

- the number of inches of rainfall or snow in a particular area;
- temperature in a particular area or for a specified period of time; and
- the severity of earthquakes.

If these contracts are not within the scope of IFRS 4, and they meet the definition of a derivative in **chapter C4**, they are within the scope of IAS 39. [IAS 39:AG1]

2.3.9 Instruments issued by Real Estate Investment Trusts (REITs)

In January 2010, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IFRS 4 and IAS 32, *Scope Issue for Investments in REITs*. In some jurisdictions, a Real Estate Investment Trust (REIT) is a tax or regulatory designation used for an entity investing in real estate that meets certain criteria, for example to attain preferential income tax status. The contractual terms of the ownership units of some such REITs require them to distribute 90 per cent of their total distributable income; distribution of the remaining 10 per cent of distributable income is at the discretion of management. The IFRIC received a request to provide guidance on whether the discretion to distribute the remaining 10 per cent of total distributable income met the definition of a discretionary participation feature as defined in IFRS 4. If the discretionary participation feature definition is met, IFRS 4 permits the ownership units to be classified as liabilities, rather than assessing the instrument for financial liability and equity components in accordance with IAS 32.

The IFRIC noted that the objective of IFRS 4 is to specify the financial reporting for insurance contracts and that the definition of discretionary participation feature in IFRS 4:Appendix A requires, among other things, that the instrument provides the holder with guaranteed benefits and that the discretionary participation feature benefits are additional to those guaranteed benefits. Further, the IFRIC noted that there must be guaranteed benefits to the holder for the definition to be met and that such guaranteed benefits are typically those present in insurance activities. The IFRIC noted that providing guidance on this issue would be in the nature of application guidance, rather than interpretative guidance. Consequently, the IFRIC decided not to add the issue to its agenda.

2.4 Contracts for contingent consideration in a business combination

Under IFRS 3(2008), contracts for contingent consideration which meet the definition of a financial instrument are within the scope of IAS 32, IAS 39 and IFRS 7 for both the acquirer and the seller. Paragraph BC349 in the Basis for Conclusions accompanying IFRS 3(2008) states that “the

boards noted that most contingent consideration obligations are financial instruments, and many are derivative instruments”.

However, if an entity still has contingent consideration balances arising from business combinations for which the acquisition date preceded the adoption of IFRS 3(2008), such balances are subject to the requirements of IFRS 3(2004) and, therefore, are not within the scope of IAS 32, IAS 39 or IFRS 7. This exemption only applies to the acquirer and not to the seller.

2.4-1

Contracts for contingent consideration in a business combination

A seller's contract for contingent consideration is within the scope of IAS 32, IAS 39 and IFRS 7. The seller will recognise a financial asset arising from the contract for contingent consideration. The measurement of this financial asset will depend on the facts and circumstances of the contractual arrangement. Because the cash flows under the contract for contingent consideration are often derived from an underlying such as the future performance of the entity that has been sold, the asset will often meet the definition of a derivative in its entirety (see **chapter C4**) and will therefore be measured at fair value through profit or loss. Alternatively, the contingent consideration asset may be partly a loan and receivable measured at amortised cost to the extent that part of the consideration is not contingent with a non-closely related embedded derivative measured at fair value through profit or loss (see **chapter C5**) if the whole contingent consideration is not designated as at fair value through profit or loss at initial recognition.

2.5 Contracts to buy or sell non-financial items

IAS 32, IAS 39 and IFRS 7 deal primarily with contracts that are financial items; however, they also capture some contracts to buy or sell non-financial items. Contracts to buy or sell non-financial items that can be settled net (either in cash or by exchanging financial instruments) are within the scope of IAS 32, IAS 39 and IFRS 7 unless they were entered into, and continue to be held, for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. [IAS 39:5]

2.5.1 Net settlement

Net settlement can be in cash, another financial instrument, or by exchanging financial instruments. It can be achieved in many ways: [IAS 39:6]

- the contractual terms may permit either party to settle net in cash or by exchanging financial instruments;

- (b) settlement may not be explicit under the terms of the contract, but the entity may have a past practice of net settling similar contracts (see 2.5.3);
- (c) for similar contracts, the entity may have a past practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term price fluctuations or from dealer's margin; or
- (d) the non-financial item that is the subject of the contract may be readily convertible to cash.

2.5.2 Non-performance penalties

The terms of a contract need to be evaluated in detail because net settlement provisions may be implicit rather than explicit.

A non-performance penalty in a purchase order, when the amount of the penalty is calculated by reference to changes in the price of the item that is the subject of the contract, is an example of an implicit net settlement provision.

2.5.2-1

Non-performance penalty equivalent to net settlement – example

Entity A enters into a forward purchase agreement with Entity B to buy 100 units of a commodity at CU1.00 per unit. Entity A defaults on the forward contract when the prevailing market price of the commodity is CU0.75 per unit. Under the terms of the contract, Entity A is required to pay Entity B a non-performance penalty of CU25, i.e. $100 \times (CU1.00 - CU0.75)$. The non-performance penalty represents an implicit net settlement provision.

Conversely, fixed penalties or normal handling fees do not amount to net settlement.

2.5.2-2

Non-performance penalty not equivalent to net settlement – example

Entity A enters into a contract to purchase wheat which will be used in its manufacturing operations. The delivery contract requires a non-performance penalty of CU1 million if Entity A fails to take delivery of the wheat. This is a fixed penalty and does not provide for net settlement because the amount of CU1 million is not based on changes in the price of wheat (the reference asset).

2.5.3 Past practice

Contracts where there is a past practice of either net settling or purchasing and selling the underlying within a short period after delivery with a view to making a short-term profit (i.e. (b) or (c) in the list at 2.5.1) are always within the scope of the financial instruments Standards. It cannot be argued that such contracts have been entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, because the entity's activities clearly indicate that this is not the case.

2.5.3-1

Rolling contracts until physical delivery – example

Entity C is in the business of milling maize and using it in its production process. Entity C's procurement strategy for maize includes purchasing futures on a futures exchange. Due to the significant quantity of maize needed, Entity C enters into forward purchases of maize to secure the level required for the running of its business. The intention at the outset is to take physical delivery of the maize under these contracts.

In January 20X6, Entity C secures maize for its 20X6 requirements. The longest available maturity of maize futures contracts is to July 20X6. Entity C's purchasing policy requires it to secure maize at least for nine months, i.e. as far out as September 20X6. Accordingly, Entity C enters into a larger number of July 20X6 contracts with a view to rolling some of them to September 20X6.

In April 20X6, Entity C will close out some of its July 20X6 futures at market value at the time, and take out September 20X6 futures. As a result, Entity C will take physical delivery of the maize under the September contracts only.

Entity C's practice of net settling some of its July futures contracts (i.e. its practice of net settling similar contracts) prevents it from arguing that it enters into futures contracts for the receipt of maize in accordance with its expected purchase, sale or usage requirements. Accordingly, both the July and September contracts are within the scope of IAS 39.

As the contract meets the definition of a derivative, fair value gains and losses would be recognised in profit or loss unless it was designated as hedging instrument in a cash flow hedge, for example, as a hedge of the forecast purchase of inventory. Effectiveness could not be presumed due to differences in the derivative's term and the timing of the forecast transaction (a July contract for a September transaction), and would need to be demonstrated.

Example 2.5.3**Choice of cash or physical settlement (1)**

[Extract from IAS 39:IG.A.1]

Entity XYZ enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper.

If XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IAS 39. Instead, it is accounted for as an executory contract [*i.e. outside the scope of IAS 39*].

2.5.3-2**Choice of cash or physical settlement – example (2)**

Entity A is a copper manufacturer. Entity A enters into forward contracts to sell its copper cathode to its customers. The forward contracts are homogenous and permit Entity A to either:

- provide physical delivery of copper at the end of the contract; or
- pay or receive a net settlement in cash based on the change in fair value of copper.

Based on its inventory levels and its production capacity, Entity A is able to meet the obligation to deliver copper if it decides to provide physical delivery of copper for all of its outstanding forward sales contracts.

The stated intention in entering into the forward sales contracts is for the purpose of delivery of copper in accordance with its sales requirements. Historically, Entity A has a practice of net settling a portion of similar forward contracts, provided that the contracts are in the money. For contracts that are out of the money, historically Entity A has opted for physical delivery.

