 June 20X0, Company B has produced and delivered the full 500 units, but Company A has only paid for 400 units in total. The contract between Company A and Company B no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Company A is required to recognise a liability for the final 100 units of component Q for which it has not yet paid.

2.3 Provisions, contingent liabilities and contingent assets covered by other Standards

When another Standard deals with a specific type of provision, contingent liability or contingent asset, the more specific Standard should be applied. For example:

[IAS 37:5]

(a) for entities that have not yet adopted IFRS 15 *Revenue from Contracts with Customers*, provisions relating to construction contracts are dealt with under IAS 11 *Construction Contracts* (see **appendix A2**);

(b) provisions relating to income taxes are dealt with under IAS 12 *Income Taxes* (see **chapter A13**);

(c) provisions relating to leases generally fall within the scope of IAS 17 *Leases* (see **chapter A17**). However, because IAS 17 contains no specific requirements to deal with operating leases that have become onerous, IAS 37 applies to such onerous contracts;

(d) provisions relating to employee benefits are dealt with under IAS 19 *Employee Benefits* (see **chapter A15**);

(e) provisions relating to insurance contracts are dealt with under IFRS 4 *Insurance Contracts* (see **chapter A39**). However, IAS 37 applies to provisions, contingent liabilities and contingent assets of an insurer other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS 4;

(f) contingent consideration of an acquirer in a business combination is dealt with under IFRS 3 *Business Combinations* (see **section 8.2** of **chapter A25**); and

(g) for entities that have adopted IFRS 15, provisions relating to contracts with customers are dealt with in accordance with that Standard (see **chapter A14**). However, because IFRS 15 contains no specific requirements to deal with contracts with customers that are, or have become, onerous, IAS 37 deals with such onerous contracts.

In addition, the acquirer's treatment of contingent liabilities assumed in a business combination is addressed by IFRS 3 *Business Combinations* (see **chapter A25**).

IAS 37 *does* apply to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see **chapter A20**). [IAS 37:9]

IAS 37:5(f) was added in December 2013 by consequential amendments arising from *Annual Improvements to IFRSs:2010-2012 Cycle*. In May 2014, consequential amendments arising from IFRS 15 *Revenue from Contracts with Customers* deleted the reference to the superseded IAS 11 in IAS 37:5(a) and added IAS 37:5(g).

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9.2.2 Assessing the relationship between the contributor and the fund

The contributor is required to assess whether it has control or joint control of, or significant influence, over the fund, in accordance with relevant IFRSs, and to account for its interest by consolidation or the equity method as appropriate under those Standards. [IFRIC 5:8]

9.2.3 Accounting for the obligation to pay decommissioning costs

The contributor's obligation to pay decommissioning costs should be recognised as a liability, separately from its interest in the fund, unless its contributions to the fund have extinguished its obligation to pay decommissioning costs (even in the event that the fund fails to pay). [IFRIC 5:7] Therefore, when an entity remains liable for expenditure, a provision should be recognised, even when reimbursement is available.

When a contributor has an obligation to make potential additional contributions (e.g. in the event of the bankruptcy of another contributor, or if the value of the investments held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations), this obligation is a contingent liability that is accounted for under IAS 37. The contributor will recognise a liability only if it is probable that additional contributions will be made. [IFRIC 5:10]

9.2.4 Accounting for the contributor's interest in the fund

In the absence of control, joint control or significant influence, the contributor's right to reimbursement from the fund is accounted for in accordance with the rules set out in IAS 37 in respect of reimbursements. [IFRIC 5:9] Therefore, if the reimbursement is virtually certain to be received when the obligation is settled, it should be treated as a separate asset.

The reimbursement should be measured at the lower of the amount of the decommissioning obligation recognised, and the contributor's share of the fair value of the net assets of the fund attributable to contributors. [IFRIC 5:9] Therefore, recognition of an asset in excess of the recognised liability is prohibited. For example, rights to receive reimbursement to meet decommissioning liabilities that have yet to be recognised as a provision are not recognised.

Changes in the carrying amount of the right to receive reimbursement other than contributions to and payments from the fund should be recognised in profit or loss in the period in which those changes occur. [IFRIC 5:9]

9.2.5 Disclosure

Contributors are required to disclose the nature of interests in funds, and any restrictions on access to the assets in the funds. [IFRIC 5:11]

In addition, when the arrangements give rise to contingent liabilities or reimbursement rights that are accounted for under IAS 37, the relevant disclosure requirements of IAS 37 apply.

