1 Introduction

1.1 Overview of IAS 23

IAS 23 *Borrowing Costs* requires that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' (one that necessarily takes a substantial period of time to get ready for its intended use or sale) are included in the cost of the asset. Other borrowing costs are recognised as an expense.

1.2 Amendments to IAS 23 since the last edition of this manual

IAS 23 was most recently amended in January 2016 by consequential amendments arising from IFRS 16 *Leases* (effective for annual periods beginning on or after 1 January 2019, with earlier application permitted). The amendments update the definition of borrowing costs to reflect the requirements of IFRS 16 (see **2.2**).

2 Core principle and scope

2.1 Core principle

The core principle of IAS 23 is that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense. [IAS 23:1]

2.2 Borrowing costs – definition

Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. [IAS 23:5]

Borrowing costs may include:

[IAS 23:6]

- interest expense calculated using the effective interest method as described in IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). See **4.1** in **chapter B6** (or, for entities that have not yet adopted IFRS 9, **4.1** in **chapter C6**) for further discussion;
- for entities that have adopted IFRS 16 *Leases*, interest in respect of liabilities recognised in accordance with that Standard;
- for entities that have not yet adopted IFRS 16, finance charges in respect of finance leases recognised in accordance with IAS 17 *Leases*; and

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- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see **2.4**).

2.3 Scope – exemptions

An entity is not required to apply IAS 23 to borrowing costs directly attributable to the acquisition, construction or production of:

[IAS 23:4]

(a) a qualifying asset (as defined in **3.2.1**) measured at fair value (e.g. a biological asset within the scope of IAS 41 *Agriculture* or an investment property under construction measured at fair value); or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

IAS 23:4 was amended in June 2014 by *Agriculture: Bearer Plants (Amendments to IAS 16 and IAS 41)* to clarify that the biological assets referred to in that paragraph are those that fall within the scope of IAS 41 *Agriculture*. Also as part of the June 2014 consequential amendments to IAS 23, a specific reference to 'bearer plants' has been added to the list of assets that, depending on the circumstances, may be qualifying assets (see **3.2.1**).

The exemption for assets measured at fair value in IAS 23:4 recognises that the measurement of such assets is not affected by the amount of borrowing costs incurred during their construction or production period. The exemption for inventories manufactured in large quantities on a repetitive basis acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventories are sold. The IASB concluded that it should not require entities to capitalise borrowing costs on such inventories because the costs of capitalisation were likely to exceed the potential benefits.

These exemptions are optional rather than mandatory. Accordingly, an entity can choose, as a matter of accounting policy, whether to apply the requirements of IAS 23 to borrowing costs that relate to assets measured at fair value and/or inventories produced in large quantities on a repetitive basis.

2.4 Exchange differences to be included in borrowing costs

2.4.1 *Exchange differences to be included in borrowing costs – general*

IAS 23 includes no further clarification as to what is meant by the inclusion of exchange differences 'to the extent that they are regarded as an adjustment to interest costs'. The question has been addressed by the IFRIC (now the IFRS Interpretations Committee) – see January 2008 *IFRIC Update*. The IFRIC reaffirmed that how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring the exercise of judgement. When the accounting policy adopted is relevant to an understanding of the financial statements, it should be disclosed as required by IAS 1 *Presentation of Financial Statements*.

It is clear that not all exchange differences arising from foreign currency borrowings can be regarded as an adjustment to interest costs; otherwise, there would be no requirement for the qualifying terminology used in IAS 23:6(e). The extent to which exchange differences can be so considered depends on the terms and conditions of the foreign currency borrowing.

Qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred, should be classified as borrowing costs. Although exchange rate fluctuations may mean that this amount is substantially higher or lower than the interest costs contemplated when the original financing decision was made, the full amount is appropriately treated as borrowing costs.

Some exchange differences relating to the principal may be regarded as an adjustment to interest costs (and, therefore, taken into account in determining the amount of borrowing costs capitalised) but only to the extent that the adjustment does not decrease or increase the interest costs to an amount below or above a notional borrowing cost based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing. In other words, the amount of borrowing costs that may be capitalised should lie between the following two amounts:

(1) actual interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred; and

(2) notional borrowing costs based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing.

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Whether any adjustments for exchange differences are made to the amount determined under (1) above is an accounting policy choice and should be applied consistently.

The extent to which foreign exchange differences can be regarded as borrowing costs is illustrated in **example 2.4.2** and **example 2.4.3**.

2.4.2 Exchange differences that increase borrowing costs

Example 2.4.2

Exchange differences that increase borrowing costs

Entity X, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

Amount borrowed (in the foreign currency)	US$100 million
Date of initial recognition of the borrowing	1 January 20X1
Exchange rate at the date of initial recognition of the borrowing	THB25:US$1
Interest rate on foreign borrowings (in US$)	6% per annum (fixed)
Interest rate on similar borrowing in THB at the date of initial recognition of the borrowing	12% per annum (fixed)
Average exchange rate for 20X1	THB36:US$1
Closing exchange rate for 20X1	THB47:US$1

The following interest payments were made in 20X1.

Interest payments (6% × US$100 million)	US$6 million
Translated at average rate	THB216 million

Entity X should capitalise THB216 million, being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred.

In addition, Entity X may choose as its accounting policy to regard exchange differences as an adjustment to interest costs. If it does so, in order to determine the maximum potential adjustment to interest costs for exchange differences, Entity X should determine the borrowing costs that would have been incurred in the 20X1 reporting period if the funds had been borrowed in THB. The calculation is set out below.

THB equivalent of US$100 million at 1 January 20X1	THB2,500 million
Annual interest expense based on THB interest rates (12%)	THB300 million

In the above scenario, the notional borrowing cost in the entity's functional currency of THB300 million is the 'cap' on the amount to be classified as borrowing costs. Consequently, when it has made the relevant accounting policy choice, Entity X should capitalise an amount of borrowing costs between THB216 million and THB300 million.

The foreign exchange loss incurred on the retranslation of the principal amount of the US$100 million borrowings at the end of the 20X1 reporting period is calculated as follows.

THB equivalent at opening rate of THB25:US$1	THB2,500 million
THB equivalent at closing rate of THB47:US$1	THB4,700 million
Foreign exchange loss	THB2,200 million

As calculated above, the cap on the amount to be classified as borrowing costs in the 20X1 accounting period is THB300 million. The difference of THB84 million between this amount and THB216 million (being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred) is the amount of foreign exchange losses on the principal eligible for capitalisation. The remaining exchange loss on the principal (THB2,116 million) is recognised in profit or loss in the year.

If the retranslation of the US$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange gain, the entire gain should be recognised in profit or loss. The amount of capitalised borrowing costs would be THB216 million (interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, because any such adjustment would result in an amount of borrowing costs outside the acceptable range.

2.4.3 Exchange differences that decrease borrowing costs

Example 2.4.3

Exchange differences that decrease borrowing costs

Entity Y, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

Amount borrowed (in the foreign currency)	US$100 million
Date of initial recognition of the borrowing	1 January 20X1
Exchange rate at the date of initial recognition of the borrowing	THB25:US$1
Interest rate on foreign borrowings (in US$)	6% per annum (fixed)
Interest rate on similar borrowing in THB as at the date of initial recognition of the borrowing	8% per annum (fixed)

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Average exchange rate for 20X1	THB36:US$1
Closing exchange rate for 20X1	THB22:US$1

The following interest payments were made in 20X1.

Interest payments (6% × US$100 million)	US$6 million
Translated at average rate	THB216 million

Entity Y should capitalise THB216 million, being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred.

In addition, Entity Y may choose as its accounting policy to regard exchange differences as an adjustment to interest costs. If it does so, in order to determine the maximum potential adjustment to interest costs for exchange differences, Entity Y should determine the borrowing costs that would have been incurred in the 20X1 reporting period if the funds had been borrowed in THB. The calculation is set out below.

THB equivalent of US$100 million at 1 January 20X1	THB2,500 million
Annual interest expense based on THB interest rates (8%)	THB200 million

In the circumstances described, the notional borrowing cost in the entity's functional currency of THB200 million is the 'floor' on the amount to be classified as borrowing costs. Consequently, when it has made the relevant accounting policy choice, Entity Y should capitalise an amount of borrowing costs between THB200 million and THB216 million.

The foreign exchange gain incurred on the retranslation of the principal amount of the US$100 million borrowings at the end of the 20X1 reporting period is calculated as follows.

THB equivalent at opening rate of THB25:US$1	THB2,500 million
THB equivalent at closing rate of THB22:US$1	THB2,200 million
Foreign exchange gain	THB300 million

As calculated above, the floor on the amount to be classified as borrowing costs in the 20X1 accounting period is THB200 million. The difference of THB16 million between this amount and THB216 million (being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred) is the amount of the foreign exchange gain on the principal to be offset in borrowing costs. The remaining exchange gain on the principal (THB284 million) is recognised in profit or loss in the year.

If the retranslation of the US$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange loss, the entire loss should be recognised in profit or loss. The amount of capitalised borrowing costs would be THB216 million (interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, as any such adjustment would result in an amount of borrowing costs outside the acceptable range of amounts.

2.5 Costs associated with shares and similar instruments classified as financial liabilities

IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability. [IAS 23:3]

By implication, IAS 23 *does* apply to costs associated with shares and similar financial instruments that are classified as liabilities, in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*. Under IAS 32:35, the dividends paid on such instruments are recognised in profit or loss as an expense. IAS 32:36 states that "dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond".

Although the definition of borrowing costs in IAS 23:5 (see **2.2**) does not define what is meant by 'the borrowing of funds', the classification of shares and similar instruments as liabilities means that they should be considered to represent such borrowings. As a result, the costs of servicing those shares (e.g. dividends) fall within the definition of borrowing costs.

2.6 Imputed interest on convertible debt instruments

In accordance with IAS 32, the liability component of a convertible debt instrument is presented on an amortised cost basis using the coupon rate for an equivalent non-convertible debt. The imputed interest is recognised in profit or loss using the effective interest method. Therefore, it is appropriate for the imputed interest expense in relation to the liability component of the convertible debt instrument to be included in borrowing costs eligible for capitalisation.

2.7 Refinancing gains and losses

An entity may be required to recognise 'refinancing' gains or losses relating to borrowings for a number of reasons; for example, such gains or losses might arise in the context of:

- a substantial modification of the terms of borrowings (see **4.1** in **chapter B8** or, for entities that have not yet adopted IFRS 9 *Financial Instruments*, **4.1** in **chapter C8**); or

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- early repayment (i.e. extinguishment) of borrowings (see **section 4** of **chapter B8** or, for entities that have not yet adopted IFRS 9, **section 4** of **chapter C8**).

Such gains and losses do not qualify as part of borrowing costs that are eligible for capitalisation under IAS 23. IFRS 9 (or, prior to the adoption of IFRS 9, IAS 39) is clear that 'refinancing' gains and losses should be recognised in profit or loss when they arise.

3 Recognition of borrowing costs

3.1 Recognition of borrowing costs – general

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Other borrowing costs are recognised as an expense in the period in which they are incurred. [IAS 23:8 & 9]

Note that IAS 23 does not permit an accounting policy of expensing all borrowing costs.

When an entity applies IAS 29 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with IAS 29:21 (see **5.1.5** in **chapter A37**). [IAS 23:9]

3.2 Qualifying assets

3.2.1 Qualifying assets – definition

A qualifying asset is defined as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. [IAS 23:5]

IAS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

Depending on the circumstances, any of the following may be qualifying assets:

[IAS 23:7]

- inventories;
- manufacturing plants;

- power generation facilities;
- intangible assets;
- investment properties; and
- bearer plants.

IAS 23:7 was amended in June 2014 by *Agriculture: Bearer Plants (Amendments to IAS 16 and IAS 41)* to clarify that, depending on the circumstances, bearer plants (accounted for under IAS 16 *Property, Plant and Equipment* following the June 2014 amendments) may be qualifying assets.

The following are *not* qualifying assets:

[IAS 23:7]

- assets that are ready for their intended use or sale when acquired;
- financial assets; and
- inventories that are manufactured, or otherwise produced, over a short period of time.

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3.2.2 Assets with an extended delivery period

IAS 16 *Property, Plant and Equipment* identifies delivery and handling costs as part of the cost of an item of property, plant and equipment. It includes such activities as part of the process of preparing the asset for its intended use. The shipping of an asset is therefore part of its acquisition and, consequently, borrowing costs attributable to the shipping period can be considered to be borrowing costs directly attributable to the acquisition of the asset as required by IAS 23.

For example, an entity orders and pays for a large piece of equipment from overseas that will take six months (in this example judged to be a 'substantial' period of time for the purposes of IAS 23) to arrive. A loan is raised to finance the acquisition. The equipment is already manufactured and available for shipment. Therefore, the period between payment for the equipment and its installation is only caused by shipping time. The asset is recognised by the entity on the date of shipping by the supplier because (in this example) that is the date on which control passes to the entity. Borrowing costs incurred on the loan raised to finance the acquisition will be capitalised as part of the cost of the equipment up to the date that the asset arrives at its destination, is installed and is ready for its intended use.

3.2.3 *Investments accounted for using the equity method*

Investments accounted for using the equity method are not qualifying assets because they are financial assets, and IAS 23:7 states that financial assets are not qualifying assets.

It is sometimes argued, when a vehicle is established for the purpose of constructing a qualifying asset, that the substance of the arrangement is that the investment is itself a qualifying asset for the investor. The logic is most appealing in the case of projects organised by a limited number of investors to pool resources in developing production facilities or properties. It is argued that, from the investor's perspective, the amount of borrowing costs capitalised should not be different simply because construction of the qualifying asset is through a separate investee vehicle, rather than by the investing entity itself.

However, the accounting for the investor's interest in the vehicle will determine whether or not there is a qualifying asset. If the vehicle is an associate or a joint venture accounted for using the equity method under IAS 28 *Investments in Associates and Joint Ventures*, the interest is a financial asset, and capitalisation of borrowing costs is not permitted by IAS 23.

Example 3.2.3

Investments accounted for using the equity method

Company X invests in construction contracts via participating interests in single-purpose entities. The entities are associates, and are accounted for using the equity method of accounting.

If Company X borrows funds for the purpose of funding the construction activities in these vehicles, should it capitalise borrowing costs as part of the carrying amount of the investments?

No. Borrowing costs should not be capitalised in these circumstances. Investments in associates are financial assets. IAS 23:7 states that financial assets are not qualifying assets.

3.2.4 *Joint operations*

In contrast to the prohibition on capitalisation of borrowing costs in respect of investments accounted for using the equity method (as described in **3.2.3**), when a joint arrangement meets the definition of a joint operation under IFRS 11 *Joint Arrangements*, the entity will instead recognise its share of the assets and liabilities of the joint operation, and capitalisation of borrowing costs will be required to the extent that any of the assets are qualifying assets (see **3.2.1**).

The investor's share of the qualifying assets of a joint operation are accounted for as qualifying assets of the investor and, therefore, capitalisation of borrowing costs incurred to fund the construction of those qualifying assets is required, provided that all of the conditions of IAS 23 are met.