These contracts are all homogenous and the fact that Entity A has a past practice of net settling a portion of similar forward contracts means that it cannot assert that the contracts are held for the purpose of the delivery of copper in accordance with its expected sale requirements. Accordingly, the forward contracts are in the scope of IAS 39 and will be accounted for as derivatives.

2.5.3-3**Past practice of net settling – net settling as part of normal operating cycle**

In some circumstances, an entity will net settle as part of its normal operating cycle, as opposed to net settling in order to generate profits from short-term movements in prices. This is particularly common for utility entities that need to balance the demand from their customers with their supply contracts. For example, a retail gas supplier purchases gas under long-term take-or-pay contracts where if it does not take physical delivery of gas it has to pay a fixed monetary amount per unit. The buyer's intent is to use the contracted volumes it takes delivery of to serve its customers. However, the demand in certain periods (usually in the summer months) may fall below the minimum required contractual take. In this case, the buyer is forced to settle net, *i.e.* pay amounts without receiving gas, because the relative scarcity of natural gas storage capacity makes it difficult to store it for later use (storage of electricity is effectively impossible, so a similar situation is likely under a power contract). This 'balancing' activity is common for gas and power entities serving retail customers because customer demand forecasts cannot be precise. The practice of net settling similar contracts needs to be considered in determining whether the long-term contracts meet the definition of own use requirements contracts for the purpose of applying the IAS 39 scope exemption.

It is a matter of judgement what is past practice of net settlement. An entity will need to consider its historical behaviour, reasons for past net settlement, and relative frequency. In some cases, it may be argued that an occurrence of a net settlement in the past was the result of an isolated non-recurring event that could not have been reasonably anticipated.

2.5.4 Written options

In addition to the restriction on contracts when there is a past practice of settling net or a practice of taking delivery of the underlying and selling it within a short period after delivery, a written option to buy or sell a non-financial item that can be settled net contractually or when the non-financial item is readily convertible to cash is always within the scope of IAS 39. [IAS 39:7]

2.5.4-1**Written call option with no net settlement – example**

Entity X owns an office building. It writes Entity A an option, allowing Entity A to purchase the office building for a fixed price on a future date. The terms of the contract do not allow for it to be net settled, and the

2.5.4-4**Unit of account for forward contracts with volumetric optionality**

In March 2010, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision on IAS 39, *Unit of Account for Forward Contracts with Volumetric Optionality*. The IFRIC had received a request to provide guidance on whether a contract that:

- (a) obliges an entity to deliver (sell) at a fixed price a fixed number of units of a non-financial item that is readily convertible to cash; and
- (b) provides the counterparty with the option to purchase, also at a fixed price, a fixed number of additional units of the same item

can be assessed as two separate contracts for the purpose of applying IAS 39:5 to 7.

For example, an entity enters into an agreement to buy 100 units of a non-financial item that is readily convertible into cash, which includes a right to purchase a further 15 units at the same contracted price. These contracts are often referred to as having 'volumetric flexibility'.

The IFRIC recognised that diversity exists in practice and noted that the Board has accelerated its project to develop a replacement for IAS 39. At the time of its decision the IFRIC expected the Board to issue a comprehensive replacement Standard by the end of 2010. The agenda decision stated the Board will consider the scope of IAS 39, including the guidance about contracts to buy or sell non-financial items in IAS 39:5 to 7, as part of the replacement Standard. Consequently, the IFRIC decided not to add this issue to its agenda.

Since IFRIC's discussion, IFRS 9 (the replacement for IAS 39) has been completed and this particular issue was not deliberated as part of the finalisation of the new standard and consequently no further guidance has been provided in this area. Because IAS 39 assesses financial instruments on a contract-by-contract basis, when assessing whether the terms of the arrangement meet the own use and net settlement requirements in IAS 39:5 to 7, it is appropriate to view the unit of account as the whole contract. Using the example described above, if the seller concludes that the option on the 15 units is a written option, then the whole contract for 115 units is a written option. The contract is a single contract over 115 units and, therefore, it is not appropriate to split it into (1) a forward over 100 units classified as a normal usage requirements contract outside the scope of IAS 39, and (2) a written option over 15 units within the scope of IAS 39.

2.5.5 Expected purchase, sale and usage requirements

Non-optional contracts or purchased options over non-financial items where either the terms of the contract permit net settlement, or where the

non-financial item that is subject to the contract is readily convertible to cash (e.g. many commodity contracts) must be assessed to see if they were entered into for the receipt or purchase of the item in accordance with the entity's expected purchase, sale or usage requirements.

2.5.5-1**Purchase contract with possible net settlement – example**

Entity X enters into a fixed price forward contract to purchase one million tonnes of copper. Copper is traded on the London Metals Exchange and is readily convertible to cash. The contract permits Entity X to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Entity X does not have a practice of settling similar contracts net or taking physical delivery of copper and selling it within a short period after delivery for the purposes of generating a profit from short-term fluctuations in price.

In order for the contract to be scoped out of IAS 39, Entity X needs to demonstrate that the contract was entered into and continues to be held for the purpose of the receipt of copper in accordance with its expected purchase or usage requirements. In addition to past practice, factors like the quantities involved, quality and grades of the commodity, and delivery locations would need to be considered.

2.5.5-2**Cash settlement option – is it relevant for 'own use' exemption assessment which party has choice of net cash settlement?**

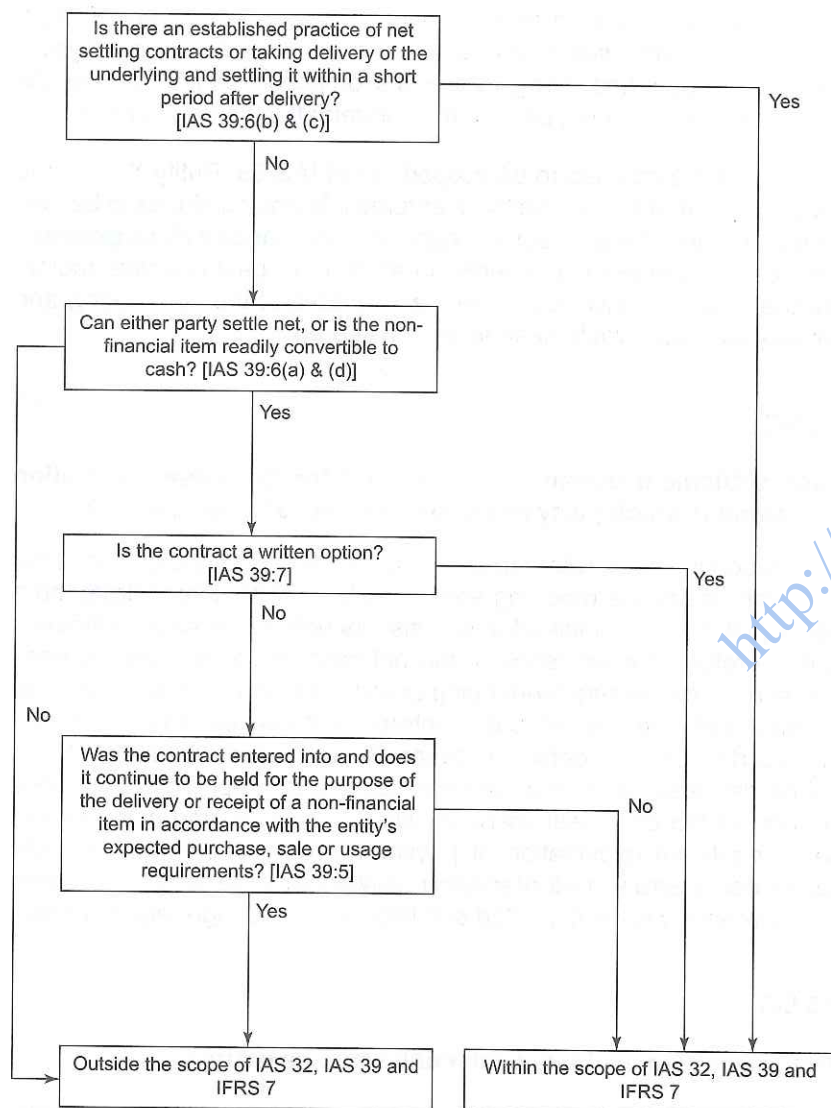
If the reporting entity, rather than the counterparty, has the choice of net cash settlement, the reporting entity may be able to demonstrate more easily that it does not intend to exercise its right to net cash settlement and, therefore, the existence of the net cash settlement feature does not result in the arrangement being scoped into IAS 39. If the choice of net cash settlement is with the counterparty, it may be more difficult for the reporting entity to demonstrate that it expects the non-financial item will be delivered under the contract because the reporting entity does not control the cash settlement decision. If the reporting entity cannot demonstrate an expectation of physical delivery, the reporting entity cannot demonstrate that it intends to receive/deliver the non-financial item in accordance with its expected purchase, sale or usage requirements.