9.3 IFRIC 6 *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*

IFRIC 6 addresses the recognition of liabilities for waste management under the European Union's Directive on Waste Electrical and Electronic Equipment (the WE&EE Directive). Specifically, the Interpretation deals with waste from private households arising from products sold on or before 13 August 2005. It does not apply to waste from sources other than private households, nor to household waste arising from products sold after 13 August 2005.

The Interpretation is therefore quite narrow in scope. The general principles in IAS 37 should be applied to determine the appropriate recognition point for other remediation and recycling obligations. However IFRIC 6:7 states that "if, in national legislation, new waste from private households is treated in a similar manner to historical waste from private households, the principles of the Interpretation apply by reference to the hierarchy in paragraphs 10 – 12 of IAS 8". Therefore, before determining an accounting policy for 'new' household waste, entities will need to determine how the WE&EE Directive has been transposed into local law. The Interpretation will also be a source of authoritative guidance on the appropriate accounting for obligations that are imposed by similar cost attribution models.

Under the WE&EE Directive, the obligation to contribute to waste management costs is allocated proportionately to producers of the relevant type of equipment who participate in the market during a specified period (the measurement period). The IFRIC (now the IFRS Interpretations Committee) was asked to determine what constitutes the obligating event for the recognition of a provision for the waste management costs.

The IFRIC decided that the event that triggers liability recognition is participation in the market during a measurement period (and not the production of the equipment, nor the actual incurrence of waste management costs).

9.4 IFRIC 21 *Levies*

9.4.1 IFRIC 21 – background

IFRIC 21 *Levies* was issued in May 2013 and is effective for annual periods beginning on or after 1 January 2014, with earlier application permitted. IFRIC 21 provides guidance on when to recognise a liability for a levy imposed by a government; it applies both for levies that are

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5.2 Eliminations of unrealised intragroup profits

When a group entity sells goods to another group entity, the seller recognises profits made on those sales in its individual financial statements. If those goods are still held in inventories by the purchaser at the end of the reporting period, the profit recognised by the seller, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories is eliminated from the group's profit, and the closing inventories of the group are recognised at cost to the group. The tax consequences to the seller (both current and deferred, if any), however, are not eliminated. If tax is charged on the results of individual entities, and not on the group, the seller will pay tax on any profits generated from the intragroup sales, even though some of those profits may be unrealised from the group's perspective.

Such consolidation adjustments may have a deferred tax impact in the consolidated financial statements. The intragroup elimination is made as a consolidation adjustment and not in the financial statements of any individual reporting entity. Therefore, the elimination will result in the creation of a temporary difference as far as the group is concerned between the carrying amount of the inventories in the consolidated financial statements and the tax base (assumed to be the carrying amount in the purchaser's individual financial statements). The deferred tax effects arising in respect of this temporary difference should be recognised in accordance with the usual principles.

The tax rate to be used when recognising the deferred tax balance arising from the elimination of unrealised profits on intragroup transactions is determined by reference to the tax jurisdiction where the temporary difference will reverse. This will generally be the tax rate in the purchaser's jurisdiction, because the deduction is available at that rate when the unrealised profit is realised from the sale to an unrelated third party. If the tax rate in the purchaser's jurisdiction differs from that in the seller's, the deferred tax recognised may not equal the tax currently payable by the seller.

Example 5.2

Elimination of intragroup profits in inventories

Company P sells inventories costing CU200 to its overseas subsidiary, Company S, for CU300. Company P's tax rate is 40 per cent, Company S's is 50 per cent. At the end of the reporting period, Company S still holds the inventories.

Company P recognises a current tax liability of CU40 (CU100 × 40%) relating to the profit on sale of the inventories but does not recognise any deferred tax balances because there are no future tax consequences from Company P's point of view.

Company S is entitled to a future deduction for the CU300 paid for the inventories and this is therefore the asset's tax base from Company S's perspective. Consequently, in Company S's individual financial statements, the tax base is equal to the carrying amount and no temporary difference arises.