3.3 Borrowing costs

3.3.1 *Borrowing costs eligible for capitalisation – general*

See **2.2** for IAS 23's definition of borrowing costs.

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. [IAS 23:10]

Paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* makes clear that capitalisation is not permitted for the periodic unwinding of the discount in relation to changes in obligations to dismantle, remove and restore items of property, plant and equipment. Instead, the periodic unwinding of the discount is recognised in profit or loss as a finance cost as it occurs.

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3.3.2 *Specific borrowing costs*

When funds are borrowed specifically for the purpose of acquiring or constructing a qualifying asset, the amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on those funds during the period. [IAS 23:12]

The financing arrangements may result in the specific borrowings being drawn down prior to some or all of the funds being utilised to finance the qualifying asset. In such circumstances, any investment income earned on the temporary investment of the funds, pending their expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation. [IAS 23:13]

Example 3.3.2

Specific borrowing costs offset by investment income on excess funds

An entity borrows CU20 million to finance the construction of a factory. The funds are to be drawn down on a monthly basis in four equal amounts. Payment of construction costs occurs throughout each month, rather than coinciding with the draw-downs. During each month, the entity invests any excess funds drawn down in accordance with the financing arrangements in short-term bank deposits.

- defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

3 Scope of IFRS 10

3.1 General requirement to present consolidated financial statements

IFRS 10 requires that a parent (i.e. an entity that controls one or more entities) should present consolidated financial statements. [IFRS 10:4] Consolidated financial statements are defined as "[t]he financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity". [IFRS 10:Appendix A]

IFRS 10 does not deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising from business combinations. [IFRS 10:3] The accounting requirements for business combinations are discussed in **chapter A25**.

3.2 Employee benefit plans excluded from the scope of IFRS 10

IFRS 10 does not apply to post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies. [IFRS 10:4A]

The wording of the scope exclusion in IFRS 10:4A is confusing. At first glance, it appears to say that IFRS 10 does not apply to financial statements presented by post-employment benefit plans or other long-term employee benefit plans. But IFRS 10 does not apply to the financial statements of such plans; rather, they are within the scope of IAS 26 *Accounting and Reporting by Retirement Benefit Plans* (see **chapter A41**).

Instead, employers are required to apply IAS 19 in accounting for employee benefit plans, and it appears that the exclusion in IFRS 10:4A is intended to apply to such employers and to exempt them from having to consider whether benefit plans of the nature described meet the definition of a subsidiary (which would result in a requirement to consolidate them). Without this exemption, it seems possible that some benefit plans might have been required to be consolidated as structured entities.

3.3 Exemption from presenting consolidated financial statements for a parent that is itself a subsidiary

An entity that has subsidiaries need not present consolidated financial statements if it meets all of the following conditions:

[IFRS 10:4(a)]

- the entity is itself either (1) a wholly-owned subsidiary, or (2) a partially-owned subsidiary and all its other owners (including those not otherwise entitled to vote) have been informed about, and do not object to, the entity not presenting consolidated financial statements;
- the entity's debt or equity instruments are not traded in a public market (i.e. a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
- the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- the ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

The criteria in IFRS 10:4(a) were amended by *Investment Entities: Applying the Consolidation Exemption (Amendments to IFRS 10, IFRS 12 and IAS 28)*, issued in December 2014 and effective for annual periods beginning on or after 1 January 2016, with earlier application permitted. If an entity applies the December 2014 amendments for a period beginning before 1 January 2016, it is required to disclose that fact. [IFRS 10:C1D]

The December 2014 amendments have clarified that the exemption under IFRS 10:4(a) is available to a parent entity that is a subsidiary of an investment entity, even if the investment entity measures all of its subsidiaries at fair value.

The criteria in IFRS 10:4(a) are only met if the ultimate or any intermediate parent produces financial statements available for public use that comply with IFRSs *as issued by the IASB* in which its subsidiaries are included either by consolidation or by measurement at fair value through profit or loss in accordance with IFRS 10.

Similarly, if the parent complies with the *International Financial Reporting Standard for Small and Medium-sized Entities* (see **appendix A6**), but not full IFRSs, the above criteria are not met.

If the parent complies instead with a modified version of IFRSs (e.g. IFRSs as endorsed for use in a particular jurisdiction), but does not comply with IFRSs as issued by the IASB (because it applies some accounting treatment that is allowed under the modified version of IFRSs but not under IFRSs as issued by the IASB), the above criteria are not met.

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3.4 Parent has no subsidiary at the end of the reporting period

IFRS 10:20 (see **10.3**) requires that the income and expenses of a subsidiary should be included in the consolidated financial statements until the date on which the parent loses control of the subsidiary. Accordingly, when a parent has had subsidiaries at any time during a reporting period, IFRS 10 requires consolidated financial statements to be presented (unless any of the exemptions in IFRS 10 is available).

3.5 No bases for exclusion of subsidiaries from consolidation (other than for investment entities)

Other than for investment entities (see **section 13**), when consolidated financial statements are presented, IFRS 10 does not allow any bases for exclusion of subsidiaries from consolidation. Notably:

- a subsidiary is not excluded from consolidation on the basis that control is temporary. If, on acquisition, a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it is included in the consolidation but is accounted for under that Standard (see **chapter A20**);
- a subsidiary is not excluded from consolidation on the basis that there are severe long-term restrictions that impair its ability to transfer funds to the parent. The IASB has concluded that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent but that, in themselves, such restrictions do not preclude control; and
- a subsidiary is not excluded from consolidation on the grounds that its activities are substantially different from those of the parent and/ or the rest of the group. Information regarding the different nature of the activities of a subsidiary can be appropriately disclosed in accordance with IFRS 8 *Operating Segments*.

4 Identification of parents and subsidiaries

4.1 Definitions – parent and subsidiary

A parent is "[a]n entity that controls one or more entities". [IFRS 10:Appendix A]

A subsidiary is "[a]n entity that is controlled by another entity" (which will be its parent). [IFRS 10:Appendix A]

A group consists of a parent and its subsidiaries. [IFRS 10:Appendix A]

There are two key aspects to the definition of a subsidiary:

- the concept of 'control' (which is discussed in detail in **section 5**); and
- what constitutes an entity (see **4.2**).

4.2 Meaning of an 'entity'

IFRS 10 does not define what is meant by an 'entity'. The definition of a subsidiary previously included in IAS 27(2008) *Consolidated and Separate Financial Statements* stated explicitly that the term encompassed an unincorporated entity. Although this clarification has not been carried forward to IFRS 10, it seems clear that a subsidiary need not be a corporate entity (e.g. it can be a partnership or a trust).

In addition, IFRS 10 allows that, in specified circumstances, a portion of an investee (often called a 'silo' or 'cell') may be accounted for as a 'deemed separate entity' (see **4.3**).

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4.3 Determining whether a portion of an investee is a deemed separate entity

In some situations, an investor may have interests in a particular set of assets and liabilities of an investee (a portion of an investee) by virtue of legal or contractual arrangements, rather than in the entire legal entity. In addition, in some jurisdictions, legal entities are divided into separate parts (often referred to as 'silos' or 'cells').

In such circumstances, the question arises as to whether it is possible to consider only an individual silo or a portion of an investee (rather than the entire legal entity) as a separate entity for the purposes of the consolidation assessment.

IFRS 10 requires an investor to treat a portion of an investee as a deemed separate entity if, and only if, the following conditions are met:

[IFRS 10:B77]

- specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee;
- parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets; and

- in substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Therefore, the key to determining whether a portion of an entity is a deemed separate entity under IFRS 10 is whether the portion of the investee is, in substance, 'ring-fenced' from the overall investee.

When the conditions in IFRS 10:B77 are met, the investor should determine whether it has control of the deemed separate entity using IFRS 10's general definition of control (see **section 5**). In particular, the investor should:

[IFRS 10:B78]

- identify the activities that significantly affect the returns of the deemed separate entity and how those activities are directed in order to assess whether it has power over that portion of the investee;
- consider whether it has exposure or rights to variable returns from its involvement with the deemed separate entity; and
- consider whether it has the ability to use its power over that portion of the investee to affect the amount of the investor's returns.

If an investor controls a deemed separate entity, the investor should consolidate that deemed separate entity. In such circumstances, other parties should exclude that portion of the investee when assessing control of, and in consolidating, the investee. [IFRS 10:B79]

4.4 Horizontal groups

Consolidated financial statements are not required for a 'horizontal group', i.e. when two or more reporting entities are controlled by a common shareholding, such as that held by a private individual. IFRS 10 requires the presentation of consolidated financial statements when an *entity* controls one or more other entities. To the extent that entities are controlled by the same *individual*, there is no requirement in IFRSs that consolidated financial statements be presented.

The existence of a controlling individual, and transactions between entities that are under common control and other related parties, are required to be disclosed under IAS 24 *Related Party Disclosures* (see **chapter A23**).

5 Assessment of control

5.1 Control – definition

An investor controls an investee when the investor "is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee". [IFRS 10:6 & Appendix A]

Specifically, an investor controls an investee if and only if the investor has all of the following elements:

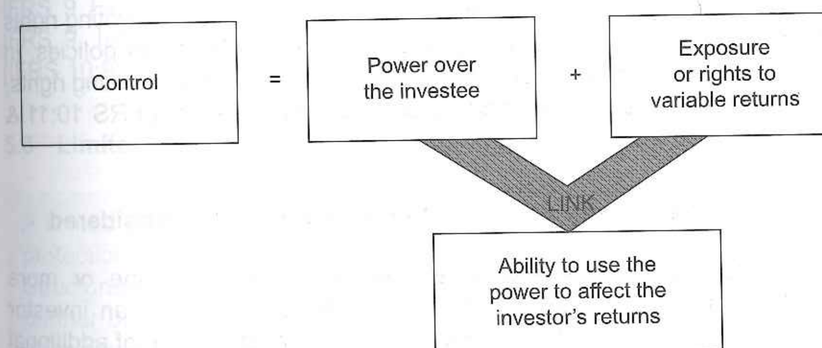
[IFRS 10:7 & B2]

- power over the investee;
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.

Power is defined as "existing rights that give the current ability to direct the relevant activities" (see **section 6**). [IFRS 10:Appendix A]

An investor must possess all three elements to conclude that it controls an investee.

The diagram below depicts the three elements of control and the relationship between them.



An investor is required to consider all facts and circumstances in assessing whether it controls an investee. [IFRS 10:8] In practice, the determination as to who controls an investee can be complex.

5.2 Requirement for an investor to assess whether it has control

An investor, regardless of the nature of its involvement with an entity (the investee), is required to determine whether it is a parent by assessing whether it controls the investee. [IFRS 10:5]

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Although IFRS 10 refers to an 'investor' having control, it does not define the term 'investor'. IFRS 10:5 states that an investor may have control of an investee "regardless of the nature of its involvement". As a specific example, IFRS 10:B15 states that control may be achieved through a management contract if the contract gives the holder the ability to direct the relevant activities (see **8.2**). Therefore, there is no requirement for the investor's interest in the investee to be in the form of debt or equity instruments.

An investor is required to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in **5.1** (see **section 9**). [IFRS 10:8]

5.3 Assessment of control – purpose and design of the investee

When assessing control, the investor should first consider the purpose and design of the investee in order to identify (1) the relevant activities (i.e. the activities of the investee that significantly affect the investee's returns), (2) how decisions about the relevant activities are made, (3) who has the current ability to direct those activities, and (4) who receives returns from those activities. [IFRS 10:B5]

Sometimes, this assessment will be very straightforward; it may be clear that control over the investee is exercised directly and solely by means of equity instruments (e.g. ordinary shares) that give the holder proportionate voting rights. In such circumstances, unless more complex arrangements have been put in place that alter decision-making, the assessment of control should focus on which party, if any, is able to exercise voting rights sufficient to determine the investee's operating and financing policies. In clear-cut situations, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee. [IFRS 10:11 & B6]

5.4 Assessment of control – additional factors to be considered

In more complex cases (e.g. when power results from one or more contractual arrangements), the determination as to whether an investor controls an investee may require more rigorous consideration of additional factors, including some or all of the following:

[IFRS 10:11, B3 & B7]

- whether the investor has power over the investee, i.e.:
  - what the relevant activities are (see **6.2**);
  - how decisions about those activities are made (see **6.3**); and
  - whether the rights of the investor give it the current ability to direct the relevant activities (see **6.4**);
- whether the investor is exposed, or has rights, to variable returns from its involvement with the investee (see **section 7**); and
- whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns (see **section 8**).

5.5 Only one party can control an investee

The Basis for Conclusions on IFRS 10 states that:

[IFRS 10:BC69 & BC70]

- only one party (if any) can control an investee; and
- the fact that other entities have protective rights relating to the activities of an investee (see **6.4.5**) does not prevent an investor from having control of an investee.

Therefore, when two or more investors collectively control an investee (i.e. the investors must act together to direct the relevant activities of the investee), no investor can direct the activities without the co-operation of the others and, consequently, no investor individually controls the investee. In such cases, each investor should account for its interest in the investee in accordance with the applicable IFRSs, as appropriate (e.g. IFRS 11 *Joint Arrangements*, IAS 28 *Investments in Associates and Joint Ventures*, IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). [IFRS 10:9]

5.6 Limited partnerships

A limited partnership is typically a form of partnership that offers the protection of limited liability to some of its partners (the 'limited partners'). Structures for limited partnerships and the functions of a general partner of a limited partnership vary widely between jurisdictions and from partnership to partnership. A limited partnership generally must meet specified legal and tax criteria to qualify as a limited partnership; therefore, the structure is often form-driven. The rights and obligations of general partners in limited partnerships are usually different from those of limited partners. Often, the limited partners are not permitted to take part in the management of the limited partnership, which is solely the responsibility of the general partner(s). Some general partners perform a function designed solely to satisfy the criteria to qualify the entity as a limited partnership.

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The determination as to whether an investor has control of a limited partnership will always need to take account of the specific partnership structure and any relevant jurisdictional factors. In general, in applying the three elements of the definition of control in IFRS 10 (i.e. having power over the investee, exposure or rights to variable returns from the investee, and the ability to use power to affect returns):

- a partnership in which the general partner has no beneficial interest in the partnership net assets or net income is unlikely to meet the definition of a subsidiary of the general partner (but it is important to ensure that all returns to the general partner have been identified and considered);
- it is possible for a limited partner to have a majority economic interest in a partnership without having power over the relevant activities; this might occur when it can be demonstrated that another partner has control and does not act as agent for the limited partner; but
- a limited partner who is also the sole general partner, or who has power to remove the sole general partner, may exercise control such that the partnership meets the definition of a subsidiary of the limited partner.

The determination as to whether any of the partners controls the partnership is a matter requiring careful judgement based on the relevant facts and circumstances.