2.5.5-3**Requirement to evaluate each contract in its entirety**

Each contract must be evaluated in its entirety. For example, an entity may have a contract for 100 units, but its expected usage requirement

is only 80 units. The entity intends to net settle the part of the contract it does not need in its normal course of business. Such partial net settlement can be achieved in different ways (e.g. by entering into an offsetting contract for 20 units, or by taking delivery of all 100 units and selling 20 immediately). The entire contract falls within the scope of IAS 39 because the entire contract cannot be argued to be in accordance with the entity's expected usage requirements.

The following decision tree illustrates how to evaluate whether contracts to buy or sell non-financial items are within the scope of IAS 32, IAS 39 and IFRS 7.



2.5.5-4

Assessment of 'own use exemption' for contracts with similar terms that may be entered for different reasons within a group

Entities may enter into multiple contracts with the same contractual terms for different reasons. Care needs to be taken in determining whether the contracts themselves should have the same accounting treatment or not. One subsidiary in a group may enter into contracts to buy non-financial items that are used in the group's production processes for the provision of finished goods and that are always physically delivered. A separate part of the group may enter into contractual arrangements with the same contractual terms but that are not always physically delivered (e.g. this separate business may cash settle the contracts or enter into offsetting contracts as part of a trading strategy). From a group perspective, it may be possible to differentiate the two portfolios of contracts in the two separate businesses and, therefore, account for them differently. Such differentiation will only be appropriate if:

- the contracts are entered into separately and not in contemplation of each other;
- there are no transfers between the businesses within the group;
- the businesses are managed independently of each other; and
- the strategies of the businesses are sufficiently different that the different settlement behaviour of each business is reasonable.

In practice, it is unlikely that such a distinction is possible because different parts of a group often choose to transact with each other rather than entering separately into offsetting transactions outside the group, which would result in additional transaction costs.

2.5.5.1 Meaning of delivery

2.5.5.1-1

Meaning of delivery: contracts to sell refined gold – example

Entity A is a gold producer that regularly enters into contracts with its customers to sell refined gold at a fixed price. To supply its customers, Entity A has to assign a gold refiner to refine the estimated amount of gold doré (i.e. gold that is less pure than refined gold). When refining is complete, the refiner allocates to the producer's account an equivalent quantity of refined gold, which is then allocated to the account of

that the scope exclusions for derivatives over own equity that meet the definition of equity also applies to non-derivatives that meet the definition of equity because the justification in the Basis for Conclusions of IFRS 7 would be equally relevant.

3.2 Forward contracts to buy or sell an acquiree in a business combination

Forward contracts between an acquirer and a selling shareholder in a business combination to buy or sell an acquiree that will result in a business combination within the scope of IFRS 3 are outside the scope of IAS 39. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction. The application of IAS 39:2(g) is assessed at the time the holder enters into the derivative contract. If the contract is a forward contract, whether partly prepaid or not, which will lead to a certain business combination, the exemption applies and the forward contract is outside the scope of IAS 39. Contracts that have settlement alternatives that may not result in all cases in the delivery of shares to the acquirer will be within the scope of IAS 39 because the exemption within IAS 39:2(g) will not apply.

The above scenarios should be distinguished from contracts between an acquirer and vendor that are options to buy or sell a business in the future. IFRS 10 requires an assessment of whether substantive potential voting rights alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities of the entity and potentially control the entity. Under IFRS 10, if control does exist, the parent's proportion of the acquiree in the consolidated financial statements is determined taking into account the present ownership interests which do not reflect the possible exercise or conversion of potential voting rights. In such circumstances, the ownership interest that excludes the exercise of the currently exercisable option is a subsidiary because there is control and, therefore, it will be necessary to consider whether the currently exercisable option (to acquire a non-controlling interest) meets the definition of equity in the consolidated financial statements (see **section 6 of chapter C3**). If the option meets the definition of equity, it is outside the scope of IAS 39. Otherwise, it will be within the scope of IAS 39 and the exemption in IAS 39:2(g) does not apply.

If the option is currently exercisable and it gives the holder the ability to control the target entity, and it is an in-substance present ownership interest, then in accordance with IFRS 10:B90 control exists and the parent's proportion of the acquiree in the consolidated financial statements is determined reflecting the in substance present ownership interest. The option is not subject to the requirements of IAS 39 in such circumstances because it is treated as a present ownership interest rather than being a derivative to acquire such an interest in the future.

If the option is not currently exercisable and would give the holder the ability to control the target entity only when it becomes exercisable, the scope exemption within IAS 39:2(g) also does not apply. The option will not always result in a business combination to buy or sell an acquiree at a future date and therefore is in the scope of IAS 39.

3.2-1

Options to buy or sell an acquiree in a business combination – example

Entity A has purchased a call option to buy 100 per cent of the ordinary shares in Entity X from Entity B and, at the same time, has written a put option to Entity B allowing Entity B to put its 100 per cent stake in Entity X to Entity A. The exercise dates and strike prices of the two options are the same.

The options are not currently exercisable, but the period until the exercise date does not exceed a reasonable period normally necessary to obtain any required approvals to complete a business combination.

It is not acceptable for Entity A to apply the scope exemption IAS 39:2(g) and treat the call option and the put option as outside the scope of IAS 39 on the basis that the combination of the put option and the call option is economically equivalent to a forward contract that would result in a business combination that is certain to occur.

The scope exclusion in IAS 39:2(g) is specifically restricted to forward contracts only and excludes option-based contracts. Paragraph BC24B of the Basis for Conclusions on IAS 39 specifically refers to the Board's conclusion that IAS 39:2(g) should not apply to option contracts.

Furthermore, IAS 39:BC24C states that the purpose of IAS 39:2(g) is to exempt from the provisions of IAS 39 contracts for business combinations that are firmly committed to be completed. Once the business combination is consummated, the entity follows the requirements of IFRS 3. This paragraph applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time is required). Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.

The combination of a written put option and a purchased call option is not the same as a forward contract to buy the shares in Entity X because there is no binding obligation on either party to exercise its option. Exercise of the options is contingent on factors other than the passage of time because either the holder of the purchased call option (Entity A) or the holder of the written put option (Entity B) could choose

represent an acquisition of the constituent assets of the investee. The purpose of IAS 39:2(g) is to exempt from the provisions of IAS 39 contracts for business combinations that are firmly committed to be completed. Once the business combination is consummated, the entity follows the requirements of IFRS 3. IAS 39:2(g) applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time is required). This contrasts with option contracts, which allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.

3.3 Certain reimbursement rights

Rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance with IAS 37, or for which, in an earlier period, it recognised a provision in accordance with IAS 37, are outside the scope of IAS 39. [IAS 39:2(j)] Such rights are within the scope of IAS 37 and are recognised as a separate asset when, and only when, it is virtually certain that the reimbursement will be received if and when the entity settles the liability. [IAS 37:53]

3.4 Rights and obligations under lease contracts

Rights and obligations under lease contracts may meet the definition of a financial instrument. For example, in a finance lease, a lease receivable recognised by the lessor represents the lessor's right to receive a stream of cash flows. This receivable is substantially the same as blended payments of principal and interest under a loan agreement. Accordingly, a finance lease is a contract that gives rise to a financial asset from the lessor's perspective. Similarly, a lease liability recognised by a lessee represents the lessee's obligation to pay cash and gives rise to a financial liability from the lessee's perspective.