Company P prepares consolidated financial statements and, for financial reporting purposes, gains and losses on intragroup transactions are eliminated on consolidation. Therefore, on consolidation, the carrying amount of the inventories is reduced from CU300 to CU200 (to eliminate the unrealised profit). A CU100 deductible temporary difference arises, representing the difference between the carrying amount (CU200) and the tax base (CU300). A deferred tax asset is calculated by multiplying the temporary difference of CU100 by 50 per cent, because the deduction is available to Company S at that rate when the unrealised profit is realised outside the group on sale of the inventories by Company S. Available evidence supports a conclusion that realisation of the deferred tax asset representing the tax benefit of Company S's deductible temporary differences is probable. The deferred tax asset arising of CU50 is therefore recognised on consolidation.

The impact of this intragroup transaction on Company P's consolidated financial statements is shown below in the following journal entries.

		CU	CU
Dr	Current tax expense (CU100 × 40%)	40	
Dr	Deferred tax asset (CU100 × 50%)	50	
Cr	Current tax payable		40
Cr	Deferred tax benefit		50

To recognise the impact of the intragroup transaction.

In a subsequent period, Company S sells the inventories that it acquired from Company P to an unrelated third party for the same amount that it had previously paid Company P, i.e. CU300. The journal entry to reflect the sales and related tax consequences to be reflected in the consolidated financial statements of Company P is as follows.

		CU	CU
Dr	Cash	300	
Dr	Cost of goods sold	200	
Dr	Income tax expense	50	
Cr	Sales		300
Cr	Inventories		200
Cr	Deferred tax asset		50

To recognise the sales and related tax consequences.

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- A **contract liability** is defined as "[a]n entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer".
- A **customer** is defined as "[a] party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration".
- **Income** is defined as "[i]ncreases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants".
- A **performance obligation** is defined as "[a] promise in a contract with a customer to transfer to the customer either:
  (a) a good or service (or a bundle of goods or services) that is distinct; or
  (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer".
- **Revenue** is defined as "[i]ncome arising in the course of an entity's ordinary activities".
- The **stand-alone selling price** of a good or service is defined as "[t]he price at which an entity would sell a promised good or service separately to a customer".
- The **transaction price** for a contract with a customer is defined as "[t]he amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties".

3 General principles and scope

3.1 Objective of IFRS 15

The objective of IFRS 15 is to establish the principles that should be applied by an entity in order to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. [IFRS 15:1]

3.2 Core principle of IFRS 15

The core principle of IFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers, reflecting the amount of consideration to which the entity expects to be entitled in exchange for those goods or services. [IFRS 15:2]

When applying IFRS 15, it is important to evaluate the terms of the contract and all relevant facts and circumstances. [IFRS 15:3]

3.3 Consistent application of IFRS 15

IFRS 15 should be applied consistently to contracts with similar characteristics and in similar circumstances. This requirement for consistent application is specifically extended to the use of any practical expedients. [IFRS 15:3]

3.4 Practical expedient – application to a portfolio of contracts (or performance obligations)

Although IFRS 15 specifies the accounting for an individual contract with a customer, the Standard allows as a practical expedient that it can be applied to a portfolio of contracts (or performance obligations) with similar characteristics provided that it is reasonably expected that the effects on the financial statements of applying a portfolio approach will not differ materially from applying IFRS 15 to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, estimates and assumptions that reflect the size and composition of the portfolio should be used. [IFRS 15:4]

Some entities manage a very large number of customer contracts and offer a wide array of product combination options (e.g. entities in the telecommunications industry may offer a wide selection of handsets and wireless usage plan options). For these entities, it would take significant effort to apply some of the requirements of IFRS 15 (e.g. the requirement to allocate the stand-alone selling price to the identified performance obligations as described in **section 8**) on an individual contract basis. In addition, the capability of information technology systems to capture the relevant information may be limited.

Entities will need to evaluate whether they are eligible to use a portfolio approach under IFRS 15:4. IFRS 15 does not provide explicit guidance on how to (1) evaluate 'similar characteristics', and (2) establish a reasonable expectation that the effects of applying a portfolio approach would not differ materially from those of applying the Standard at a contract or performance obligation level. Accordingly, entities will need to exercise significant judgement in determining that the contracts or performance obligations that they have segregated into portfolios have similar characteristics at a sufficiently granular level to ensure that the outcome of using a particular portfolio approach can reasonably be expected not to differ materially from the results of applying the Standard to each contract or performance obligation in the portfolio individually.

In segregating contracts (or performance obligations) with similar characteristics into portfolios, entities should apply objective criteria associated with the particular contracts or performance obligations and their accounting consequences. When determining whether particular contracts have similar characteristics, entities may find it helpful to focus particularly on those characteristics that have the most significant

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that). In such a scenario, the seller might conclude that only 30 per cent of the variable consideration should be included, because inclusion of a higher amount might result in a significant revenue reversal. In that case, the amount of revenue recognised would be restricted to the following.