5.7 Employee share trusts

Employee share trusts (sometimes established in conjunction with employee share ownership plans (ESOPs) or employee share plans) are designed to acquire an entity's shares and distribute the shares to employees under remuneration schemes. The detailed structure of such trusts varies, but often includes the following:

- the trust holds shares in the sponsoring entity (or another group entity) to be sold or transferred to employees under the terms of a share-based payment plan;
- the trust acquires shares either directly from the sponsoring entity or by purchasing them in the market. These acquisitions may be financed by a cash contribution or loan from the sponsoring entity or by a third-party loan (often guaranteed by the sponsoring entity); and
- the activities of the trust are narrowly defined, typically in a trust deed.

See **section 9** of **chapter A16** for a discussion of the factors that should be considered when determining whether a sponsoring entity applying IFRS 10 controls a trust established as part of an employee remuneration scheme.

6 Power over an investee

6.1 Power over an investee – definition

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities. [IFRS 10:10]

Key steps in the determination as to whether an entity has power over an investee are:

- identifying the relevant activities (see **6.2**);
- understanding how decisions about relevant activities are made (see **6.3**); and
- determining whether the investor's rights give it the current ability to direct the relevant activities (see **6.4**).

6.2 Identifying the relevant activities

6.2.1 *Relevant activities – general*

Relevant activities are defined as "activities of the investee that significantly affect the investee's returns". [IFRS 10:Appendix A]

It could be difficult to determine the relevant activities of an investee in certain scenarios. In these situations, it is important for an investor to understand the purpose and design of an investee (see **5.3**).

IFRS 10 requires an investor to focus on the activities that significantly affect the returns of an investee.

- When the investee is directed through voting or similar rights (see **6.4.6**), power often relates to governing the strategic operating and financing policies of an investee. However, as explained in the Basis for Conclusions on IFRS 10, that is only one of the ways in which power to direct the activities of an investee can be achieved. In the IASB's view, referring to the power to govern the financial and operating policies of an investee is not necessarily appropriate for investees that are not directed through voting or similar rights. [IFRS 10:BC42]
- It is important to focus on activities that have a *significant* effect on the investee's returns rather than on administrative activities that have little or no effect on the investee's returns. This focus

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the securitisation vehicle that significantly affect the returns of the transaction (even before the default of the receivables).

Note that it is expected to be extremely rare for a structured entity to have no relevant activities (i.e. it operates on full 'autopilot' and the only decisions to be made after formation of the structured entity relate to administrative activities that will not significantly affect the investee's returns). Such a determination should be made only after a thorough analysis of both the expected activities of the structured entity and decisions to be taken in response to contingent events (see **6.2.3** for additional guidance for those rare circumstances when such a determination is made).

6.2.3 *Relevant activities – involvement in the design of a structured entity operating on autopilot*

It is common for a structured entity to operate in a way so that seemingly no decisions are made in conducting the entity's ongoing activities after its formation (i.e. the entity effectively operates on 'autopilot'). A thorough understanding of (1) the purpose and design of the structured entity, and (2) any decisions to be made after its formation, is critical in assessing who has power.

As discussed in **6.2.2**, virtually all structured entities that operate in a largely predetermined way have relevant activities. However, there may be extremely rare situations when, after careful assessment of the purpose and design of a structured entity, the only decisions to be made after formation of the entity relate to administrative activities that will not significantly affect the investee's returns. If this is the case, there are no decisions to be made on relevant activities of the structured entity subsequent to its formation and the only decisions that significantly affect the returns of the structured entity are the decisions taken at the formation stage.

In those extremely rare situations when there are no decisions to be made on relevant activities after formation of a structured entity, an investor can have power over the structured entity as a result of the investor's decisions and involvement in the design and creation of the structured entity. Specifically, the initial design of the entity may be the relevant activity that significantly affects the returns of the structured entity. Consequently, in determining whether an investor has power over the structured entity, the activities performed and decisions made as part of the entity's design at formation should be assessed carefully.

Nevertheless, the fact that an investor is involved in the design of an investee does not necessarily mean that the investor has decision-making rights to direct the relevant activities of the investee. Often,

several parties are involved in the design of an investee and the final structure of the investee includes whatever is agreed to by all those parties (see IFRS 10:BC77). Consequently, an investor's involvement in establishing an investee would not, in isolation, be sufficient evidence to determine that the investor has power over the entity.

In making this assessment, an investor should consider the significance of its interest in the investee and its involvement in the design of the investee (including an assessment of the scope of its decision-making authority during the design process). The more significant an investor's (1) interest, and (2) involvement in the design of the investee, the more indicative it is that the investor had the ability and incentive to make decisions for its own benefit and, therefore, that it has power over the investee.

6.3 How decisions about relevant activities are made

6.3.1 *Decisions about relevant activities*

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Having identified the relevant activities of an investee, the next key step in understanding who has power over an investee is to understand the mechanisms for making decisions about those relevant activities.

Examples of decisions about relevant activities include, but are not limited to:

[IFRS 10:B12]

- establishing operating and capital decisions of the investee, including budgets; and
- appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

Accordingly, it will often be appropriate to focus on the purpose and design of the investee and how decisions are made in relation to, for example:

- changes of strategic direction, including acquisitions and disposals of subsidiaries;
- major capital purchases and disposals;
- appointment and remuneration of directors and other key management personnel;
- approval of the annual plan and budget; and
- dividend policy (see also the discussion in **section 7**).

of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee. The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investee's asset portfolio is the relevant activity of the investee. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value. The asset manager and the debt investor each need to determine whether they are able to direct the activities that *most* significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

6.3.2.3 *Entity has more than one governing body*

In practice, entities will have a variety of governance structures, frequently determined by the regulatory requirements in relevant jurisdictions and/or agreements between their shareholders. A clear understanding of the governance structure of an investee is essential in order to identify how decisions about relevant activities are made.

In some situations, the direction of the relevant activities of an investee is determined by majority vote at shareholders' meetings. In such cases, an investor that has the ability to cast the majority of votes at shareholders' meetings generally has power over the investee.

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When an investee has more than one governing body, it is important to understand the rights and obligations of each governing body. It should not be assumed merely because one body has oversight of another that the former is necessarily the body that makes decisions about the relevant activities of the entity. In all cases, the assessment of control should be based on a careful analysis of all relevant facts and circumstances.

6.3.2.4 *Majority of directors are independent*

In many jurisdictions, best practice or mandatory corporate governance codes require that an entity appoint directors who are independent. The term 'independent director' has a variety of meanings in different jurisdictions, but it is generally taken to describe a director who does not represent a specific shareholder.

If the majority of an entity's directors are independent, it should not be automatically assumed that none of the shareholders has power over decisions made by the directors.

In assessing whether a particular shareholder controls an entity, all relevant facts and circumstances should be considered. [IFRS 10:8] As discussed at **6.3.2.3**, a clear understanding of the governance structure of an investee is essential in order to identify how decisions about relevant activities are made and, consequently, who has power over the investee. In the circumstances under consideration, this would involve analysing both the process for decision making at a director level and the extent to which decisions over relevant activities are taken by the directors rather than via a shareholder vote.

In the context of an entity with independent directors, it is necessary to consider the role of those directors in making decisions regarding relevant activities. It may be that their role is limited to ensuring that proper governance procedures are followed (through, for example, membership of an audit or nominations committee); this may involve challenging the basis for decisions made by the non-independent directors (in, for example, a committee of which the independent directors are not members) but not active involvement in the decision-making process.

In circumstances such as these, it may be that an investor can exercise power over decisions made by an entity's directors through power over a majority of an entity's non-independent directors. As for other decision makers (see **8.2.6**), powers to appoint and remove independent directors should also be considered.

6.4 Whether the investor's rights give it the current ability to direct the relevant activities

6.4.1 *Focus on the 'ability to direct' rather than the actual exercise of power*

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. [IFRS 10:11 & B14] Therefore, the assessment of power is based on the investor's *ability* to direct the relevant activities of the investee; specifically, IFRS 10 does not require the investor to have actually exercised its power. An investor with the current ability to direct the relevant activities of an investee has power over the investee even if its rights to direct have yet to be exercised. Conversely, evidence that the investor has been directing the relevant activities of the investee can help

determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over the investee. [IFRS 10:12]

An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities (e.g. when another entity has significant influence). [IFRS 10:14]

6.4.2 Rights that give an investor power over an investee

The rights that give an investor power can differ between investees. [IFRS 10:B14] Different types of rights that, either individually or in combination, can give an investor power over an investee include, but are not limited to:

[IFRS 10:B15]

- rights in the form of voting rights (or potential voting rights) of an investee (see **6.4.6**);
- rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
- rights to appoint or remove another entity that directs the relevant activities;
- rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

The specific factors that apply when voting or similar rights do not have a significant effect on the investee's returns are considered in **6.4.7**.

6.4.3 Evidence to be considered when it is difficult to determine whether the investor's rights are sufficient to give it power

When it is difficult to determine whether an investor's rights are sufficient to give it power over an investee, to enable the assessment of power to be made, the investor should consider evidence regarding whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to whether:

[IFRS 10:B18]

- the investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities;

- the investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor;
- the investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights;
- the investee's key management personnel are related parties of the investor (e.g. the chief executive officer of the investee and the chief executive officer of the investor are the same person); and/or
- the majority of the members of the investee's governing body are related parties of the investor.

When considered together with the investor's rights and the indicators in IFRS 10:B19 and B20 (see below), the factors listed in IFRS 10:B18 may provide evidence that the investor's rights are sufficient to give it power over the investee.

Sometimes there will be indications that the investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power or provide evidence of existing power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate that the investor has power over the investee:

[IFRS 10:B19]

- the investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor;
- the investee's operations are dependent on the investor, such as in the following situations:
  - the investee depends on the investor to fund a significant portion of its operations;
  - the investor guarantees a significant portion of the investee's obligations;
  - the investee depends on the investor for critical services, technology, supplies or raw materials;
  - the investor controls assets such as licences or trademarks that are critical to the investee's operations; and/or
  - the investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations;

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1 Introduction

IAS 32 *Financial Instruments: Presentation* requires an issuer of a financial instrument to classify the financial instrument, or its component parts, as a financial liability or as equity in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. The overriding principles are that when the issuer does not have an unconditional right to avoid the obligation to deliver cash or another financial asset, and when the contract does not, in substance, evidence a residual interest in the net assets of the issuer after deducting all of its liabilities, the instrument is not an equity instrument (see **section 2**).

A more complex area, in respect of which the Standard provides additional guidance, is the treatment of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments. The definitions of a financial asset and a financial liability also include certain contracts on own equity and are applied to evaluate whether such contracts are, in substance, equity, financial liabilities or derivatives (derivatives can be either financial assets or financial liabilities). For example, a written put option on own shares that will be settled, if the option is exercised by the holder, by delivering cash in exchange for the entity's own shares, is a financial liability because the entity will have an obligation to deliver cash (see **section 6**).

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IAS 39 *Financial Instruments: Recognition and Measurement* is superseded by IFRS 9 *Financial Instruments* which is effective for annual reporting periods beginning on or after 1 January 2018. The characteristics of financial liabilities and equity as detailed in IAS 32 are unchanged following the introduction of IFRS 9. The IASB has included financial instruments with characteristics of equity as part of its research agenda (see **section 9**).

This chapter addresses the application of the financial liability and equity definitions to various types of financial instruments issued in practice and contracts indexed to and settled in an entity's own equity. It also indicates the implications of classification as either debt, equity or a derivative for the measurement of that contract or its component parts.

2 Principles of liability/equity classification

A financial instrument or its component parts should be classified upon initial recognition as a financial liability or an equity instrument according to the substance of the contractual arrangement, rather than its legal form, and the definitions of a financial liability and an equity instrument. [IAS 32:15 & 18] For some financial instruments, although their legal form may be equity, the substance of the arrangements is that they are liabilities. A preference share, for example, may display either equity or liability characteristics depending on the substance of the rights attaching to it.

The appropriate classification as a financial liability, equity or a combination of both, is determined by the entity when the financial instrument is initially recognised and that classification is not generally changed subsequently unless the terms of the instrument change. As exceptions to this general principle, **section 8** discusses a number of circumstances in which reclassification may be appropriate even though the terms of the instrument have not changed. In addition, when the specific requirements for puttable 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 (now IFRS 9).

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 (now IFRS 9). In particular, IFRS 13:47 states that "the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid."

2.1 Contractual obligation to deliver cash or another financial asset

The key feature in determining whether a financial instrument is a liability is the existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or to exchange financial assets or liabilities under conditions that are potentially unfavourable. In contrast, in the case of an equity instrument (e.g. ordinary

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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 an obligation to deliver a pro rata share of net assets only at liquidation (see **2.1.2.1** and **2.1.3**).

Items such as deferred revenue and warranty obligations require delivery of goods or services rather than an obligation to deliver cash or another financial asset and, therefore, are not financial liabilities. [IAS 32:AG11] Obligations to pay tax, company registration fees and other similar charges are obligations to pay cash. However, these are statutory rather than contractual requirements and, therefore, they are not financial liabilities. Similarly, constructive obligations (as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) do not arise from contracts and are not financial liabilities. [IAS 32:AG12]

Liability characteristics are established in practice in a number of ways, as discussed in the following sections.

In November 2012 the IFRS Interpretations Committee received a request to clarify how an entity classifies the liability that arises when it issues a prepaid card in exchange for cash and how the entity accounts for any unspent balance on such a card. Specifically, the Interpretations Committee discussed a prepaid card with the following features:

- no expiry date and no back-end fees, which means that any balance on the prepaid card does not reduce unless it is spent by the cardholder;
- non-refundable, non-redeemable and non-exchangeable for cash;
- redeemable only for goods or services to a specified monetary amount; and
- redeemable only at specified third-party merchants that, depending upon the card programme, range from a single merchant to all merchants that accept a specific card network. Upon redemption by the cardholder at a merchant(s) for goods or services, the entity delivers cash to the merchant(s).

The Interpretations Committee was asked to consider whether the liability for the prepaid card is a non-financial liability on the basis that the entity does not have an obligation to deliver cash to the cardholder.

The Interpretations Committee observed that the entity's liability for the prepaid card meets the definition of a financial liability. This is because the entity:

- has a contractual obligation to deliver cash to the merchants on behalf of the cardholder, which is conditional upon the cardholder using the prepaid card to purchase goods or services; and
- does not have an unconditional right to avoid delivering cash to settle this contractual obligation.

Consequently, an entity that issues such a card applies the requirements in IFRS 9 to account for the financial liability for the prepaid card.

The Interpretations Committee noted that customer loyalty programmes were outside the scope of its discussion on this issue.

In the light of the existing requirements in IAS 32 and IFRS 9, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, in March 2016 the Interpretations Committee finalised its decision not to add this issue to its agenda.

2.1.1 Mandatory redemption and/or mandatory interest payments

When an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists and, therefore, the instrument includes, and is presented as, a liability. An exception to this principle applies for certain puttable instruments and certain instruments that contain an obligation to deliver a pro rata share of net assets at liquidation as described in **2.1.2.1** and **2.1.3**.