Under IFRS 16 *Leases*, a lessor does not recognise its entitlement to receive lease payments under an operating lease. The lessor continues to account for the underlying asset itself rather than any amount receivable in the future under the contract. Accordingly, a lessor does not regard an operating lease as a financial instrument (except as regards individual payments currently due and payable by the lessee).

IFRS 16 *Leases* sets out the accounting framework for leases, however:

- lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of IAS 39 (see **section 3 of chapter C8** and **section 5 of chapter C6** respectively);
- lease liabilities recognised by a lessee are subject to the derecognition requirements of IAS 39 (see **section 4 of chapter C8**);

- derivatives embedded in lease contracts are subject to the embedded derivative requirements of IAS 39 (see **section 9 of chapter C5**); and
- lease liabilities, finance lease receivables and the payments currently due and receivable by the lessor under an operating lease are subject to the disclosure and presentation requirements of IFRS 7 and IAS 32.

3.5 Loan commitments

Loan commitments that cannot be settled net in cash or another financial instrument are outside the scope of IAS 39, unless the entity designates them as financial liabilities at fair value through profit or loss. If an entity has a past practice of selling the asset resulting from a loan commitment shortly after its origination, it should apply IAS 39 to all loan commitments in the same class. [IAS 39:4(a)]

Loan commitments that can be settled net in cash or another financial instrument are derivatives within the scope of IAS 39. Instalment payments do not constitute net settlement. Thus, for example, a mortgage construction loan that is paid out in instalments in line with the progress of the construction is not within the scope of IAS 39. [IAS 39:4(b)]

3.5-1

Loan commitments

A financial institution may write a loan commitment to a large corporate borrower as a lead lender with the expressed intention of selling part of the loan to other financial institutions immediately when lent. The intention to sell part of the loan is part of the financial institution's predetermined credit risk management. At the inception of the loan commitment, the financial institution cannot assert that it does not have a past practice of selling the asset resulting from a loan commitment shortly after its origination and, therefore, it cannot consider the loan commitment wholly outside the scope of IAS 39. The financial institution may be able to demonstrate that, consistent with its predetermined credit risk management, only part of the loan that may be originated from the loan commitment is intended to be sold and, if so, that only that proportion of the loan commitment is in the scope of IAS 39 and is measured at fair value through profit or loss. If the loan is originated, the part of the loan commitment that is measured at fair value through profit or loss will be derecognised and will be incorporated into the initial carrying amount of the resulting loan.

If an entity commits to providing a loan at a below-market interest rate, it should initially recognise the written commitment at fair value. Subsequently, the commitment is measured at the higher of: [IAS 39:47(d)]

- (i) the amount determined under IAS 37; and

When the fee paid by the holder is more in the nature of a facility fee such that the amounts and timing of the drawdown and the repayment of the borrowing can vary at the discretion of the borrower (e.g. an overdraft fee), it would not be appropriate to capitalise the fee as a transaction cost when amounts are drawn down. The fee is not specific to an amount borrowed and, therefore, a systematic release of the fee over the period of the facility is more appropriate.

3.5.2 Loan commitment where the loan includes a non-closely related embedded derivative

3.5.2-1

Loan commitment where the loan includes a non-closely related embedded derivative

When the loan to be originated under a loan commitment will be in the scope of IAS 39 and will include a non-closely related embedded derivative (see **section 3 of chapter C5**), the question arises as to whether it is still permissible for the loan commitment to be scoped out of IAS 39 for the writer or the holder of the loan commitment. Once the loan is originated under the commitment, if it is under IAS 39 the non-closely related embedded derivative will be separated from the host loan contract and separately accounted for at fair value through profit or loss (unless the whole loan is designated at fair value through profit or loss at initial recognition – see **3.1 in chapter C2** and **7.1.2 in chapter C3**). It could be argued that applying the scope exemption in such circumstances creates a measurement inconsistency between the measurement of the loan commitment (outside the scope of IAS 39 and not measured at fair value) and the subsequent measurement of the loan (within the scope of IAS 39 and either wholly at fair value through profit or loss if so designated or in part measured at fair value in the case of a separately recognised embedded derivative). However, it should be noted that IAS 39 already allows such a measurement inconsistency when a loan commitment that will result in a loan not containing any embedded derivatives is outside the scope of IAS 39 (and not measured at fair value) and the loan subsequently originated under the commitment is designated at fair value through profit or loss under certain conditions. Therefore, it seems appropriate that the scope exemption for loan commitments that will result in loans with separately accounted embedded derivatives under IAS 39 should still apply if the relevant conditions are met (i.e. the loan commitment cannot be settled net in cash, the entity has not designated it as at fair value through profit or loss, and the entity does not have a past practice of selling the assets resulting from loan commitments shortly after origination).

To illustrate, Entity X may enter into a firm commitment to lend to Entity Y. The loan to be originated under the commitment will be a loan

that the lender can convert into a fixed number of equity shares of the borrower. Once originated, the lender will have a loan asset with a separate non-closely related embedded derivative if the analysis in the paragraph above would apply. For Entity X the loan commitment would be outside the scope of IAS 39.

From Entity Y's perspective, the loan commitment is a right jointly to borrow cash and issue a derivative over its own equity. The loan commitment is partly a derivative over debt and partly a derivative over a derivative over own equity. The definition of a financial liability (see **section 2 of chapter C3**) makes it clear that a derivative over a derivative over own equity would itself not meet the definition of equity and, therefore, it could be argued that the loan commitment can be considered to be within the scope of IAS 39. However, IAS 39:BC15 recognises that all loan commitments are in fact derivatives that are excluded from the scope of IAS 39. Consequently, it is reasonable to consider such a loan commitment for Entity Y as also being outside the scope of IAS 39.

4 Future developments

In July 2014 the Board finalised IFRS 9. When IFRS 9 is effective it will replace IAS 39. The effective date of IFRS 9 is for annual reporting periods beginning on or after 1 January 2018.

The scopes of IFRS 9 and IAS 39 are substantially aligned. A major difference is IFRS 9 extends the scope of financial instruments accounting to include more non-financial contracts than are permitted in IAS 39. IFRS 9 permits, at initial recognition, to irrevocably designate as measured at fair value through profit or loss a contract to buy or sell a non-financial item that can be settled net in cash or another financial asset, or by exchanging financial instruments, as if the contract was a financial instrument, that was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. An entity may make this designation only if doing so eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of IFRS 9.

A further difference between the scope of IFRS 9 and IAS 39 is that the impairment requirements of IFRS 9 apply to all issued loan commitments that are not measured at fair value through profit or loss as compared to the scope of IAS 39 which requires issued loan commitments to be measured in accordance with IAS 37 if they are not in the scope of IAS 39.

return was indexed to the country's Gross Domestic Product (GDP). The Committee noted that the fact pattern submitted was based on the assumption that indexation to the issuer's GDP is a non-financial variable specific to a party to the contract. The September 2012 IFRIC Update states:

"The Interpretations Committee noted that the question of what constitutes an underlying that is a non-financial variable specific to a party to the contract had been considered on several previous occasions by itself and by the IASB. Consequently, the Interpretations Committee was concerned that it would not be able to resolve the issue efficiently within the confines of existing IFRSs and the Conceptual Framework and the demands of the Interpretation process and that it was not likely that it would be able to reach a consensus on the issue on a timely basis. The Interpretations Committee therefore considered that the question of whether the assumption in the submission is appropriate would remain open."

Neither IAS 39 nor any other IFRS Standard addresses whether the exclusion from the definition of a derivative is limited to insurance contracts and the phrase continues to be subject to varying interpretations. Both the Board and the Committee have considered this question in the past, but to date no clarifying guidance has been issued.

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

Accounting policy 1

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

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

- IAS 39:IG.A.2 *Option to put a non-financial asset* – in which an option to put an office building that can be either physically settled or net cash settled is a derivative; and
- IAS 39:IG.B.8 *Definition of a derivative: foreign currency contract based on sales volume* – in which a contract based on foreign currency and sales volume is a derivative.

Accounting policy 2

The inclusion of the term 'non-financial variable specific to a party to the contract' is broader than simply excluding insurance contracts from the definition of a derivative. Therefore, a contract (other than an insurance contract) that is either fully or partly in the scope of IAS 39 may have a non-financial variable that is specific to a party to the contract and, consequently, it may not meet the definition of a derivative.