(CU100 × 30%) + (CU90 × 70%) = CU93

7.2.5 *Reassessment of variable consideration*

The estimated transaction price is updated at the end of each reporting period (including updating the assessment of whether an estimate of variable consideration should be constrained – see **7.3**) to represent the circumstances present at the end of the reporting period and any changes in circumstances during the reporting period. IFRS 15 specifies how changes in the estimated transaction price should be recognised (see **8.5**). [IFRS 15:59]

7.3 Constraining estimates of variable consideration

IFRS 15 includes separate requirements in relation to the recognition of revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property. These are discussed at **11.2**.

For all other types of variable consideration, variable consideration should only be included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. [IFRS 15:56]

The term 'highly probable' is intended here to mean that 'the future event or events are likely to occur'. [IFRS 15:BC211]

An entity should consider both the likelihood and the magnitude of the revenue reversal when assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved. Factors that may increase the likelihood or the magnitude of a revenue reversal include the following:

[IFRS 15:57]

(a) the amount of consideration is highly susceptible to factors outside the entity's influence. For example volatility in a market, the judgement or actions of third parties, weather conditions or a high risk of obsolescence of the promised good or service;

(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time;

(c) the experience (or other evidence) that the entity has with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value;

(d) the entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances; and

(e) there are a large number and broad range of possible consideration amounts within the contract.

Example 7.3A

Price concessions

[IFRS 15:IE116 - IE123, Example 23]

An entity enters into a contract with a customer, a distributor, on 1 December 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of CU100 per product (total consideration is CU100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on 1 December 20X7.

On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A – Estimate of variable consideration is not constrained

The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 per cent of the sales price for these products. Current market information suggests that a 20 per cent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 per cent in many years.

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see [IFRS 15:53(a)]) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be CU80,000 (CU80 × 1,000 products).

The entity also considers the requirements in [IFRS 15:56 to 58] on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of CU80,000 can be included in the transaction price. The entity considers the factors in [IFRS 15:57] and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative

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to continue to perform as required under the contract (ie pay the promised consideration) are enforceable.

9.2.4.4 Real estate sales – example

Example 9.2.4.4

Real estate sales before completion by a property developer

Entity A, a real estate developer, entered into sales and purchase agreements with various buyers before the completion of a property project. The properties are located in Country B. The sales and purchase agreements include the following key terms:

- a specific unit is identified in the contract;
- Entity A is required to complete the property in all respects in compliance with the conditions set out in the sales agreement and the related building plans within two years from the time when the sales contracts are entered into;
- the property remains at Entity A's risk until delivery;
- the buyer is not permitted at any time before delivery to sub-sell the property or transfer the benefit of the agreement. However, the buyer can at any time before the date of assignment mortgage the property in order to finance the acquisition of the property;
- the sales agreement can be cancelled only when both the buyer and Entity A agree to do so – in effect, the buyer does not have the right to cancel the sales agreement. If both the buyer and Entity A agree to cancel the contract, Entity A has the right to retain 10 per cent of the total purchase price, and the buyer is required to pay for all necessary legal and transaction costs incurred by Entity A in relation to the cancellation;
- if Entity A fails to complete the development of the property within the specified two-year period, the buyer has the right to rescind the sales contract and Entity A is required to repay to the buyer all amounts paid by the buyer together with interest. Otherwise, the buyer does not have a right to cancel the contract; and
- the purchase consideration is payable as follows:
  - 5 per cent of the purchase consideration upon entering into the sales agreement;
  - 5 per cent of the purchase consideration within one month from the date when the sales agreement is entered into;
  - 5 per cent of the purchase consideration within three months from the date when the sales agreement is entered into; and
  - the remaining 85 per cent of the purchase consideration upon delivery of the property.

Note that, for simplicity, this example does not consider whether there is a significant financing element.

Should Entity A recognise revenue over time or at a point in time?

Under IFRS 15, an entity satisfies a performance obligation over time when it transfers control of the promised good or service over time. IFRS 15:35 states that an entity transfers control of a good or service over time and, consequently, satisfies a performance obligation and recognises revenue over time if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset (e.g. work in progress) that the customer controls as the asset is created or enhanced; or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Criterion IFRS 15:35(a) is not relevant in determining whether revenue from real estate sales (before completion) should be recognised over time or at a point in time. This is because buyers generally do not consume all of the benefits of the property as the real estate developers construct the property; rather, those benefits are consumed in the future.