Example 2.1.1A

Mandatorily redeemable preference shares

Entity A issues preference shares that are mandatorily redeemable at par in 10 years. A contractual obligation to deliver cash exists for the repayment of principal – the issuer cannot avoid the outflow of cash in Year 10. Therefore, the preference shares should be classified as a financial liability.

Perpetual instruments provide the holder with no right to require redemption. However, the terms of such instruments often require the issuer to make coupon payments into perpetuity. A perpetual instrument with a mandatory coupon is a liability in its entirety because the whole of its value is derived from the stream of future coupon payments.

Example 2.1.1B

Perpetual coupon-bearing preference shares

A perpetual instrument is issued at a par amount of CU100 million requiring coupon payments of 6 per cent to be made annually. Provided that 6 per cent

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is the market rate of interest for this type of instrument when issued, the issuer has assumed a contractual obligation to make a future stream of 6 per cent interest payments. The net present value of the interest payments is CU100 million and represents the fair value of the instrument. The preference shares should be classified as a financial liability.

Many traditional debt instruments such as bonds and bank loans involve both mandatory redemption and mandatory interest payments.

Other instruments may require a mandatory distribution of a percentage of the profits of an entity (to the extent that such profits are generated) rather than of a traditional interest payment. Such an instrument meets the definition of a liability because it is a contractual obligation of the issuer to deliver cash or another financial asset to the holder. The issuer has no discretion over paying out a percentage of its profits.

A distinction must be drawn between those circumstances in which the issuer genuinely contractually has no discretion over payment of interest (or dividends) and those in which payment may be avoided but this decision will have consequences (even if significant). For example, an entity may issue instruments under which it contractually retains the discretion regarding the distribution of a percentage of profits but, if the distribution is not paid, the entity ceases to benefit from a favourable tax treatment. Such arrangements are common for Real Estate Investment Trusts (REITs) in some jurisdictions. In such circumstances, although the entity may intend to pay dividends in order to retain the significant tax benefits, it has no contractual obligation to deliver cash (or another financial asset) to the holder of the instrument and, therefore the instrument is not a financial liability.

The terms of shares issued by REITs may differ and each situation should be assessed on its own merits. The scope of REITs from the perspective of the issuer is also discussed in **2.3.9** in **chapter B1**.

2.1.2 Puttable instruments

A puttable instrument is defined as a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or that is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. [IAS 32:11]

2.1.2.1 Puttable instruments presented as equity

Because puttable instruments contain a contractual obligation for the issuer to deliver cash or another financial asset to the holder, such instruments are generally classified as financial liabilities. However, certain puttable

instruments that meet specified criteria must be presented as equity. The criteria for equity classification are extensive and restrictive.

The requirements regarding equity classification for some puttable instruments originated from an amendment to IAS 32 issued in February 2008, *Puttable Financial Instruments and Obligations Arising on Liquidation*. The purpose of the amendment was to provide a limited scope exception to the definition of a financial liability that would apply to certain financial instruments that contain obligations but that, in the IASB's view, also represent a residual interest in the net assets of the issuing entity. The exception applies to puttable instruments (described in this section) as well as to instruments containing an obligation to deliver a pro rata share of the net assets of the entity only on liquidation (see **2.1.3**). Because the requirements of the amendment are designed as an exception, they should be applied narrowly and should not be used by analogy (IAS 32:96B). Failure to meet one of the requirements results in failure to qualify for the exception, in which case the instrument will not meet the criteria for classification as equity.

A puttable instrument is classified as equity if it meets all of the following criteria:

[IAS 32:16A]

(a) the holder is entitled to a pro rata share of the entity's net assets in the event of the entity's liquidation;

The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by: (i) dividing the entity's net assets on liquidation into units of equal amount; and (ii) multiplying that amount by the number of the units held by the financial instrument holder. The IASB decided that the instrument must entitle the holder to a pro rata share of the net assets on liquidation because the net assets on liquidation represent the ultimate residual interest in the entity. [IAS 32:BC57]

An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. An instrument has a preferential right on liquidation, for example, if it entitles the holder to a fixed dividend on liquidation, in addition to a share of the entity's net assets, when other instruments in the subordinate class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation. [IAS 32:AG14C]

(b) the instrument is in the class of instruments that is subordinate to all other classes of instruments;

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For an instrument to be in the most subordinate class, the financial instrument must have no priority over other claims to the assets of the entity on liquidation and must not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments. [IAS 32:BC58] The instrument must be in the class of instruments that is subordinate to all other classes of instruments on liquidation in order to represent the residual interest in the entity.

When determining whether an instrument is in the subordinate class, an entity evaluates the instrument's claims on liquidation as if liquidation were to occur on the date when the instrument is classified. The initial classification should be reassessed if there is a change in relevant circumstances. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument under consideration is in the class of instruments that is subordinate to all other classes. [IAS 32:AG14B]

If an entity has only one class of financial instruments, that class is treated as if it were subordinate to all other classes. [IAS 32:AG14D]

In some circumstances, the most subordinate class of instruments is immaterial compared to the overall capital structure of the entity. This is particularly so when the most subordinate instruments are 'founder shares' (i.e. shares issued when the entity was formed) but the entity is capitalised by other issued instruments (e.g. puttable instruments issued after the founder shares were issued). The founder shares in this case, although immaterial, cannot be ignored in determining whether the puttable instruments should be classified as equity. Because the puttable instruments are not the most subordinate instruments issued by the entity, they are not classified as equity.

Example 2.1.2.1A

Immaterial founder shares

Entity A is capitalised principally by issue of puttable instruments whose contractual terms meet the requirements of IAS 32:16A for classification as equity except for the criterion of IAS 32:16A(b) that such an instrument be subordinate to all other classes of instruments. This is due to the existence of 'founder shares' (i.e. shares issued when Entity A was formed), the value of which is immaterial compared to the puttable instruments and the overall capital structure of the entity. The puttable instruments rank ahead of the ordinary shares on liquidation of Entity A.

Entity A should classify the puttable instruments as liabilities. IAS 32:16A(b) requires that, for a puttable instrument to be classified as equity, it must be in the class of instruments that is subordinate to all other classes of instruments.

In the circumstances described, although immaterial, the founder shares cannot be ignored in determining whether the puttable instruments should be classified as equity. Because the puttable instruments are not the most subordinate instruments issued by Entity A, they should not be classified as equity.

Example 2.1.2.1B

Classification of puttable instruments – two equally subordinate classes

Entity A has issued two classes of puttable instruments that are subordinate to all other classes of instruments but have equal priority with each other on liquidation of the entity. The two classes of puttable instruments are considered, in accordance with IAS 32:16A(b), to be equally subordinate.

Unless the terms of the two classes of instruments are identical, neither of the classes of puttable instruments meet the condition in IAS 32:16A(b) for classification as equity because neither is 'subordinate to all other classes of instruments' as contemplated in IAS 32:16A(b).

If the terms of the instruments are identical, they form a single class of instruments that should be classified as equity subject to the other requirements of IAS 32:16A and 16B.

In assessing whether two classes of shares can be considered to form a single class for this purpose, it is necessary to consider the requirements of IAS 32:16A(c), which states that all financial instruments in the most subordinate class must have identical features. This requirement is explained in IAS 32:BC59 as follows: "in order to ensure that the class of instruments as a whole is the residual class, the Board decided that no instrument holder in that class can have preferential terms or conditions in its position as an owner of the entity".

Consequently, two classes of shares that have identical terms and that are differentiated only for administrative purposes or due to factors other than the features of the shares themselves (e.g. the timing or price of their issue) should be considered 'identical' for the purposes of IAS 32:16A(c). In contrast, any economic difference in the terms of the instruments (e.g. in the calculation of the repurchase or redemption price) would result in a conclusion that there are two classes of instruments and, if the two rank equally on liquidation, that neither qualifies for classification as equity.

(c) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class;

In January 2009, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IAS 32, *Classification of Puttable and Perpetual Instruments*. The IFRIC considered whether a puttable

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Company B determines that the hypothetical market participant would be willing to transfer the liability for only CU80 million. In other words, the fair value of the bonds has decreased by CU20 million due to the decline in value of the collateral even though Company B's credit standing remains unchanged.

Example 5.2.3B

Effect of a decline in the borrower's credit standing

Assume the same facts as in **example 5.2.3A** except that, at 30 September 20X3, the fair value of the aircraft pledged as collateral remains unchanged. Instead, the credit standing of Company B has declined from AAA to AA-.

When measuring the fair value of the bonds at 30 September 20X3, Company B is required to consider the effect of the decline in its credit standing but also the fact that the fair value of the collateral has not changed.

Company B observes that the wider credit spread for uncollateralised AA- corporate bonds suggests that the fair value of the bonds has declined by 10 per cent (i.e. to CU90 million). However, because the fair value of the collateral has not changed, the note remains well collateralised. Consequently, the fair value of the note may not have declined by as much as 10 per cent. Company B determines that the increase in non-performance risk arising from the decline in its own credit standing is partially offset by the collateral. Based on credit spreads observed for similar, collateralised bonds, Company B concludes that the fair value of the notes has decreased by CU7 million to CU93 million.

5.3 Restriction preventing the transfer of a liability or an entity's own equity instrument

When measuring the fair value of a liability or an entity's own equity instrument, no separate input or adjustment to other inputs should be included to reflect the existence of a restriction that prevents the transfer of the item. The effect of a restriction that prevents the transfer of a liability is either implicitly or explicitly included in the other inputs to the fair value measurement. [IFRS 13:45]

For example, at the transaction date for a liability, both the creditor and the obligor accepted the transaction price for the liability with full knowledge that the obligation includes a restriction that prevents its transfer. As a result of the restriction being included in the transaction price, a separate input or an adjustment to an existing input is not required at the transaction date to reflect the effect of the restriction on transfer. Similarly, a separate input or an adjustment to an existing input is not required at subsequent measurement dates to reflect the effect of the restriction on transfer. [IFRS 13:46]

5.4 Financial liability with a demand feature

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. [IFRS 13:47]

6 Measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk

An entity that holds a group of financial assets and financial liabilities is exposed to market risks (as defined in IFRS 7) and to the credit risk (as defined in IFRS 7) of each of the counterparties. If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to the general requirements of IFRS 13 for measuring fair value.

The exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. This fair value measure for the group of financial assets and financial liabilities should be consistent with how market participants would price the net risk exposure at the measurement date. [IFRS 13:48] This exception only applies to financial assets, financial liabilities and other contracts within the scope of IFRS 9. [IFRS 13:52]

In December 2013 the IASB issued *Annual Improvements to IFRSs 2011 - 2013 Cycle* that amended IFRS 13:52 to clarify that the portfolio exception applies to all contracts within the scope of IFRS 9 regardless of whether they meet the definitions of financial assets or financial liabilities as defined in IAS 32. The clarification was in response to questions raised about whether the scope included contracts that are accounted for as if they were financial instruments, but that do not meet the definitions of financial assets or financial liabilities in IAS 32, such as contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments.

An entity is permitted to apply the measurement exception in IFRS 13:48 to a portfolio that contains *only* financial assets (as opposed to a group of financial assets and financial liabilities) provided that the financial instruments have offsetting positions in market risks or counterparty

credit risk and that the detailed conditions in IFRS 13:49 (see below) are met.

An example of a portfolio containing only financial assets is a portfolio of bonds measured at fair value and purchased credit default swaps also measured at fair value. The credit default swaps may provide an offset to the credit risk associated with the specific bonds.

An entity is permitted to use this exception only if the entity does all of the following:

[IFRS 13:49]

- it manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the entity's documented risk management or investment strategy;
- it provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel, as defined in IAS 24 *Related Party Disclosures*; and
- it is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

This exception does not apply for financial statement presentation. When the basis for the presentation of financial instruments in the statement of financial position differs from the group basis for the measurement of financial instruments (e.g. if IAS 32 does not require the group of financial instruments to be presented on a net basis) an entity may need to allocate the portfolio-level adjustments to the individual instruments that make up the group. That allocation should be performed on a reasonable and consistent basis using a methodology appropriate in the circumstances. [IFRS 13:50]

A common example of an adjustment made at the portfolio level as contemplated in IFRS 13:48 is a credit valuation adjustment (CVA). An entity might incorporate the effect of exposure to a particular counterparty's credit risk by netting its derivative asset and liability contracts with a given counterparty in accordance with a master netting arrangement and then calculate a CVA on the basis of the net position with the counterparty.

Another example of a portfolio-level adjustment is a 'mid-to-bid' or 'mid-to-ask' adjustment. A derivatives dealer might initially compute the value of a portfolio of both its long (buy) and short (sell) derivative positions with the same underlying risk using the mid-point in the bid-ask spread. The derivatives dealer would then make a 'mid-to-bid' or 'mid-to-ask' adjustment at the portfolio level effectively to move the net open position

of the portfolio to the bid or ask price depending on whether the portfolio is net long or net short by period.

The question arises as to how should an entity allocate a portfolio-level adjustment to the individual financial assets and financial liabilities in the portfolio.

IFRS 13:50 requires that an entity should allocate a portfolio-level adjustment to the individual financial assets and financial liabilities in the portfolio on a reasonable and consistent basis using a methodology appropriate in the circumstances.

The following table illustrates one approach to allocating a CVA to a group of derivative contracts under a master netting arrangement with a single counterparty.

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	Asset/(Liability) in CU	**Hierarchy level (prior to allocation of CVA)**
Contract A	100	2
Contract B	200	3
Contract C	(175)	3
Net position before CVA	125	Not applicable
Credit valuation adjustment	(10)	See discussion below
Fair value of portfolio	115	Not applicable

The unit of account, in this example, is each individual derivative contract in its entirety. Accordingly, the CU10 CVA must be allocated to the units of account within the portfolio. For example, the entity might allocate the CU10 CVA on the basis of the relative fair value of the asset positions (Contracts A and B in the example above). The resulting fair value of Contract A would be CU97 (i.e. CU100 less 100/300 × CU10). The resulting fair value of Contract B would be CU193 (i.e. CU200 less 200/300 × CU10). Other approaches may also be appropriate depending on the circumstances.

When a portfolio-level adjustment is allocated to individual assets and/or liabilities in the circumstances described, this will affect the classification of the assets and/or liabilities within IFRS 13's fair value hierarchy (see **section 10**). An allocated portfolio adjustment is an input to the measurement of the fair value of the asset or liability. If such an input is not based on observable data and has a significant effect on the measurement of the fair value of an individual asset or liability, the fair value measurement is categorised in Level 3 of the fair value hierarchy.

Assume in the example above that, before the allocation of the CVA, the inputs used in determining the fair value of Contract A were based on observable market data. However, if the effect of the counterparty's credit risk is not considered observable market data, the allocated

amount of CVA is a Level 3 input. In determining the classification of Contract A within the hierarchy, the entity must determine whether the amount of CVA allocated to Contract A is significant to the measurement of Contract A in its entirety (see **10.3.3.1** for discussion). Because the CVA is unobservable, if the allocated portion of the CVA for Contract A is considered significant, then Contract A would be classified in Level 3 in its entirety.

