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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IAS 39 *Financial Instruments: Recognition and Measurement* is superseded by IFRS 9 *Financial Instruments* which is effective for annual reporting periods beginning on or after 1 January 2018.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

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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.

	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

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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]

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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]

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).

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.

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(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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