Criterion IFRS 15:35(b) is not directly relevant in the circumstances under consideration because, without further consideration of criterion 15:35(c), a conclusion cannot be reached about whether the buyers have control of the property as Entity A develops the property.

Entity A should focus on criterion IFRS 15:35(c), and in particular:

- whether an asset has been created with an alternative use to the real estate developer; and
- whether the real estate developer has an enforceable right to payment for performance completed to date.

Has an asset been created with an alternative use to Entity A?

In accordance with IFRS 15:36, an asset does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset, or is limited practically from readily directing the asset in its completed state for another use.

With regard to contract restriction, IFRS 15:B6 states that the entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

Because, in the circumstances under consideration, each sales contract specifies the unit to be delivered, the property unit does not have an alternative use to Entity A. The contract precludes Entity A from transferring the specified unit to another buyer.

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In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see [IFRS 15:95(b)]). Therefore, the costs do not meet the criteria in [IFRS 15:95] and cannot be recognised as an asset using IFRS 15. In accordance with [IFRS 15:98], the entity recognises the payroll expense for these two employees when incurred.

12.4 Amortisation and impairment of contract costs

12.4.1 Amortisation of capitalised contract costs

An asset recognised in respect of a cost of obtaining or fulfilling a contract should be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in IFRS 15:95(a) – see **12.3**). [IFRS 15:99]

IFRS 15 does not provide specific guidance on the method an entity should use to amortise these assets. Amortisation of capitalised costs on a 'systematic basis' should take into account the expected timing of transfer of the goods and services related to the asset (which typically corresponds to the period and pattern in which revenue will be recognised in the financial statements). The pattern in which the related revenue is recognised could be significantly front-loaded, back-loaded or seasonal, and costs should be amortised accordingly.

To determine the pattern of transfer, entities may need to analyse the specific terms of each arrangement. In determining the appropriate amortisation method, they should consider all relevant factors including:

- experience with, and ability to reasonably estimate, the pattern of transfer; and
- the timing of the transfer of control of the goods or services to the customer.

In some situations, more than one amortisation method may be acceptable if this reasonably approximates the expected period and pattern of transfer of goods and services. However, an amortisation method is unacceptable if it is not expected to reflect the period and pattern of such transfer. When entities select a method, they should apply it consistently to similar contracts. If there is no evidence to suggest that a specific pattern of transfer can be expected, a straight-line amortisation method may be appropriate.

If the pattern in which contractual goods or services are transferred over the contract term varies significantly each period, it may be appropriate to use an amortisation model that more closely aligns with the variations in the transfer pattern. For example, amortisation could be allocated to the periods on the basis of the proportion of the total goods or services transferred each period. If the cost is related to goods or services transferred at a point in time, it follows that the amortised cost should be recognised at the same point in time.

When the contractual goods or services are transferred over an uncertain duration, entities should consider whether the relationship with the customer is expected to extend beyond the initial term of "a specific anticipated contract" (as referred to in IFRS 15:99 and described in IFRS 15:95(a)). For example, if an entity enters into a four-year contract with a customer but the customer relationship is expected to continue for six years, the appropriate amortisation period may be six years (i.e. the expected duration of the relationship).

When an entity's customer has been granted a material right to acquire future goods or services, and revenue related to the material right is being deferred, an entity should consider whether it would be appropriate to allocate to that right a portion of the costs that are capitalised in accordance with IFRS 15:91 or IFRS 15:95.

In situations in which the customer has been granted a material right to acquire future goods or services, and some revenue is being deferred in respect of that right, it would typically be reasonable also to regard a proportion of the costs capitalised in accordance with IFRS 15:91 or 95 as relating to that right. The amortisation is updated to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Any change is accounted for as a change in accounting estimate in accordance with IAS 8 (see **chapter A5**). [IFRS 15:100]

12.4.2 Impairment of contract costs

An impairment loss is recognised in profit or loss to the extent that the carrying amount of an asset recognised in respect of a cost of obtaining or fulfilling a contract exceeds:

[IFRS 15:101]

(a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less

(b) the costs that relate directly to providing those goods or services (see **12.3**) and that have not been recognised as expenses.

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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.

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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

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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

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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).