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

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

For an underlying to be specific to a party to the contract the underlying must be unique to the party. For example, an entity's real estate may be specific to the party to the contract. However, commodities may not be specific to the party when they are fungible and readily tradeable. For example, an entity's inventory of gold may not be specific to the party to the contract as it is not distinguishable from the same commodity held by a different party.

A change in the fair value of a non-financial asset is specific to the owner if the fair value affects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car. [IAS 39:AG12A]

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

Under this policy, when the feature does not meet the definition of a derivative, and therefore does not meet the definition of an embedded derivative, consideration will need to be given to the implications of this on the computation of the effective interest rate when the feature is included in a contract that is a debt instrument in the scope of IAS 39.

Even though an embedded derivative is not recognised, changes in the value of the feature may still be recognised immediately in profit or loss through the application of IAS 39:AG8 which requires the re-estimation of cash flows discounted at the original effective interest rate.

2.2 Notional amounts and payment provisions

2.2-1

Definition of derivative: interaction of notional amount and underlying

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

2.2-2

Payment provision based on interest rates – example

Entity A receives CU200 to enter into a contract that requires it to pay CU500 if 6-month LIBOR increases by 75 basis points over the next six months. Even though this contract does not have a notional amount, it contains a payment provision that does not move proportionally with the underlying. [IAS 39:AG9]

2.2-3

Payment provision based on share price – example

Entity X enters into a contract that requires it to pay CU10 million if Entity A's share price increases by CU5 per share during a six-month period; conversely Entity X will receive CU10 million if Entity A's share price decreases by CU5 per share during the same six-month period.

In this example, the underlying is the price of Entity A's shares. There is no notional amount to determine the settlement amount. Instead,

there is a payment provision that does not move proportionally with the underlying. The absence of a notional amount does not preclude the instrument from meeting the definition of a derivative because there is a payment provision.

It is sometimes the case that a contract has neither a notional amount nor a fixed payment provision. In addition, a contract may have multiple underlyings.

2.2-4

Foreign currency forward contract linked to sales – example

Entity X, a euro functional currency entity, sells products in Switzerland. The sales are denominated in Swiss francs. Entity X enters into a contract with an investment bank to convert Swiss francs to euros at a fixed exchange rate. The contract requires Entity X to remit Swiss francs based on its sales volume in Switzerland in exchange for euros at a fixed exchange rate of 1.60.

The contract with the bank has two underlyings (sales volume and the €/SFr exchange rate). The contract does not have a specified notional amount or a fixed payment provision, but still meets the definition of a derivative. [IAS 39:IG.B.8]

2.2-5

Multiple underlyings, including a climatic underlying – example

Entity X enters into a fixed price forward contract to purchase one million shares of Entity B, a public company that owns and manages holiday resorts in Country Z. The forward contract is priced at market value and has a conditional underlying that is based on the number of sunny days in Country Z in June. If there are less than 10 days of sunshine in Country Z in June, the forward contract is terminated for nil consideration.

The forward contract has two underlyings: (1) Entity's B's equity price, and (2) the number of days of sunshine in Country Z in June.

IAS 39:AG1 states that derivatives based on climatic, geological, or other physical variables are in the scope of IAS 39 unless they meet the definition of an insurance contract in IFRS 4. In the scenario described above, the weather feature does not qualify as an insurance contract. An insurance contract requires the issuer to accept significant insurance

risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. Therefore, the instrument is wholly a derivative within the scope of IAS 39 and should be accounted for at fair value through profit or loss.

2.3 Interaction of notional amounts with the underlying

2.3-1

Interaction of notional amount and underlying

The settlement amount of a derivative instrument with a notional amount is determined by the interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants.

2.3-2

Interest rate swap – example (1)

Entity X enters into an interest rate swap that requires Entity X to pay a fixed rate of interest and receive a variable rate of interest. The fixed interest rate amount is 7.5 per cent, while the variable interest rate amount is 3-month LIBOR, reset on a quarterly basis. The notional amount of the swap is CU100 million.

The underlying is an interest rate index, 3-month LIBOR. Net regular settlements are calculated by applying the difference between 7.5 per cent and 3-month LIBOR to the notional amount of CU100 million.

2.4 Initial net investment

The second part of the definition of a derivative is that there is either no initial net investment, or that any initial investment is smaller than would be required for other contracts that are expected to have a similar response to changes in market factors. This is a comparative measure, and excludes any margin accounts. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take a form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately. [IAS 39:IG.B.10]

Various examples are set out in the following sections.

2.4.1 Interest rate swaps

2.4.1-1

Interest rate swap – example (2)

Entity B enters into a contract with a counterparty that requires it to pay a LIBOR-based variable rate of interest, and receive a fixed rate of 8 per cent. The contract is an interest rate swap with a notional amount of ¥10 billion. Entity B did not pay or receive cash at inception (i.e. the contract is at-market at inception) and, therefore, does not require an initial net investment by either party.

2.4.1-2

Initial net investment: interest rate swap

In some instances, the terms of the interest rate swap may be favourable or unfavourable and may require one of the parties to make an upfront initial investment in the contract. If the initial investment represents a premium or discount for market conditions, the initial net investment would normally still be smaller than the notional amount on the debt instrument from which the interest rate cash flows are derived, and so would satisfy the initial net investment criterion of a derivative.

2.4.1.1 Interest rate swap with fixed leg prepaid

2.4.1.1-1

Prepaid fixed leg – example

Entity X enters into an eight-year pay fixed at 7 per cent, receive LIBOR interest rate swap on CU100 million. It prepays the fixed leg at inception. The amount it pays is calculated as CU7 million (CU100 million × 7 per cent) for eight years, discounted at market rates.

This initial payment is significantly less than the amount Entity X would have to pay to acquire an instrument that would have a similar response to changes in market factors. Entity X would need to acquire CU100 million debt with a LIBOR return in order to replicate the return on the floating rate leg of the swap. Therefore, the swap with a prepaid fixed leg will still meet the definition of a derivative.

If the fixed rate payment obligation on the interest rate swap is prepaid after initial recognition, the payment would be considered termination of the old swap and an origination of a new instrument that would need to be classified for the first time. [IAS 39:IG.B.4]

that a gambling contract is not an insurance contract and is outside the scope of IFRS 4.

The inability to trade or sell the wager contract to another party does not preclude the wager from qualifying as a financial asset or financial liability. From the time the wager is placed and until the instrument is settled, the gambler has a contractual right to receive cash if certain events occur, and the operator has an obligation to pay cash if certain events occur.

Most wager contracts meet the definition of a derivative in accordance with IAS 39:9, because:

- (1) Their value changes in response to a variable (namely, the event that determines whether the wager is a winning bet) that is not a non-financial variable specific to a party of the contract (i.e. a bet that pays out only if a specified event occurs is a payment provision as described in IAS 39:AG9, as the instrument requires a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount).
- (2) They require no initial net investment or one that is smaller than would be required for other contracts with similar responses to changes in market factors (the return on the bet is larger than the initial amount paid to place the bet).
- (3) They are settled at a future date (if the wager is a winning bet, the operator will pay the gambler).

In accordance with IAS 39:43, upon initial recognition, the financial asset (from the gambler's perspective) and the financial liability (from the operator's perspective) must be measured at fair value, which generally will be the price paid to enter into the wager, assuming the operator and gambler are unrelated parties transacting at arm's length. IAS 39:46 and 47 require all derivative financial assets and liabilities to subsequently be measured at fair value with gains or losses recognised in profit or loss (except if designated as an effective cash flow or net investment hedge).