During the IASB's deliberations it was noted that some respondents requested additional guidance for allocating the bid-ask and credit adjustments to the individual assets and liabilities that make up the group of financial assets and financial liabilities. The Boards noted that although any allocation method is inherently subjective, it was concluded that a quantitative allocation would be appropriate if it was reasonable and consistently applied. Therefore, the Boards decided not to require a particular method of allocation. [IFRS 13:BC131]

The application of this exception is an accounting policy choice in accordance with IAS 8 and, when selected, should be applied consistently from period to period (including the entity's policy for allocating any portfolio adjustments). [IFRS 13:51]

In May 2013 the Interpretations Committee received a request to clarify the interaction between the use of Level 1 inputs and the portfolio exception set out in IFRS 13. The portfolio exception in IFRS 13 permits an entity to measure its net exposure to either market risks or credit risk arising from a group of financial assets and financial liabilities in specified circumstances. The portfolio exception was intended to align the valuation of financial instruments for financial reporting with an entity's internal risk management practices. In particular, the issue that was discussed by the Interpretations Committee was whether an entity is:

(a) permitted to apply the portfolio exception in IFRS 13 to measure the resulting net risk exposure of a portfolio made up solely with identical Level 1 instruments; or

(b) required to measure the financial assets and the financial liabilities of such a portfolio on an individual basis, using the corresponding Level 1 prices for each financial instrument.

In its discussions, the Interpretations Committee observed that, in relation to (a) above, the main question that needs to be addressed is whether an entity:

(a) would be required to measure such a net risk exposure on the basis of the Level 1 prices for the individual instruments that comprise that net risk exposure; or

(b) would be allowed to consider the net risk exposure as a whole and, consequently, consider adjusting it with any appropriate premiums or discounts.

The Interpretations Committee noted that there was insufficient guidance in the Standard for it to be able to answer this question and so it decided that this issue needs to be considered by the IASB. Accordingly it asked the staff to present the Interpretations Committee's concerns to the IASB.

The IASB also noted that this issue has similarities with the issue of the interaction between the use of Level 1 inputs and the unit of account that arises when measuring the fair value of investments in subsidiaries, joint ventures and associates (discussed above). Consequently, the IASB included this issue in Exposure Draft ED/2014/4 *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* issued in September 2014. In the ED the IASB included an illustrative example to illustrate the application of IFRS 13:48 to a group of financial assets and financial liabilities whose market risks are substantially the same and whose fair value measurement is categorised within Level 1 of the fair value hierarchy.

As part of the IASB's redeliberations following the publication of the ED, the illustrative example was discussed by the IASB in April 2015 when it decided that the example appropriately illustrates the application of IFRS 13:48. That is, if an entity elects to use the exception in IFRS 13:48, the appropriate fair value measurement of the net risk exposure arising from a group of financial assets and financial liabilities whose market risks are substantially the same, and whose fair value measurement is categorised within Level 1 of the fair value hierarchy, would be determined by multiplying the financial instruments included in the resulting net position by the corresponding unadjusted Level 1 price.

The IASB noted that the proposed illustrative example to IFRS 13 is non-authoritative, and the comments received did not reveal significant diversity in practice. Accordingly, the IASB concluded that it was unnecessary to publish the proposed illustrative example in IFRS 13 as a separate document. Therefore the illustrative example is not due to be published by the IASB.

The example below is taken from the IASB staff paper that was discussed by the IASB in April 2015 (agenda reference 6). It is based on the illustrative example from the ED but also includes some of the changes proposed by the IASB staff following feedback received on the ED.

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Example 6

Measuring the fair value of a portfolio of Level 1 financial assets and financial liabilities with offsetting risk positions

Entity A holds a group of financial assets and financial liabilities consisting of a long position of 10,000 financial assets and a short position of 9,500 financial liabilities whose market risks are substantially the same. Entity A manages that group of financial assets and financial liabilities on the basis of its net exposure to market risks. The fair value measurement of all financial instruments in the group is categorised within Level 1 of the fair value hierarchy.

The bid-ask spread is CU98 - CU102, with the mid-price being CU100. The most representative bid price is CU99 and the most representative ask price is CU101.

Entity A applies the exception in IFRS 13:48 that permits Entity A to measure the fair value of the group of financial assets and financial liabilities on the basis of the price that would be received to sell, in this particular case, a net long position (i.e. an asset) for the exposure to market risks in an orderly transaction between market participants at the measurement date under current market conditions.

Since the market risks arising from the financial instruments are substantially the same, the measurement of the net exposure to market risks arising from the group of financial assets and financial liabilities coincides with the measurement of the net long position (500 financial assets). Consequently, Entity A measures the group of financial assets and financial liabilities on the basis of the price that it would receive if it would exit its outstanding net exposure to market risks as follows:

	Quantity held (Q)	Level 1 price (CU) (P)	(CU) P × Q
Net exposure to market risks, which in this case coincide with the measurement of the net long position	500	99	49,500

Entity A would also have achieved the same measurement of CU49,500 by measuring the net exposure to market risks at the mid-price (i.e. CU100 × 500 = CU50,000) adjusted by a bid-offer reserve (CU1 × 500 = CU500).

Since the basis for the presentation of the financial instruments in the statement of financial position differs from the basis for their measurement, Entity A subsequently allocates the resulting measurement (i.e. CU49,500) to the individual (10,000) financial assets and (9,500) financial liabilities. In accordance with IFRS 13:50 & 51, Entity A performs this allocation on a reasonable basis that is consistent with previous allocations of that nature using a methodology appropriate to the circumstances.

6.1 Exposure to market risks

Consistent with the normal fair value measurement requirements, when measuring the fair value of a group of assets and liabilities based on the net exposure to one or more market risks, IFRS 13 requires an entity to apply the price within the bid-ask spread that is most representative of fair value in the circumstances to the entity's net exposure to those market risks. [IFRS 13:53]

In order to measure a group of financial assets and financial liabilities on a net basis for a particular market risk, it is necessary for that market risk within that group of financial assets and financial liabilities to be substantially the same. For example, an entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the entity's exposure to interest rate risk or commodity price risk. [IFRS 13:54]

In some cases, the market risk parameters will not be identical due to basis differences. In those cases the basis risk should be taken into account in the fair value measurement of the financial assets and financial liabilities within the group. [IFRS 13:54]

Similarly, the term of the entity's exposure to market risk arising from the financial assets and financial liabilities should be substantially the same. For example, an entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a five-year financial instrument within a group made up of only those financial assets and financial liabilities measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (i.e. Years 2 - 5) on a gross basis. [IFRS 13:55]

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6.2 Exposure to the credit risk of a particular counterparty

When applying the fair value measurement exception described in **section 6** above for financial instruments with the same counterparty, the entity should include the effect of the entity's net exposure to the credit risk of that counterparty or the counterparty's net exposure to the credit risk of the entity in the fair value measurement when market participants would take into account any existing arrangements that mitigate credit risk exposure (e.g. a master netting agreement with the counterparty or an agreement that requires the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party) in the event of default. The fair value measurement should reflect market participant expectations about the likelihood that such an arrangement would be legally enforceable in the event of default. [IFRS 13:56]

Reflecting in the fair value measurement of the portfolio of items the net credit risk exposure with the same counterparty is appropriate when the two parties have an agreement that requires that in the case of default

the reporting entity is only required to pay or receive the net amount of the various contracts that are owed to and due from the counterparty. Applying the fair value measurement exception in this case reduces the extent of credit risk included in the measurement of the portfolio of items relative to including credit risk in the measurement of each of the individual items and summing the assets and liabilities together.

Netting the credit risk exposure with the counterparty and reflecting only the credit risk associated with the net open credit risk position is often referred to as a CVA (credit valuation adjustment, or a 'positive CVA') in the case when the reporting entity has a net credit exposure to the counterparty, i.e. when the reporting entity is net owed amounts by the counterparty; or as a DVA (debit valuation adjustment, or a 'negative CVA') in the case when the counterparty has a net credit exposure to the reporting entity, i.e. when the reporting entity owes amounts to the counterparty.

7 Fair value measurement at initial recognition

7.1 Potential for difference between the transaction price and fair value at initial recognition

IFRS 9:5.1.1 requires that all financial assets and financial liabilities, except certain trade receivables, should be recognised initially on the basis of 'fair value'. The exception applies to trade receivables that do not have a significant financing component (determined in accordance with IFRS 15 *Revenue from Contracts with Customers*) that are not initially measured at fair value, rather they are initially measured at their transaction price.

If the asset has been acquired, or the liability assumed, in a market transaction, it might be assumed that the transaction price (i.e. the price paid to acquire an asset or received to assume a liability) can be taken to be the fair value of the asset or the liability. However, the price paid to acquire an asset, or received to assume a liability, is an *entry* price and, consequently, it is not necessarily the same as the fair value of the asset or liability for IFRS 13 purposes (which is an *exit* price – see **section 3**). The Standard notes that entities do not necessarily sell assets at the prices paid to acquire them; nor do they necessarily transfer liabilities at the prices received to assume them. [IFRS 13:57]

7.2 Indicators that the transaction price differs from fair value at initial recognition

When determining whether the fair value at initial recognition equals the transaction price, an entity should take into account factors specific to the transaction and to the asset and liability. [IFRS 13:59]

In many cases the transaction price and the fair value will be equal (e.g. when the transaction date is the same as the measurement date and the asset is acquired in the market in which the asset would be sold). [IFRS 13:58] However, when the amounts are not equal, the asset or liability should be measured at fair value and the difference between the transaction price and fair value (generally referred to as a 'day 1 gain or loss', 'day 1 profit or loss' or as 'day 1 p&l') is required to be recognised as a gain or loss in profit or loss unless the relevant IFRS specifies otherwise. [IFRS 13:60] See **7.3** for the appropriate treatment of 'day 1 p&l' under IFRS 9.

IFRS 13:B4 lists a number of factors which may suggest that the transaction price is not the fair value of the asset or liability at initial recognition.

The following table repeats the factors listed in IFRS 13:B4 and provides examples for each. Note that this list of indicators is not exhaustive, and other factors may exist that should be considered in evaluating whether a transaction price represents fair value (see IFRS 13:BC133).

Factor (IFRS 13:B4)	**Example**
The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.	An entity purchases a portfolio of troubled loans from an unconsolidated investee. The parties meet the definition of related parties under IAS 24 *Related Party Disclosures*. The fact that the parties are related may indicate that the transaction price does not reflect fair value. However, this alone would not be determinative. Evidence that the transaction was entered into at market terms may include: • the appointment of third parties to negotiate or measure fair value; or • the terms of the transaction are consistent with available market data for similar transactions between unrelated parties; or • there is no evidence that one of the parties to the transaction is under duress (see the next factor).
The transaction takes place under duress or the seller is forced to accept the price in the transaction (e.g. if the seller is experiencing financial difficulty).	A hedge fund must sell all of its non-marketable assets in response to a spike in redemptions that may lead to a liquidity crisis. A liquidity crisis may be an indicator of financial difficulty. The factors in IFRS 13:B43 indicating that a transaction is not orderly (see **9.6**) may also indicate that the transaction price does not represent fair value.

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Factor (IFRS 13:B4)	Example
The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, this might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (e.g. in a business combination), if the transaction includes unstated rights and privileges that are measured separately in accordance with another IFRS, or if the transaction price includes transaction costs.	IFRS 13:14 requires that the unit of account for an asset or a liability should be determined in accordance with the IFRS that requires or permits the fair value measurement, except as provided in IFRS 13 (see **3.2.1**). The following example illustrates a scenario in which the unit of account for the asset is different from the unit of account represented by the transaction price. On 30 June 20X1, Company A acquires a 3 per cent equity interest (three million shares) in Company B from an independent third party. Quoted prices in an active market are available for Company B's shares. Company A pays CU100 million for the entire 3 per cent equity interest (the transaction price is determined based on a negotiated arm's length price for the entire 3 per cent equity interest). The quoted price for Company B's shares on 30 June 20X1 is CU36 per share. Company A needs to identify the unit of account in order to measure the fair value of the 3 per cent equity interest on initial recognition. In identifying the unit of account for fair value measurement purposes, IFRS 9 is the applicable Standard. IFRS 13:BC47 states, in part, that "[i]n IAS 39 and IFRS 9 the unit of account is generally an individual financial instrument". This guidance is also consistent with the guidance set out in IFRS 13:80 which states that "[i]f an entity holds a position in a single asset… and the asset… is traded in an active market, the fair value of the asset… shall be measured within Level 1 as the product of the quoted price for the individual asset… and the quantity held by the entity". Therefore, notwithstanding the fact that Company A paid a transaction price of CU100 million for the entire three million shares, the unit of account in this example is each individual share, not the entire 3 per cent equity interest acquired. Specifically, the fair value of the 3 per cent equity interest in Company B is measured as the product of the quoted price for each individual share and the quantity held ('P × Q') (i.e. CU108 million = 3 million shares × CU36 per share).

Factor (IFRS 13:B4)	Example
The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.	Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a dealer) for no initial consideration (i.e. the transaction price is zero). Entity A can access only the retail market. Entity B can access both the retail market (i.e. with retail counterparties) and the dealer market (i.e. with dealer counterparties). From the perspective of Entity A, the fair value at initial recognition is zero because Entity A does not have access to the dealer market. From Entity B's perspective, the transaction price of the interest rate swap (i.e. zero) does not represent fair value at initial recognition if prices observed or market participant assumptions in the dealer market (i.e. Entity B's principal market) indicate that fair value is something other than zero. Note: This final scenario is a summary of Example 7 from the illustrative examples accompanying IFRS 13 (see IFRS 13:IE24 - IE26).

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7.3 Day 1 profit or loss

When there is a difference between the fair value at initial recognition and the transaction price, IFRS 13:60 states that any resulting gain or loss should be recognised in profit or loss unless another IFRS specifies otherwise.

With respect to financial instruments, an entity should understand the reason for any difference between the fair value at initial recognition and the transaction price. This difference may represent consideration for goods or services between the two entities or a capital contribution or deemed distribution in circumstances when one party is acting in its capacity as an owner. Other IFRSs will determine how such amounts are accounted for.

Example 7.3A

Interest-free loan (1)

On 1 January 20X0, Parent A grants a non-callable interest-free loan of CU100 to a wholly-owned subsidiary, Subsidiary B. The loan is repayable on 31 December 20X0 and is not callable prior to that date by Parent A. The market rate of interest for a loan to the subsidiary would be 8 per cent. Consideration paid is made up as follows.

(i) CU92.59 is the fair value of the financial asset (i.e. CU100/1.08).

(ii) CU7.41 is a capital contribution. This amount represents the fair value of Parent A's providing Subsidiary B with interest-free finance. The amount should be recognised by Subsidiary B directly in equity as a capital contribution because it does not meet the definition of income under paragraph 4.25 of the *Conceptual Framework for Financial Reporting*.