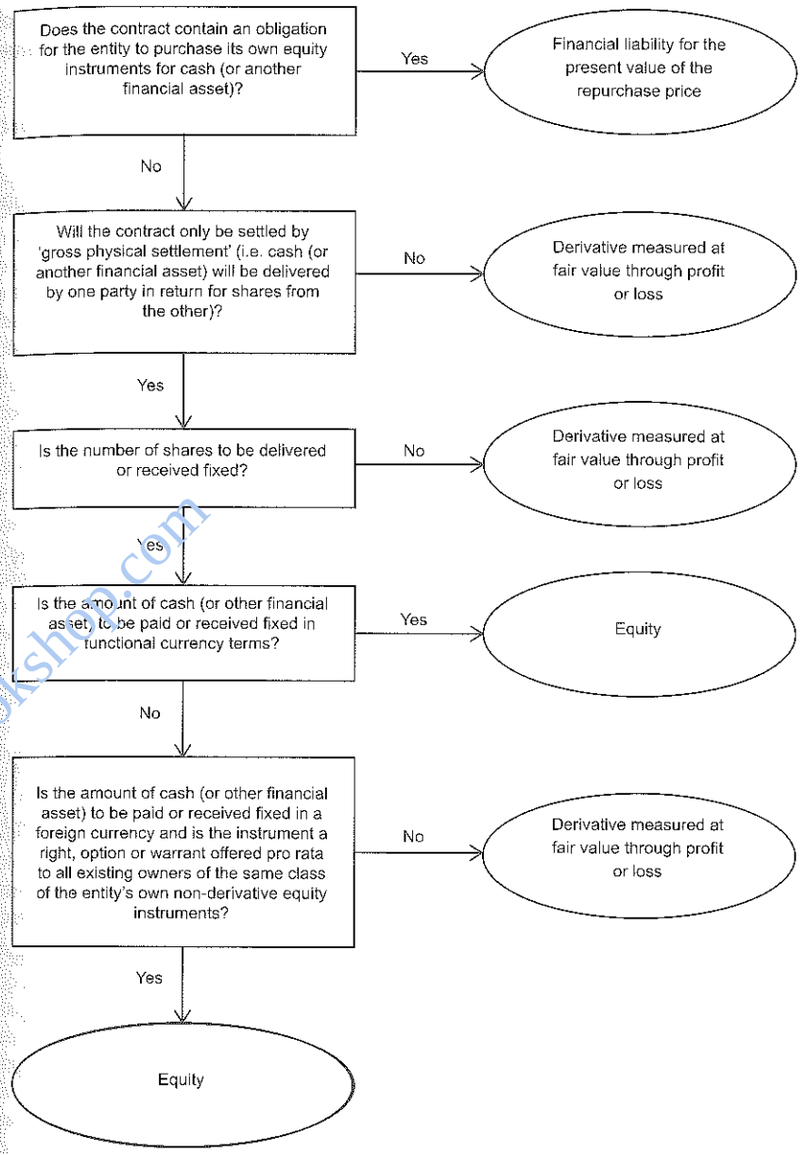
If net cash settlement is chosen, the following entry will be made at settlement of the contract.

		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]



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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

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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

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(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

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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:

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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.*

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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

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- 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.

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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

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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

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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

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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.

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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.

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

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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 of 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.

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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."

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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	2,046,331

* 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	600,000
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	500,000

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 × CU5 = CU500,000

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 × CU1 = CU500,000

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

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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.

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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.

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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

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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**).

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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.

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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).

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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:

(i) the carrying amount of the asset (CU100); and

(ii) 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.

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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.

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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.

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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.

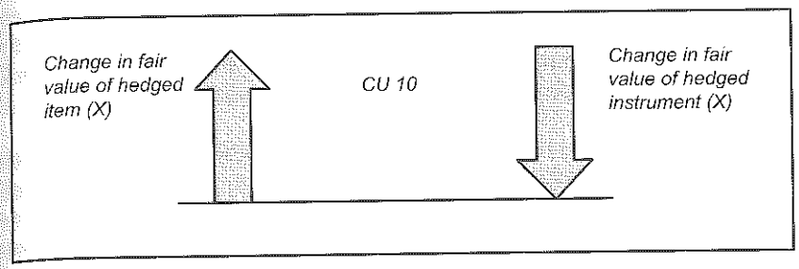
5.1.7 Frequency of hedge effectiveness assessment

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

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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)		

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