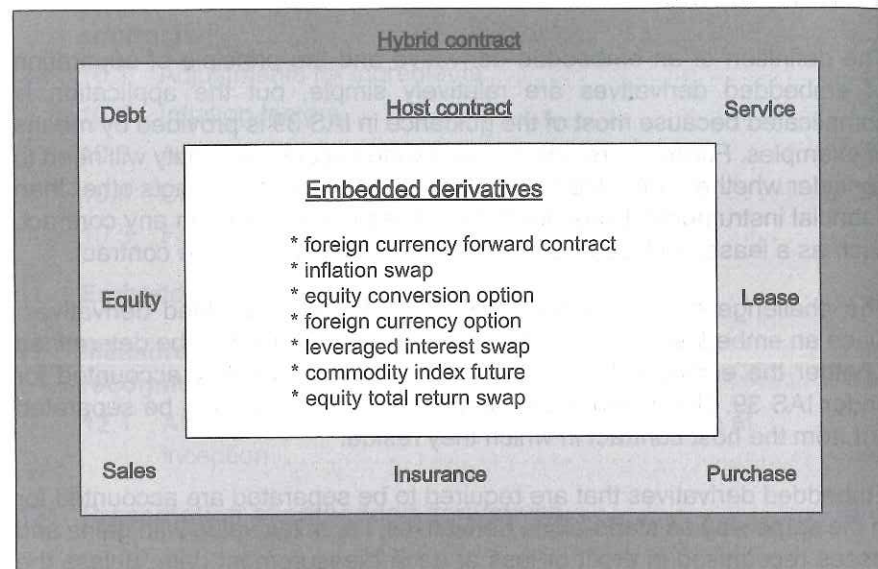
The fair value gains or losses relating to wagers should be recorded in the balance sheet gross (i.e. they should not be set-off with other financial instruments unless the criteria for offset in IAS 32:42 are met). Similarly, the gain or loss on the wager will be recognised in profit or loss as a single amount and should not be split into component parts, such as the initial stake and the payout.

In addition, because wagers are derivative financial instruments, the disclosure requirements of IFRS 7 will apply.

Care should be taken when assessing the different types of operations of entities in the gaming industry. In certain instances some operations may have contracts that do not meet the definition of a derivative because the arrangement does not have an underlying. A derivative must have either a notional or a payment provision (where the amount payable is fixed or can change but does not change in proportion to a change in the underlying).

For example, a lottery operator will issue tickets to players when the player has a pre-determined probability of winning. As the player selects a set of numbers that, if chosen in the lottery draw, will result in the player winning, the chance of being a winner never changes, regardless of the number of tickets sold. Because the underlying is the event upon which the wager is placed, in this case the chosen numbers on the lottery ticket equalling that of the lottery draw, this is not a derivative as the chances of the event occurring are always the same. However, the lottery tickets issued are a financial liability of the operator and therefore the total tickets issued should be measured at the total amount that will be required to be paid to the winner of the lottery draw. If there is no winner in a particular draw or time period, the operator usually rolls over the total wagers received to the next draw and the amount carried forward, together with any additional wagers that will then be available to the next winner. The fair value of such a liability should therefore reflect the amount that the operator would be expected to pay if a winner emerged. This is consistent with IFRS 13:47, which 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.

In May 2007, the IFRIC (now the IFRS Interpretations Committee) issued a rejection notice on gaming transactions stating that an unsettled wager is likely to meet the definition of a derivative and will therefore be accounted for under IAS 39. The IFRIC recognised that, in other situations, a gaming institution does not take a position against a customer but instead provides services to manage the organisation of games between two or more gaming parties. In these circumstances, the gaming institution earns a commission regardless of the outcome of the wager and, therefore, it is likely that the commission would meet the definition of revenue and would be recognised when the conditions in IAS 18 *Revenue* (now IFRS 15 *Revenue from Contracts with Customers*) are met.

**2-1****Debt host contract – example**

Entity X issues a bond that is convertible into ordinary shares of Entity Y. The hybrid contract is the convertible bond; the host contract is the bond liability, and the embedded derivative is the conversion option.

2-2**Lease host contract – example**

Entity A enters into a lease with an inflation factor, such that each year lease payments are adjusted for changes in a retail price index. The hybrid contract is the entire lease; the host is the lease contract, and the embedded derivative is the adjustment to the retail price index.

2-3**Executory host contract – example**

Entity T, a UK entity whose functional currency is sterling, enters into a contract to sell a non-financial item in US dollars. The hybrid contract is the entire sale contract which will be settled in US dollars; the host contract is the sterling sale contract; the embedded derivative is the foreign exchange £/US\$ forward contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative but a separate financial instrument. [IAS 39:10]

2-4**Contractually separate derivative – example**

Entity A issues floating rate debt. To protect itself against rising interest rates, it purchases an interest rate cap, capping interest payable at 8 per cent. The cap is contractually separate from the debt, so that it is not an embedded derivative but a stand-alone derivative.

Entity A could have instead issued floating rate debt, where the debt instrument itself is capped such that, once interest rates rise above 8 per cent, interest payable is restricted to 8 per cent until rates fall below that level. In this case, there is an embedded derivative within the debt (i.e. the interest rate cap), and this cap would need to be assessed to see if it should be separately accounted for. [IAS 39:IG.C.6]

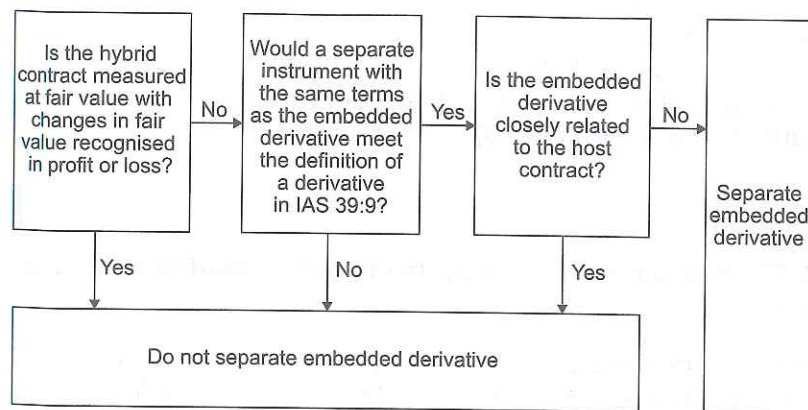
3 Separation conditions

Not all embedded derivatives should be separated from their host contracts. An embedded derivative is separated from its host contract and accounted for separately as a stand-alone derivative when all of the following criteria are met: [IAS 39:11]

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic risks and characteristics of the host contract (see IAS 39:AG30 and AG33);
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

Condition in IAS 39:11(b) means that an embedded feature should only be separated from its host contract if it meets the definition of a derivative, i.e.: [IAS 39:9]

- it has an underlying;
- it involves no initial net investment (or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors); and
- it is settled at a future date.



If it is determined that an embedded derivative is closely related to the host contract, it should not be separated from the host contract because the entire hybrid contract is accounted for in accordance with the relevant Standard that deals with the host contract. For example, if an embedded derivative in a lease contract is deemed to be closely related to the lease host, then the entire contract is accounted for in accordance with IFRS 16 *Leases*.

If an identified embedded derivative is not closely related to the host contract, then it must be separately accounted for as if it were a stand-alone derivative. This is considered further in **section 12**.

IFRIC Interpretation 9 *Reassessment of Embedded Derivatives* provides guidance on whether an entity should assess whether embedded derivatives are closely related at the time the entity first becomes a party to the contract or on an ongoing basis. The Interpretation clarifies the following. [IFRIC 9:7]

- An entity is generally prohibited from reassessing its conclusion as to whether an embedded derivative needs to be separated from the hybrid contract after it is initially recognised.
- An entity is required to revisit its assessment if there is a change in the terms of the contract that significantly modifies the cash flows that would otherwise be required under the (original) contract. The significance of the change in cash flows is evaluated by considering the extent of the change in the cash flows of the embedded derivative, the host contract or both, and whether these changes are significant relative to the previously expected cash flows of the contract.
- An entity is required to revisit its assessment when a financial asset is reclassified out of the FVTPL category.

The Interpretation does not apply to embedded derivatives acquired in: [IFRIC 9:5]

- a business combination (as defined in IFRS 3 *Business Combinations*);
- a combination of entities or businesses under common control as described in IFRS 3:B1 to B4; or
- the formation of a joint venture as defined in IFRS 11 *Joint Arrangements* or their possible reassessment at the date of acquisition.

IFRIC 9:5 includes a footnote stating that IFRS 3 addresses the acquisition of contracts with embedded derivatives in a business combination.