Example 7.3B

Interest-free loan (2)

On 1 January 20X0, Subsidiary C grants a non-callable interest-free loan of CU100 to its parent, Parent A. The loan is repayable on 31 December 20X0 and is not callable prior to that date by Subsidiary C. The market rate of interest for a loan to Parent A would be 8 per cent. Consideration paid is made up as follows.

(i) CU92.59 is the fair value of the financial asset (i.e. CU100/1.08).

(ii) CU7.41 is in substance a distribution from Subsidiary C to Parent A. This amount represents the fair value of the Subsidiary C's providing its parent with interest-free finance. The amount should be recognised by Subsidiary C directly in equity as a deemed distribution because it does not meet the definition of an expense under paragraph 4.25 of the *Conceptual Framework for Financial Reporting*.

When the difference is not consideration for goods or services, or a capital contribution or deemed distribution, IFRS 9 sets out specific guidance as to whether that difference (often referred to as 'day 1 p&l') may be recognised in profit or loss at initial recognition.

If, in an arm's length transaction, the transaction price differs from fair value at initial recognition, the appropriate accounting for the difference depends on how fair value is determined in those circumstances. If the fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. a Level 1 input) (see **10.2.1**) or based on a valuation technique that uses only data from observable markets, then the difference is recognised as a gain or loss on initial recognition (i.e. day 1 p&l). In all other circumstances, the fair value at initial recognition is adjusted to bring it in line with the transaction price. Consequently, the day 1 p&l is deferred by including it in the initial carrying amount of the asset or liability. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability. [IFRS 9:B5.1.2A(b)]

Example 7.3C

Day 1 p&l (1)

Bank A sells a 30-year cash-settled forward-sale contract over a commodity to Entity B.

Forward prices for the specific commodity are freely quoted in the market for 10, 15, and 20 year periods. Bank A uses an extrapolation technique and its proprietary pricing system to estimate the 30-year forward rate and incorporates an additional premium on top of this internal price. Some of the premium may be received in cash at inception and some may be included in the contracted price of the forward contract.

The valuation technique uses both the available forward prices and Bank A's estimates of the commodity prices between years 20 and 30. Because some of the inputs are entity-specific and not observable, a day 1 profit cannot be recognised.

Example 7.3D

Day 1 p&l (2)

Bank X issues credit-linked notes to institutional investors.

The credit-linked notes are debt instruments with an interest rate higher than normal bonds issued by Bank X because the performance of the notes is linked to the performance of a basket of underlying corporate bonds. The terms require that if a corporate bond in the basket defaults, then the notional principal will be reset on the next payment date to reflect the outstanding value of the remaining bonds in the basket. This term is commonly referred to as 'first-to-default', because it is the first bond in the basket that defaults that results in the early repayment of the notes at an amount less than was originally invested by the holder.

Bank X does not actually hold the corporate bonds that the credit-linked notes are linked to. Instead Bank X purchases a large number of credit default options over the individual corporate bonds. These purchased options serve as an economic hedge in case any of the referenced credits default. The remaining proceeds from issuing the credit-linked notes are invested in high quality government debt.

If the credit-linked notes are not traded in an active market, then Bank X must use a valuation technique to measure the financial liability. At inception the proceeds received from the issuance of the notes are equal to their fair value.

It would not be possible to recognise an upfront profit on initial recognition of the credit-linked notes, even if the sum paid to purchase the government bonds and the credit options is less than the proceeds from the notes if:

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3.4.2 Securitised loans

A purchased interest in a pool of assets that are themselves loans and receivables can be classified as loans and receivables if it meets the criteria for such classification. If an entity acquires a beneficial interest in a securitised pool of loans and receivables, this would not meet the definition of loans and receivables if the beneficial interest is quoted in an active market.

3.5 Available-for-sale financial assets (AFS)

AFS financial assets are those non-derivative financial assets that are designated as AFS, or that are not classified as loans and receivables or HTM investments, are not held for trading and are not designated as at FVTPL on initial recognition.

AFS financial assets are measured at fair value with fair value gains or losses recognised in other comprehensive income. On sale or impairment of the asset, the cumulative gain or loss previously recognised in other comprehensive income is reclassified to profit or loss as a reclassification adjustment.

However, interest calculated using the effective interest method on interest-bearing AFS financial assets, impairment losses and foreign exchange gains and losses on monetary AFS financial assets are recognised in profit or loss (see **chapter C6**).

Dividends are recognised in profit or loss only when:

(a) the entity's right to receive payment of the dividend is established;

(b) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(c) the amount of the dividend can be measured reliably.

Examples of AFS financial assets are equity investments that are not designated on initial recognition as at FVTPL, debt securities that are quoted in an active market (which may or may not have put features that would also prohibit them from being classified as HTM) and other financial assets held for liquidity purposes.

Example 3.5

Held for trading versus available-for-sale

[IAS 39:IG.B.12]

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio

value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A's intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available-for-sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

In July 2014, the IFRS Interpretations Committee issued an agenda decision on IAS 39 titled *Classification of a hybrid financial instrument by the holder*. The Committee was asked to clarify the classification by the holder of a hybrid financial instrument with a revolving maturity option, an early settlement option and a suspension of interest payments option (all at the option of the issuer). Specifically, the submitter raised the question of whether the host of such a financial instrument should be classified by the holder as equity or as a debt instrument under IAS 39.

On the basis of the responses to the outreach request, the Interpretations Committee observed that the issue is not widespread. The Interpretations Committee also noted that the financial instrument described in the submission is specific and it would not be appropriate to provide guidance on this particular issue.

The Interpretations Committee considered that its agenda criteria are not met. Consequently, the Interpretations Committee decided not to add this issue to its agenda.

4 Reclassifications

IAS 39 permits limited reclassifications of certain financial assets subject to meeting specified criteria. Reclassifications are not permitted for financial liabilities, derivatives or financial assets for which the fair value option has been selected.

4.1 Into FVTPL

IAS 39:50 prohibits any reclassification of a financial instrument into the FVTPL category after initial recognition.

Although IAS 39:50 is categorical that reclassifications into FVTPL are prohibited, there does appear to be one exception to this prohibition, which is described in IAS 39:12. If an entity is not able to measure an embedded derivative separately at a financial reporting date

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subsequent to acquisition, the entity is required to designate the entire hybrid (combined) contract as at FVTPL. Because embedded derivatives are only required to be separated from contracts that are not measured at FVTPL, the situation described in IAS 39:12 would appear to be a reclassification from a measurement category other than FVTPL to FVTPL.

4.2 Out of FVTPL

As described in **3.1**, financial assets may be classified at initial recognition as at FVTPL if specified conditions are met. In some cases, this classification is mandatory (e.g. in the case of derivatives that are not designated as effective hedging instruments or non-derivative financial assets that are deemed held for trading). In other cases, the classification is by election (e.g. when an entity applies the fair value option). IAS 39 only permits reclassification out of FVTPL, subject to specified criteria, for non-derivative financial assets that were originally classified as at FVTPL because they met the definition of held for trading. Financial assets that are classified as at FVTPL because they are derivatives or because they are designated as at FVTPL under the fair value option cannot be reclassified under any circumstances.

Loan commitments that are within the scope of IAS 39 and recognised and measured as at FVTPL cannot be reclassified because they meet the definition of derivatives and derivatives cannot be reclassified. In addition, a financial asset cannot be reclassified if it is designated as at FVTPL under the fair value option which would also prohibit reclassification of loan commitments designated as at FVTPL in accordance with IAS 39:4(a). Also, in the case of written loan commitments, they are financial liabilities and financial liabilities cannot be reclassified.

The first condition to be met in order to reclassify a financial asset from FVTPL is that the financial asset is no longer held for the purpose of selling or repurchasing it in the near term. [IAS 39:50(c)] This criterion applies irrespective of whether the asset was initially classified as held for trading because (i) it was acquired principally for the purpose of selling in the near term or (ii) because it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

If an entity wishes to reclassify a financial asset that was classified as held for trading because it was part of a portfolio of identified financial instruments that are managed together and for which there was evidence of a recent actual pattern of short-term profit-taking, the entity must demonstrate that the specific asset subject to reclassification is

not intended to be sold in the near term. For an asset that forms part of a portfolio of assets, this may be difficult to demonstrate unless the asset has been isolated from the portfolio or the mandate of the portfolio has changed such that there is no longer evidence of short-term profit-taking.

IAS 39:50(c) refers to "selling or repurchasing it in the near term" which is the same terminology that is used in the held for trading definition. Both selling *and* repurchasing is relevant in the held for trading definition as the held for trading definition applies to both financial assets and financial liabilities. The reference to "repurchasing" in IAS 39:50(c) appears to be superfluous because this relates to financial liabilities and financial liabilities cannot be reclassified.

The second condition to be considered in order to reclassify a financial asset from FVTPL is whether the financial asset meets the definition of loans and receivables. If it does, the financial asset may be reclassified out of FVTPL if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity. [IAS 39:50D] If it does not meet the definition of loans and receivables, it may be reclassified out of FVTPL only in rare circumstances. [IAS 39:50B]

The following summarises the criteria for reclassifying out of FVTPL.

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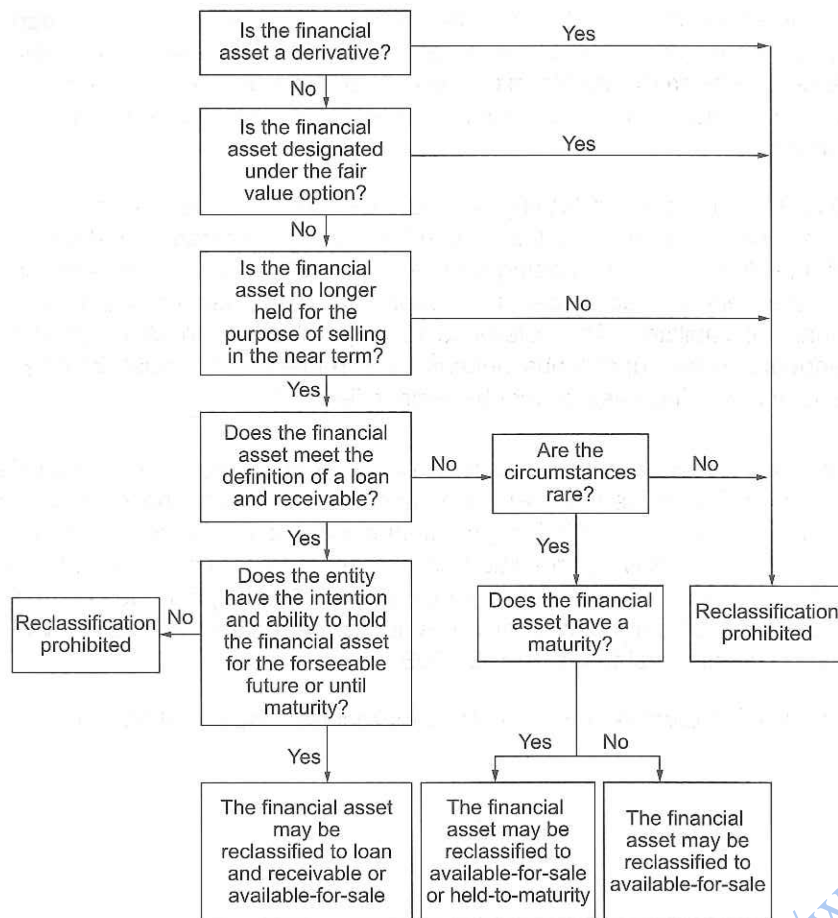

IAS 39 does not state explicitly at what date an entity should determine whether the financial asset meets the definition of loans and receivables when assessing whether the financial asset can be reclassified. Two interpretations are acceptable:

(i) assess the definition of loans and receivables at the date of initial recognition of the financial asset; or

(ii) assess the definition of loans and receivables at the date of reclassification of the financial asset. This is particularly relevant for financial assets that would not have met the definition of loans and receivables at initial recognition (e.g. because the instrument was traded in an active market), but that meet the definition at the date of reclassification.

An entity should decide on the appropriate interpretation and apply it consistently as an accounting policy choice to all reclassification assessments that require the entity to apply the definition of loans and receivables. If the accounting policy is considered relevant for the

understanding of the financial statements, it should be disclosed in accordance with IAS 1:117.

The financial asset reclassified from FVTPL should be reclassified at its fair value on the date of reclassification. Any gain or loss recognised in profit or loss up until the date of reclassification should not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost (in the case of equity instruments) or amortised cost (in the case of debt instruments). [IAS 39:50C]

For financial assets reclassified out of FVTPL, the entity will start to apply the impairment guidance described in IAS 39:58 - 70 for that asset. Prior to the date of reclassification, an assessment of impairment was not required because the asset was measured at FVTPL. Because the instrument's fair value at the date of reclassification becomes its new deemed cost or deemed amortised cost, impairment losses recognised after the reclassification date may differ from the impairment losses that would have been recognised had the instrument never been previously measured at FVTPL (see **5.4.3** in **chapter C6** for more detail).

A financial asset reclassified out of FVTPL is subject to extensive disclosure requirements (see **4.1.4** in **chapter C12**).

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4.2.1 Rare circumstances

IAS 39 does not provide any specific guidance as to how an entity should determine whether the circumstances under which reclassification is being contemplated are 'rare'. However, the Board expressed in IAS 39:BC104D that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term. In a press release that accompanied the issuance of the amendment to IAS 39, *Reclassification of Financial Assets*, in October 2008 the IASB stated that "the deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments".

In order for circumstances to be considered rare, there should be cause and effect between those circumstances and the financial assets held that are subject to reclassification. In the second half of 2008, some markets for asset-backed securities became in effect closed because of the stark reduction in new instruments being issued and very low trading volumes for existing instruments, partly due to a lack of price transparency and lack of investor appetite. An entity with investments in asset-backed securities in those markets, which had originally been classified as held for trading, may have ceased to intend to hold the investments for trading purposes and, due to the rare circumstances in those markets, been unable to sell the assets. Depending on the specific facts and circumstances reclassification may be acceptable. The mere reduction in the price of assets is generally not evidence of

rare circumstances because falling prices, even in a stock market crash, are not in themselves rare. In addition, the reduction in the value of an asset (e.g. an investment in an equity security) does not necessarily have an effect on the intentions or investment strategy of the holder of the instrument. Often the only effect is the fair value loss that would be realised if the entity disposed of the asset, and the realisation of a fair value loss is not in itself rare.

4.2.2 Foreseeable future

IAS 39 does not provide guidance on how an entity should assess whether it intends to hold the financial asset for the foreseeable future.

'Foreseeable future' is not a new term introduced in the IAS 39 amendment because it is a term used in other IFRSs. IAS 21:15 permits the foreign exchange gains/losses on a monetary item that is a receivable from or a payable to a foreign operation to be recognised in other comprehensive income if settlement is neither planned nor likely to occur in the foreseeable future. Paragraph 39 of IAS 12 *Income Taxes* allows an exemption from recognising certain 'controllable' deferred tax liabilities in circumstances where it is probable that temporary differences will not reverse in the foreseeable future.

What is regarded as the 'foreseeable future' will depend on the facts and circumstances and intentions of the entity and the specific asset that is being assessed for reclassification. If an entity is actively marketing the asset in an attempt to sell it, this activity would be inconsistent with the assertion that the entity does not intend to sell the asset in the foreseeable future. An entity may at the date of reclassification have the intention to retain the asset for the foreseeable future, but later it may receive an unsolicited offer and choose to sell the asset. An entity determines the foreseeable future at the date of reclassification and it does not need to revisit this assessment. However, to the extent that an entity sells reclassified assets shortly after the reclassification date, this would call into question the entity's assertion that it has the intention to hold other assets that it wishes to reclassify until the foreseeable future.

4.2.3 Assessing embedded derivatives

Hybrid contracts that are financial instruments may contain embedded derivatives which were not separately accounted for because these hybrid contracts are measured at FVTPL (see **section 3** in **chapter C5**) may be reclassified out of FVTPL subject to meeting specific criteria. As the embedded derivative was not separated out at initial recognition a question arises whether IFRSs require or prohibit an entity from assessing the separation of the embedded derivative at the date the financial asset is reclassified.

In March 2009, the IASB issued amendments to IAS 39 and IFRIC 9 titled *Embedded Derivatives*. The amendments state that, upon reclassification of a financial asset out of FVTPL, an entity is required to assess whether embedded derivatives should be separated from the host financial contract. In addition, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the FVTPL category, that reclassification is prohibited. In such circumstances, the hybrid (combined) contract remains classified as at FVTPL in its entirety. The Board noted that when IFRIC 9 was issued, reclassifications out of the FVTPL category were prohibited and, therefore, IFRIC 9 did not consider the possibility of such reclassifications. The Board believed it was appropriate that embedded derivatives should be assessed at the date of reclassification. Not to require this would allow an entity to circumvent the requirement to assess embedded derivatives by classifying a financial asset initially as at FVTPL and subsequently reclassifying the asset.

The amendments also state that when assessing for embedded derivatives at the date of reclassification, the assessment should be made on the basis of the circumstances that existed at the later of when the entity first became a party to the contract and the date of change in the terms of the contract that significantly modifies the cash flows that otherwise would have been required under the contract. The Board considered that looking to circumstances when the entity became party to the contract was consistent with one of the stated purposes of embedded derivative accounting which is to prevent circumvention of the recognition and measurement requirements for derivatives and provide some degree of comparability. Furthermore, because the terms of the embedded features in the hybrid (combined) financial instrument have not changed, the Board did not see a reason for arriving at an answer on separation different from what would have been the case at initial recognition of the hybrid (combined) contract.

The Board's decision to look to circumstances when an entity became party to the contract when determining whether an embedded derivative is closely related to the host financial contract will be most relevant when determining whether put options, call options, or other prepayment options in debt instruments are closely related. IAS 39 deems such options to be non-closely related if the conditions in IAS 39:AG30(g) are not met. The condition in IAS 39:AG30(g)(i) requires the option's exercise price to be approximately equal to the amortised cost of the host debt instrument. At the date of reclassification, an entity will be required to make the embedded derivative assessment it would have made had the debt instrument not been initially classified as at FVTPL, i.e. the entity will need to determine the instrument's amortised cost for all dates when the instrument may be put, called, or prepaid and compare the amortised cost with the exercise price of the option on those dates.

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4.3 Into AFS investments

A debt or equity instrument may be reclassified out of held for trading (part of the FVTPL category) into AFS in accordance with IAS 39:50 (see **4.2**). Because the instrument is measured at fair value both before and after reclassification, there is no gain/loss on reclassification and all amounts previously recognised in profit or loss prior to the date of reclassification are retained in profit or loss.

An entity must reclassify a debt instrument from HTM to AFS if there is no longer the intention and ability to hold the debt instrument to maturity. Also, all debt instruments must be reclassified out of HTM into AFS when there are sales or reclassifications of more than an insignificant amount of HTM investments that do not meet any of the conditions in IAS 39:9 (see **4.6**). At the date of reclassification, the difference between the carrying amount of such investments and their fair value should be recognised in other comprehensive income. [IAS 39:52]

If the fair value of an investment in an unquoted equity instrument becomes sufficiently reliable following a period during which the investment was measured at cost in accordance with IAS 39:53, resulting in the measurement of that investment at fair value, this is not a reclassification between financial asset categories. Investments in equity instruments can only ever be classified in either FVTPL or AFS (both of which are required to be measured at fair value) and IAS 39 does not have a fifth classification category. Therefore, although IAS 39:53 refers to financial assets that became reliably measurable when the measure was not previously available and this paragraph is included in the section titled 'Reclassifications', it is not apparent what category such assets could be reclassified to. It is reasonable to consider such assets as continuing to belong to the same classification category to which they were originally classified, but that their basis of measurement has been changed to fair value. The difference between cost and fair value at the date the fair value becomes reliably measureable should be recognised in other comprehensive income if the asset is classified as an AFS asset (see **4.10** and **4.11**).

4.4 Out of AFS investments

Investments in debt instruments may be reclassified out of AFS. Investments in equity instruments classified as AFS cannot be reclassified.

If the fair value of an investment in an unquoted equity instrument classified as an AFS asset becomes unreliable and, therefore, an entity ceases to measure this investment at fair value and begins to measure it at cost in accordance with IAS 39:54, this is not a reclassification between financial asset categories. Investments in equity instruments can only ever be classified in either FVTPL or AFS (both of which require

measurement at fair value) and IAS 39 does not have a fifth classification category. Therefore, although IAS 39:54 refers to examples where the fair value of an investment in an unquoted equity instrument becomes unreliable, and this paragraph is included in the section of the Standard titled 'Reclassifications', it is not apparent what category such assets could be reclassified to. It is reasonable to consider such assets as continuing to belong to the same classification category to which they were originally classified, but that their basis of measurement has been changed to cost (see **4.10** and **4.11**).

A financial asset classified as AFS may be reclassified to HTM if the entity has the intent and ability to hold the asset to maturity. The asset may be reclassified during the instrument's life except during the two-year tainting period (see **3.3**) if the entity has disposed of more than an insignificant amount of held-to-maturity assets.

A financial asset classified as AFS may be reclassified out of the AFS category to the loans and receivables category if it meets the definition of loans and receivables and the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

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As described in **4.2**, an entity should determine an accounting policy with respect to the date it determines whether a reclassified AFS debt instrument meets the definition of loans and receivables. Two interpretations are acceptable:

(i) assess the definition of loans and receivables at the date of initial recognition of the financial asset; or

(ii) assess the definition of loans and receivables at the date of reclassification of the financial asset.

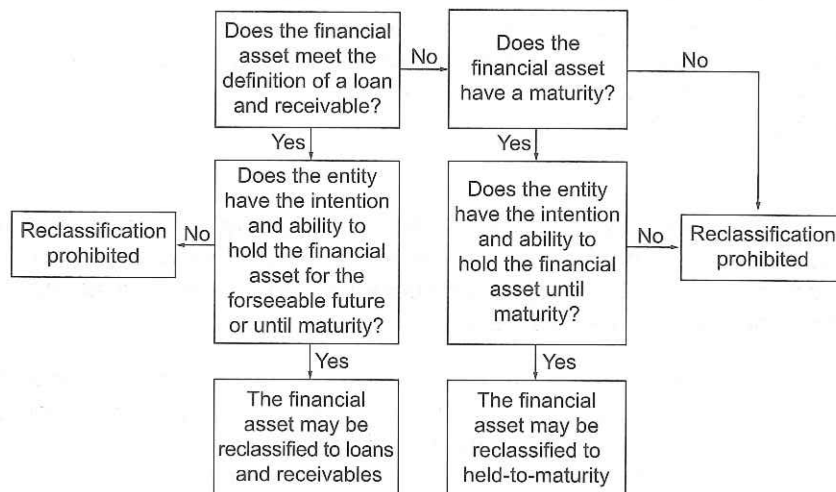
An entity should decide on an appropriate interpretation and apply it consistently as an accounting policy choice to all reclassification assessments that require the entity to apply the definition for loans and receivables. If the accounting policy is considered relevant for the understanding of the financial statements, it should be disclosed in accordance with IAS 1:117.

If an entity's accounting policy is to assess the definition of loans and receivables at the date of initial recognition, then the entity will not be able to reclassify an AFS debt instrument where that AFS debt instrument was classified as such because it did not meet the definition of loans and receivables at initial recognition due to the fact that it was traded in an active market.

If an entity's accounting policy is to assess the definition of loans and receivables at the date of reclassification, then the debt instrument may no longer be traded in an active market and so the entity may be able

to reclassify the AFS debt instrument even though it did not meet the definition of loans and receivables at initial recognition.

The following summarises the criteria for reclassifying out of AFS.



A financial asset reclassified from AFS should be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss should not be reversed. The fair value of the financial asset on the date of reclassification becomes its new amortised cost.

Any previous gain or loss on an AFS asset that has been recognised in other comprehensive income should be amortised to profit or loss over the remaining life of the investment using the effective interest method in the case of an instrument with a fixed maturity. Any difference between the new amortised cost (being the asset's fair value at the date of reclassification) and its maturity amount should also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium or a discount. In the case of a financial asset that does not have a fixed maturity (e.g. a perpetual debt instrument reclassified from AFS to loans and receivables), the gain or loss should be recognised in profit or loss when the financial asset is sold or otherwise disposed of or impaired. If the reclassified financial asset is subsequently impaired, any previous gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss irrespective of whether or not the asset has a fixed maturity. [IAS 39:54]

A financial asset reclassified out of AFS to loans and receivables is subject to extensive disclosure requirements (see **4.1.4** in **chapter C12**).

4.5 Into HTM investments

A financial asset classified as at FVTPL may be reclassified to HTM if the financial asset is no longer held for the purpose of selling or repurchasing it in the near term [IAS 39:50(c)] and it meets the definition of a HTM investment. The criteria for reclassification are described in **4.2**.

A financial asset classified as AFS may be reclassified to HTM if the entity has the intent and ability to hold the asset to maturity. The asset may be reclassified during the instrument's life except during the two-year tainting period if the entity has disposed of more than an insignificant amount of HTM assets. When the two-year period subsequent to the period in which tainting occurred has passed, the entity is allowed to reclassify the assets back into HTM provided that it intends and is able to hold these assets to maturity. On the date of reclassification, an asset's carrying amount (i.e. its fair value at the date of reclassification) becomes the asset's new amortised cost. [IAS 39:54] Any previous fair value gain or loss on the asset that has been accumulated in equity is amortised to profit or loss over the remaining life of the financial asset using the effective interest method.

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4.6 Out of HTM investments

When, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as HTM, it is reclassified to AFS and remeasured at fair value. [IAS 39:51] The 'tainting' provisions of IAS 39 (see **3.3**) apply not only to sales but also to reclassifications of HTM investments. Therefore, reclassifications of more than an insignificant amount of HTM investments, which do not meet any of the conditions for permitted sales, taint the HTM portfolio and all remaining HTM investments must be reclassified into AFS.

On reclassification out of HTM into the AFS category, as a consequence of tainting, any difference between an asset's carrying amount and its fair value is recognised in other comprehensive income. [IAS 39:51 and IAS 39:55(b)] This difference must be disclosed in addition to the reason for reclassification. [IFRS 7:12]

When an entity taints its HTM portfolio in the current reporting period, and is required to reclassify all of its HTM investments into the AFS category, it does not restate its comparatives for the reporting period to reflect this change of classification, because this would conceal the impact of 'tainting' the portfolio.

4.7 Into loans and receivables

Reclassifications of financial assets classified either as at FVTPL or as AFS to the loans and receivables category are permitted in certain circumstances. The criteria for reclassifying out of these categories are described in **4.2** and **4.4**.

4.8 Out of loans and receivables

Although IAS 39 provides explicit guidance on reclassifications into loans and receivables, it is silent as to whether and when reclassifications out of loans and receivables are permitted or required. As the loan and receivable definition requires that the instrument is not quoted in an active market the Standard is not clear whether reclassification is permitted or required if the instrument becomes quoted in an active market after it is classified as a loan and receivable. Reclassification would only be permitted to an available-for-sale financial asset as reclassifications into the fair value through profit or loss category are expressly forbidden by IAS 39:50.

Due to the lack of specific guidance in IAS 39 an entity should determine an accounting policy whether financial assets should be reclassified from loans and receivables to available-for-sale financial assets in the case where the loans and receivables definition is no longer met. This policy should be applied consistently for similar events and circumstances for all loans and receivables. If an entity chooses reclassification as its accounting policy, it will need to reclassify as available-for-sale all items classified as loans and receivables that become quoted in an active market; it would not be appropriate for an entity to reclassify only some of its loans and receivables that become quoted in an active market. The date of reclassification should be the date when the market for the financial asset becomes active.

4.9 Summary of reclassifications

The summary of reclassifications below excludes investments in equity instruments (or derivatives linked to them and settled by delivery of an unquoted equity instrument) for which fair value is unreliable (see **4.10** and **4.11**).

Out of	Into	Criteria	Example
FVTPL	L&R	*Debt instrument meets the definition of L&R* The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future.	A trade receivable that at initial recognition was intended to be sold when that intent no longer applies.

Out of	Into	Criteria	Example
FVTPL	HTM	*Debt instrument does not meet the definition of loans and receivables (if the instrument met the definition of L&R it could not be reclassified to HTM because the HTM definition specifically excludes L&R)* The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset until maturity (this requirement applies for all HTM assets) and the circumstances are rare.	A debt security that at initial recognition was intended to be sold in the near term and is a security that is traded in an active market (e.g. corporate debt, government bond) and where the entity now considers it has the intent and ability to hold to maturity. The circumstances for the reclassification are deemed rare.
FVTPL	AFS	*Debt instrument meets the definition of L&R* The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future.	A trade receivable that at initial recognition was intended to be sold where the intent no longer applies.
FVTPL	AFS	*Equity instrument or debt instrument does not meet the definition of L&R* The asset is no longer held for the purpose of selling in the near term and the circumstances are rare.	A debt security that at initial recognition was intended to be sold and is a security that is traded in an active market (e.g. corporate debt, government bond). The circumstances for the reclassification are deemed rare.
AFS	L&R	*Debt instrument meets the definition of L&R* The entity has the intention and ability to hold the financial asset for the foreseeable future.	A trade receivable that at initial recognition was designated as AFS.

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[IFRS 13:72]

- Level 1 inputs comprise unadjusted quoted prices in active markets for identical assets and liabilities that the entity can access at the measurement date (see **10.2.1**);
- Level 2 inputs comprise other observable inputs not included within Level 1 of the fair value hierarchy (see **10.2.2**); and
- Level 3 inputs comprise unobservable inputs (including the entity's own data, which are adjusted, if necessary, to reflect the assumptions market participants would use in the circumstances) (see **10.2.3**).