3-3

Assessment of embedded derivatives as part of a business combination

The guidance in IFRIC 9:5 and the footnote are curious from the perspective of the acquirer because, at the date of acquisition of a subsidiary, the acquirer is not *reassessing* embedded derivatives, but rather it is *assessing* them for the first time; for the purposes of the consolidated financial statements, the date of acquisition is the date the acquirer first becomes party to the acquiree's contractual arrangement. IFRS 3 states that if a contractual arrangement is acquired as part of a business combination, the acquirer must determine what the appropriate classification of the contractual arrangement is at the date of acquisition because this is the date of initial recognition. At the date of acquisition, for contracts that are not measured at fair value through profit or loss, the acquirer will need to consider whether the contractual arrangement includes any embedded derivatives that require separation.

For the acquiree, the accounting for a hybrid contract is not affected by the acquisition as in the acquired entity the contractual arrangements in the acquiree continue to be recognised, i.e. the acquisition date is not the initial recognition date for the acquiree. Unless the terms of the hybrid contract are changed as a result of the acquisition, with the effect that the cash flows are significantly modified, any embedded derivative will not be reassessed.

The acquirer's determination as to whether or not an embedded derivative is closely related to a host contract at the date of acquisition may differ to the determination arrived at by the acquiree when it first recognised the same contract. Differences are not uncommon because the determinations are based on the economic conditions and particular circumstances at different dates.

the contractual terms of the contract and, therefore, the group would not reassess the embedded derivative assessment it made when Subsidiary B entered into the arrangement.

In March 2009, the Board issued amendments to IFRIC 9 and IAS 39 titled *Embedded Derivatives*. The amendments clarify that, upon reclassification of a financial asset out of FVTPL to loans and receivables, AFS financial assets or HTM investments (see **section 4** of **chapter C2**), 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. [IAS 39:12 & IFRIC 9:7A]

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. [IFRIC 9:BC11D] 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 need to assess embedded derivatives by classifying a hybrid contract initially as at FVTPL and subsequently reclassifying it. The Board noted that the inability to reclassify if the embedded derivative that would have to be separated cannot be measured separately would prevent reclassification of a hybrid (combined) financial asset out of that category between financial reporting dates and, therefore, avoid a requirement to reclassify the hybrid (combined) financial asset back into the FVTPL category at the end of the financial reporting period.

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 a 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. [IFRIC 9:BC11F]

IFRIC 9 does not address remeasurement issues arising from a reassessment of embedded derivatives. [IFRIC 9:4] This will require careful consideration depending on particular facts and circumstances.

3-7

Reassessment of embedded derivatives: modification to terms – example

Entity B, a euro functional currency entity, is party to a contract to purchase a fixed quantity of electricity at a future date for £10 million (€12 million at the spot rate at inception of the contract of €1.2:£1). The electricity will always be physically delivered under the contract and will be used for Entity B's production processes. The contract is a hybrid contractual arrangement containing a host contract that is an executory contract to purchase electricity in euros and a non-closely related embedded foreign currency derivative based on the guidance at **10.5**. The two elements are:

- (i) non-closely related embedded €/£ forward with an initial fair value of zero to buy €12 million, sell £10 million; and
- (ii) host purchase contract to buy a set quantity of electricity with a purchase price of €12 million (that matches the euro leg of the foreign currency forward in (i) above).

Upon entering into the contract, Entity B separates out the non-closely related foreign currency embedded derivative and measures it at FVTPL.

At a later date, there is a contractual modification to the terms such that the currency in which the contract is denominated changes to the functional currency of Entity B, i.e. euro. The embedded derivative had a negative fair value at the date of modification of €1 million. Due to the redenomination of the currency of the contract, Entity B pays the counterparty €1 million which is equal to the value of the change in contractual terms of the arrangement. Entity B derecognises the embedded derivative.

The change in denomination of the contract in this case is a significant modification of the contract's cash flows that triggers reassessment under IFRIC 9. Because the denomination of the contract after modification is in the functional currency of Entity B, the contract no longer has a non-closely related embedded derivative and the entire arrangement will be accounted for prospectively as an executory contract outside the scope of IAS 39.

2.2.1-2

Interpreting 'highly probable'

The term 'highly probable' is not defined in IAS 39. The probability of occurrence must be significantly in excess of a 50 per cent likelihood, but will not be as high as 100 per cent because it can never be claimed that a transaction to which an entity is not yet committed is guaranteed to occur.

IFRS 5:BC81 also refers to 'highly probable' although in a different context. It states that in IFRS Standards 'probable' is defined as "more likely than not" and that 'highly probable' is regarded as implying a significantly higher probability than 'more likely than not' and as being equivalent to the phrase 'likely to occur'.

Probability is assessed based on observable facts and the relevant circumstances. In assessing the likelihood that a transaction will occur, consideration should be given to the following:

- the frequency of similar past transactions;
- the financial and operational ability of the entity to carry out the transaction;
- substantial commitments of resources to a particular activity (e.g. a manufacturing facility that can be used in the short-run only to process a particular type of commodity);
- the extent of loss or disruption of operations that could result if the transaction does not occur;
- the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (e.g. an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering); and
- the entity's business plan.

In addition, both the length of time until a forecast transaction is projected to occur and the quantity of the forecast transaction should be considered in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be considered highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable. For example, a forecast that a transaction will occur in five years may be less reliable than a forecast of a transaction expected to occur in one year.

Other factors being equal, the greater the physical quantity or future value of a forecast transaction, the less likely it is that the transaction

would be considered highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, it is easier to support forecast sales of 100,000 units in a particular month than to support forecast sales of 300,000 units in that month by an entity, when recent sales have averaged 300,000 units per month for the past three months. [IAS 39:IG.F.3.7]

IAS 39:IG.F.2.4 provides an example of an airline operator that could use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are 'highly probable', it may designate a currency borrowing as a cash flow hedge of the future revenue stream.

To meet the 'highly probable' requirement, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective, it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the cash flows occur within close proximity to each other. [IAS 39:IG.F.3.11]

A pattern of discovering that hedged forecast transactions are no longer expected to occur would call into question both an entity's ability to predict accurately forecast transactions and the propriety of using hedge accounting in the future for similar transactions. [IAS 39:IG.F.3.7]

A hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is the designated hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified with sufficient specificity: it could be units 20,001 to 35,000 or units 120,001 to 135,000. [IAS 39:IG.F.3.10]

For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period because that would not lead to an identifiable amount, e.g. designating 75 per cent of sales in February 20X7 can be only identified after February 20X7 and not at the time of designation.

- **3.10** Cash flow hedging foreign currency risk of the principal only on interest-bearing debt.
- **3.14** Cash flow hedging share appreciation rights.
- **3.16** Cash flow hedging of an acquisition of an equity-method investment.

In a cash flow hedge of a forecast transaction when the spot foreign exchange rate is being hedged, the effective amount recognised in other comprehensive income is calculated on a discounted basis, i.e. it is based on the present value of the spot element of the derivative. [IAS 39:IG.F.5.6]

2.2.2-1

Types of derivatives used for hedging foreign currency monetary items in order to improve hedge effectiveness

A foreign currency monetary item (e.g. a loan) can be cash flow hedged for foreign currency risk for both interest and principal, interest only, principal only, or any proportion thereof.

If an entity hedges both interest and principal with a derivative, in order for the hedging instrument to be highly effective, the derivative will need to have contractual cash flows that match the foreign currency interest and principal flows but swap them into the functional currency equivalent cash flows. An example would be a cross-currency swap with gross physical exchange of principal at inception and at maturity. **3.7-1** and **3.8-1** in **chapter C11** illustrate this approach for hedging floating rate and fixed rate loans respectively.

If an entity hedges only the interest cash flows with a derivative, in order for the hedging instrument to be highly effective, the derivative will need to have contractual cash flows that match the foreign currency interest flows but swap them into the functional currency equivalent interest flows. An example would be a cross-currency swap without gross physical exchange of principal at inception and at maturity.

If an entity hedges only the principal cash flows with a derivative, in order for the hedging instrument to be highly effective, the derivative will need to have contractual cash flows that match the foreign currency principal cash flows but swap them into the functional currency equivalent principal cash flows. An example would be a foreign currency forward contract. Example at **3.10-1** in **chapter C11** illustrates a cash flow hedge of foreign currency risk of the principal only on an interest-bearing debt instrument.

For hedges of forecast transactions, it is permitted, but not required, to adjust the carrying amount of an acquired non-financial asset or a non-financial liability by the effective gain or loss on the hedging instrument as explained at **2.2.3**.