Observable inputs are defined as "[i]nputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability". [IFRS 13:Appendix A]

Unobservable inputs are defined as "[i]nputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability". [IFRS 13:Appendix A]

The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs. [IFRS 13:72]

For example, if a fair value measurement for an asset is based on an unadjusted quoted price in an active market for an identical asset that the entity can access at the measurement date, this is categorised within Level 1 of the fair value hierarchy. In contrast, a valuation based on unobservable inputs would be categorised within Level 3. [IFRS 13:72]

When an entity approaches the measurement of an asset, or a liability, or an entity's own equity instrument, at fair value, it looks at the available valuation techniques and at the inputs available for these techniques. When selecting the techniques and inputs to be used, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs (see **section 8**). Once the selection has been made, each of the inputs is categorised within the fair value hierarchy outlined above; **10.2** summarises IFRS 13's requirements regarding the categorisation of inputs.

When an entity has determined the appropriate categorisation of the inputs into a fair value measurement, and has arrived at a measure of fair value using those inputs, it is then necessary to determine the appropriate categorisation of the fair value measurement in its entirety; this topic is discussed in **10.3**.

10.2 Categorisation of inputs to valuation techniques within the fair value hierarchy

10.2.1 Level 1 inputs

10.2.1.1 Level 1 inputs – general

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. [IFRS 13:76 & Appendix A]

A quoted price for an identical asset or liability in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except in any of the circumstances described in IFRS 13:79 (see below). [IFRS 13:77]

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]

Determining whether a market is active focuses on the trading activity for the individual asset or liability being measured and not on the general levels of activity in the market in which the asset or liability is traded. For example, a security listed on the FTSE in London or HKEx in Hong Kong could be considered to be traded in an inactive market if the security itself is traded infrequently.

IFRS 13:B37 sets out a list of factors that may indicate that there has been a significant decrease in the volume or level of activity for an asset or a liability relative to normal market activity for that asset or liability (or similar assets or liabilities) (see **9.5**).The presence of one or more of the factors listed in IFRS 13:B37 alone is not sufficient to conclude that a market is not active. An entity should evaluate the relevance and significance of these factors to the individual asset or liability measured at fair value in order to determine whether the market for that asset or liability is inactive. A market is not deemed inactive simply because of insufficient trading volume relative to the size of an entity's position.

The characterisation of a market as 'active' or 'inactive' may change as market conditions change. However, a decline in the volume of transactions for a particular asset or liability does not automatically mean that the market has become inactive. A market would still be considered active as long as the frequency and volume of relevant transactions are sufficient to provide ongoing pricing information.

Further, quoted prices from a market affected by a decline in the volume or level of activity should not be ignored unless the price is associated with a transaction that is not orderly. It is not appropriate to conclude automatically that all transactions occurring in a market

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exhibiting a significant decline in volume or level of activity are not orderly. IFRS 13:B43 sets out a list of factors that may indicate that a transaction is not orderly (see **9.6**). Very little weight should be given to prices observed for a transaction that is not orderly; more weight may be given to a price observed for an orderly transaction. However, the entity should evaluate carefully whether an adjustment may be needed to that price to ensure the fair value measurement is consistent with the objectives in IFRS 13.

When a financial asset or financial liability is exchanged in multiple active markets (e.g. on different exchanges), the entity will need to consider which market is the most relevant for measuring fair value. IFRS 13 states explicitly that the emphasis within Level 1 is on determining both of the following:

[IFRS 13:78]

- the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability (see **3.3**); and
- whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

When a quoted price in an active market is available, it should not be adjusted except in the circumstances listed below.

[IFRS 13:79]

- When an entity holds a large number of similar (but not identical) assets or liabilities (e.g. debt securities) that are measured at fair value and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities individually (i.e. given the large number of similar assets or liabilities held by the entity, it would be difficult to obtain pricing information for each individual asset or liability at the measurement date). In such circumstances, as a practical expedient, an entity may measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (e.g. matrix pricing – see **8.4**). However, the use of an alternative pricing method results in a fair value measurement categorised within a lower level of the fair value hierarchy.
- When a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events (such as transactions in a principal-to-principal market, trades in a brokered market or announcements) take place after the close of a market but before the measurement date. An entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a fair value measurement categorised within a lower level of the fair value hierarchy.
- When measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset (see **5.1.2**). If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorised within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorised within a lower level of the fair value hierarchy.

If an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability should be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity. That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. [IFRS 13:80]

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10.2.1.2 *Published net asset values for open-ended investment funds as Level 1 inputs*

Some open-ended investments funds not listed on a stock exchange may publish daily quotations of their net asset values (NAVs) at which redemptions or purchases of units occur without any adjustments to the published NAV. The redemptions and unit purchases may take place regularly at the quoted NAVs and there is no secondary market for the units because they are not transferrable (i.e. the sole transactions are issuances and redemptions of the units by the fund). These quoted NAVs may meet the definition of a Level 1 input provided that all of the elements of the definition in IFRS 13:76 (see **10.2.1.1**) are met.

Consequently, the following criteria must be satisfied:

- the price must be quoted in an active market (see **10.2.1.1**);
- the price must be unadjusted;
- the price must be for an asset or a liability that is identical to the asset or liability being measured; and
- the entity must have access to the price at the measurement date.

For the price to be classified as a Level 1 input, it is not required that there be an active market between the holders of the financial instrument and other potential holders that are not the issuer of the financial instrument; it is possible that the financial instrument does not

have an active market other than between the holders of the financial instrument and the issuer of the financial instrument.

Careful analysis is required when assessing whether such prices meet the definition of a Level 1 input. In particular, the assessment should include: (1) whether quoted prices are readily and regularly available; (2) whether transactions occur regularly; and (3) whether the regularly occurring transactions take place at the quoted (unadjusted price) on an arm's length basis.

10.2.2 Level 2 inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. [IFRS 13:81 & Appendix A]

Level 2 inputs include the following:

[IFRS 13:82]

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in markets that are not active;
- inputs other than quoted prices that are observable for the asset or liability, for example:
  - interest rates and yield curves observable at commonly quoted intervals;
  - implied volatilities; and
  - credit spreads; and
- inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

Under IFRS 13:82 (see above), when an entity measures the fair value of an asset or a liability and no Level 1 inputs are available, it may use quoted prices for 'similar' assets or liabilities in active markets as a Level 2 input. Equally, under IFRS 13:79(a) (see **10.2.1**), entities holding a large number of 'similar' assets or liabilities for which a quoted price is not accessible for all of the assets and liabilities being measured, may measure fair value using alternative pricing (e.g. matrix pricing) as a practical expedient.

IFRS 13 does not provide any specific guidance as to what is meant by 'similar' in this context. The identification of a similar asset or liability involves the exercise of judgement and requires both:

- an understanding of the terms and other factors that affect the fair values of the asset or liability being measured and the asset or liability for which the quoted price exists; and
- an identification and assessment of any differences in the terms and other factors that affect the fair values of these assets or liabilities.

In October 2008, the IASB's Expert Advisory Panel issued a report *Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active* which describes practices entities use when measuring financial instruments at fair value. Paragraph 32 of the report (quoted below) provides examples of the basic terms of a financial instrument with contractual cash flows. Entities may consider these terms, and any associated differences, when assessing whether the instrument for which a quoted price exists is 'similar' to the instrument being measured.

> "The basic terms of a financial instrument include, for example:
>
> (a) **the timing of the cash flows:** when the entity expects to realise the cash flows related to the instrument.
>
> (b) **the calculation of the cash flows:** for example, for a debt instrument the interest rate that applies (i.e. the coupon), or for a derivative instrument how the cash flows are calculated in relation to the underlying instrument or index (or indices).
>
> (c) **the timing and conditions for any options in the contract:** for example:
>
> (i) prepayment options (one or both parties can demand or make an early payment).
>
> (ii) extension options (one or both parties can extend the period of the instrument).
>
> (iii) conversion options (one or both parties can convert the instrument into another instrument).
>
> (iv) put or call options (one or both parties can exchange the instrument for a defined amount of cash or other assets or liabilities).
>
> (d) **protection of the rights of the parties to the instrument:** for example:
>
> (i) terms relating to credit risk in debt instruments, such as collateral, event of default and margin call triggers.
>
> (ii) subordination of the instrument, for example the priority of the instruments in the event of a winding up.
>
> (iii) the legal enforceability of the cash flows."

Further, paragraph 33 of the report notes that "to measure the fair value of an instrument it is necessary to assess the return that market participants would require on the instrument to compensate for" certain risks. This principle is largely consistent with the fair value measurement

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principles in IFRS 13. Accordingly, any differences between the compensation that market participants would require for the risk associated with the instrument being measured and the compensation required for the instrument for which a quoted price exists should be considered in determining whether the instruments are similar and whether an adjustment to the quoted price is necessary.

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. [IFRS 13:82]

Example 10.2.2

Determining how an input is classified when the item being measured has a specified contractual term

Company X enters into a fixed-price six-year agreement to sell 50 megawatts (MW) of on-peak electricity for delivery at location ABC beginning on 1 January 20X1 and continuing through to 31 December 20X6. On 31 March 20X1, Company X is measuring the fair value of the fixed-price agreement. Active market quotes are available for forward contracts to sell electricity at location ABC for two years (31 March 20X1 to 31 March 20X3). Accordingly, Company X will use the two years of observable forward pricing data and develop an expectation for the remaining 3 years and nine months (i.e. 1 April 20X3 to 31 December 20X6) using a model that relies on pricing data and weather patterns from the previous four years. The model also incorporates all relevant physical constraints (capacity of existing power plants and power plants expected to be completed near location ABC, projected supply and demand etc.).

In the circumstances described, the five-year and nine-month forward price curve represents a Level 3, rather than a Level 2, input.

An input for an item with a specified contractual term falls within Level 2 of the hierarchy only if it meets both of the following criteria:

- as required by IFRS 13:82 (see above), the input must be observable for substantially the full term of the asset or liability (see above); and
- the impact of the unobservable period must not be significant to the fair value of the asset or liability. The guidance set out in **10.3.3.2** should be applied when evaluating whether the effect of the unobservable period is significant.

IFRS 13:B35(b) cites as an example an interest rate swap with a term of 10 years and for which the fair value is determined using a swap rate based on a yield curve that is observable at commonly quoted intervals for nine years. The swap rate input is a Level 2 input 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.

In contrast, in the circumstances described, Company X can observe forward prices for only 24 months of the remaining 69-month term of the agreement (i.e. 35 per cent of the term). Because this does not represent substantially the

full term, the first criterion above is not met. An analysis of the second criterion is unnecessary; the forward price curve is considered a Level 3 input. However, if the forward price curve had been observable for substantially the full term, Company X would need to consider the second criterion (i.e. whether the effect of the unobservable term is significant to the fair value of the agreement) to determine whether the forward price curve is a Level 2 or Level 3 input.

Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:

[IFRS 13:83]

- the condition or location of the asset;
- the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in IFRS 13:39 – see **5.1.2**); and
- the volume or level of activity in the markets within which the inputs are observed.

An entity should consider whether adjustments to the quoted price for a similar asset or liability are necessary to reflect differences between the terms of the items being compared and other factors that may affect the fair values of those items. For example, the entity may need to make adjustments to reflect differences in the condition, location or risks (including non-performance risk and liquidity risk) of the items being compared.

Under IFRS 13:37, when a quoted price for the transfer of an identical or similar liability is not available and the identical item is held by another party as an asset, the fair value of the liability is measured 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 **5.1.2**).

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

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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 nine 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 (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; and
  (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 **9.5** to **9.7**). [IFRS 13:88]

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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). IFRS 13 does not require an entity to undertake exhaustive efforts to obtain information about market participant assumptions. However, the entity is required to take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement. [IFRS 13:89]

IFRS 13 provides the following examples of Level 3 inputs for particular assets and liabilities.

[IFRS 13:B36]

- **Long-dated currency swap** A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.
- **Three-year option on exchange-traded shares** A Level 3 input would be historical volatility, i.e. the volatility for the shares derived from the

shares' historical prices. Historical volatility typically does not represent current market participant expectations about future volatility, even if it is the only information available to price an option.

- **Interest rate swap** A Level 3 input would be an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.

10.2.4 *Determining the level within the fair value hierarchy when broker or pricing service quotes are used*

IFRS 13 allows the use of quoted prices provided by brokers or pricing services if the entity has determined that the quoted prices provided by a broker or pricing service are developed in accordance with IFRS 13. See **9.7** for more detailed guidance regarding when a quoted price provided by a broker or pricing service can be considered to be determinative of fair value.

When quoted prices are provided by a broker or pricing service, and are used by an entity in measuring the fair value of an asset or a liability, the following considerations are relevant for the entity's assessment of the level within the fair value hierarchy in which the quoted prices fall.

Level 1 inputs

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities. If the quote provided by a broker or pricing service relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date, the quoted price should be used to measure the fair value of the asset or liability without adjustment, subject to limited exceptions as discussed in IFRS 13:79 (see **10.2.1.1**).

If an adjustment is necessary in accordance with IFRS 13:79, or if the quoted price originates from a market that is not active, the broker or pricing service quote does not represent a Level 1 input.

Level 2 inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Observable inputs are defined in IFRS 13:Appendix A as "[i]nputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability [or own equity instrument]".

If a quote from a broker or pricing service meets any of the following criteria, it represents a Level 2 input.

- The entity can determine that the broker or pricing service quote itself represents a quoted price for similar assets or liabilities in active markets.
- The entity can determine that the quote is based on quoted prices for identical or similar assets or liabilities in markets that are not active, from transactions that are orderly and for which adjustments are based only on information that is (1) observable, or (2) market-corroborated, or (3) unobservable, but insignificant to the measurement.
- The entity can determine that the quote was established using a valuation technique and that the inputs the broker or pricing service used to arrive at the quoted price are observable or market-corroborated and any unobservable inputs do not have a significant effect on the measurement.
- The entity can corroborate the broker or pricing service quote or inputs using prices (1) from orderly transactions in an active market or (2) from orderly transactions in an inactive market for which any adjustment needed to ensure the price is representative of fair value is insignificant to the measurement.

In some circumstances, adjustments to the Level 2 inputs may be necessary, for example if the quoted price is based on a similar (but not identical) asset or liability. If an adjustment is required, an entity should determine whether the adjustment is significant to the entire measurement and whether it is based on unobservable inputs (see **10.3.3.2**). If this is the case, the entire measurement will be categorised within Level 3.

Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability. Broker or pricing service quotes meeting any of the following criteria are categorised in Level 3 of the fair value hierarchy.

- The entity can determine that the quote is based on a Level 1 or Level 2 input but an adjustment is required that is significant to the measurement and based on unobservable inputs.
- The entity can determine that the quote is based on unobservable inputs with a significant effect.

Regardless of whether the entity determines that the broker or pricing service quote is based on observable or unobservable inputs, it is not appropriate for an entity to accept, without further analysis, that the inputs used are appropriate in the circumstances. The entity must gain sufficient understanding of the inputs to be able to conclude that they reflect assumptions market participants would use, including assumptions about risks inherent in a particular valuation technique

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