2.2.3 Basis adjustments

An entity has a choice of accounting policy regarding the presentation of gains and losses recognised in other comprehensive income if a cash flow hedge of a forecast transaction subsequently results in the recognition of a *non-financial asset* (or a *non-financial liability*), or if a forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied. The accounting policy chosen must be applied consistently to all such hedges. [IAS 39:99]

The entity can either: [IAS 39:98]

- reclassify the associated gains and losses from equity to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised); or
- remove the associated gains and losses that were recognised in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability (in which case they will automatically affect profit or loss when the item is depreciated or sold).

2.2.3-1

Application of a basis adjustment to a cash flow hedge of a forecast transaction that results in the recognition of an equity-method investment

It is clear that IAS 39:98(b) allows an adjustment to the cost basis of an asset recognised in a cash flow hedge of a forecast transaction for the effects of the hedge, if the recognised asset is a *non-financial asset*.

However, it is less clear whether the basis adjustment alternative under IAS 39:98(b) is available for a cash flow hedge that results in the recognition of an interest in an associate that is accounted for using the equity method.

The acquisition of an interest in an associate represents the acquisition of a financial instrument (IAS 39:BC24D) and the basis adjustment alternative under IAS 39:98(b) is generally not available for a financial asset.

However, IAS 39:BC161 explains that the rationale for prohibiting basis adjustments for financial assets is that such adjustments would be contrary to IAS 39's requirement that all financial instruments be recognised at fair value on initial recognition. A basis adjustment does not, however, result in any divergence from the general requirements for accounting for an investment in an associate using the equity method because such investments are required to be measured at cost (rather than fair value) on initial recognition (see paragraph 10 of

As part of the Board's deliberations it considered whether voluntary novation to a CCP should be part of the scope of the amendment. The exposure draft that preceded the amendment was limited to circumstances where novation was required by laws and regulations. The Board concluded that the novation does not have to be required by laws or regulations, however, for hedge accounting to continue voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives and that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting. [IAS 39:BC220Q]

The Board acknowledged that permitting relief only where novation is directly to a CCP was too narrow. Consequently, the Board accepted that the relief would also be available if novation is undertaken with the objective of effecting clearing with a CCP. Examples where this may apply are where the novation is to a clearing member in order to transact with a CCP, so called 'indirect clearing'. The Board also observed that an intragroup novation also can occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP. [IAS 39:BC220R & BC220S]

The Board notes in IAS 39:BC220W that if an entity had previously discontinued hedge accounting, as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (i.e. hedge accounting cannot be applied retrospectively).

2.2.4.2-1

Novation of a derivative instrument: impact on existing hedge relationship – example

Entity A executes a derivative with Entity B; the derivative is designated by Entity A as an effective hedging instrument in a hedging relationship. Entities A and B are not related parties.

After the hedge is designated, Entity A's original counterparty, Entity B, is acquired by Entity C. The impact for the existing hedge relationship for Entity A is considered in the following scenarios.

Scenario 1

The contractual terms and conditions of the derivative are not affected by the acquisition of Entity B by Entity C (no novation).

Because the acquisition of Entity B by Entity C does not amend the contractual terms and conditions of the derivative, there is no impact on the hedge relationship for Entity A.

Scenario 2

Some contractual terms and conditions of the derivative are changed by the acquisition (e.g. different collateralisation due to new group context), but the legal counterparty for Entity A is still Entity B (no novation).

In contrast to Scenario 1, there is a change to some contractual terms and conditions but there is no change in legal counterparty (no novation) so that Entity B is still the counterparty for Entity A. Depending on the extent of the changes in the contractual terms and conditions, Entity A may be required to derecognise the derivative.

If the changes in the contractual terms and conditions require derecognition of the hedging instrument by Entity A, hedge accounting is discontinued by Entity A in accordance with IAS 39:91(a) (in case of a fair value hedge) or IAS 39:101(a) (in case of a cash flow hedge or a net investment hedge).

If the changes in the contractual terms and conditions do not require derecognition of the hedging instrument by Entity A, Entity A is not required to discontinue hedge accounting. However, the amended terms and conditions may affect the effectiveness of the hedging relationship.

Scenario 3

In contrast to Scenarios 1 and 2, there is a change in legal counterparty so that Entity C is now the counterparty for Entity A instead of Entity B (novation).

Derivatives are generally bilateral contractual arrangements between two named parties. Consequently, when the counterparty to a derivative changes, this generally leads to derecognition of the derivative for the party that faces that counterparty because the original counterparties have been released from their responsibilities to make payments to each other. This conclusion was highlighted in the amendments to IAS 39 in June 2013, *Novation of Derivatives and Continuation of Hedge Accounting*, based on the derecognition requirements for financial liabilities in IAS 39:AG57(b). As an exception to that conclusion, the June 2013 amendments state that in circumstances in which the counterparty transfers the derivative to a central clearing counterparty and subject to meeting the specified criteria in IAS 39:91(a) or IAS 39:101(a) respectively for fair value hedges, cash flow hedges and net investment hedges, a novation does not cause an expiration or termination of the hedging instrument, nor requires discontinuation of hedge accounting.

2.2.4.4-2**Change in timing of forecast sale of a non-financial item – example**

Entity S designates a derivative as a hedging instrument in a cash flow hedge of a forecast sale of silver. The hedging relationship meets all of the conditions for hedge accounting, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and generally narrow range of time.

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

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

If the hedged transaction is no longer expected to occur, then the cumulative amounts in other comprehensive income are reclassified from equity to profit or loss. [IAS 39:101(c)]

2.2.4.4-3**Change in timing of forecast debt issuance – forecast transaction no longer expected to occur – example**

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

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

2.2.4.5 An entity de-designates the hedge relationship

An entity can de-designate a hedge relationship at any point in time. Any gains or losses recognised in other comprehensive income up to the point of de-designation will remain in equity until the forecast transaction occurs. [IAS 39:101(d)] Gains or losses on the hedging instrument after de-designation will be recognised in profit or loss if the hedging instrument continues to be held.

2.2.5 Reclassification from equity to profit or loss after a business combination**2.2.5-1****Reclassification from equity to profit or loss after a business combination**

Following a business combination, when the acquiree has applied cash flow hedging and recognised gains or losses in other comprehensive income prior to the acquisition, the acquirer will not be able to reclassify those gains and losses to consolidated profit or loss. Because the pre-acquisition reserves of the acquiree do not exist in the consolidated financial statements of its new parent (acquirer), any amounts recognised in other comprehensive income by the acquiree prior to the business combination cannot be reclassified. Thus, in the consolidated accounts, the group can only hedge account for the specific relationship prospectively from the date of acquisition and only amounts recognised in other comprehensive income post-acquisition can be reclassified from equity to consolidated profit or loss in accordance with IAS 39:95. See 4.5 in chapter C10 for further details.

2.2.6 Reclassification of amounts deferred in the cash flow hedge reserve when hedging interest rate risk with an off-market swap**2.2.6-1****Reclassification of amounts deferred in the cash flow hedge reserve for hedges of interest rate risk using an off-market swap**

When the hedged risk is cash flow variability from changes in interest rates, the hedged item will often consist of multiple cash flows. For example, if an entity issues floating rate debt with five interest payments, it is common to hedge all five interest payments with a single interest rate swap. If the hedging instrument, when designated, is an off-market interest rate swap (i.e. fair value is not nil) (see 3.7 and 4.1 in chapter C10) care needs to be taken to establish the correct amount to reclassify in relation to each cash flow. This is particularly true in the case of an 'under-hedge' (i.e. when the cumulative gain or loss on the

hedging instrument accumulated in equity is less than the cumulative gain or loss on the hedged item) because the total amount deferred in the cash flow hedge reserve will not be sufficient to fully offset the variation in the hedged cash flows.

A basic approach to determine the amount to be reclassified from the cash flow hedge reserve for a particular relationship is to first calculate the amount that should remain in the cash flow hedge reserve at the reporting date for that relationship, and then reclassify the difference between that amount and the previous balance in the cash flow hedge reserve.

In a hedge of variability in interest cash flows due to changes in interest rates, the hedged item affects profit or loss through the interest accrual (e.g. interest accrual on debt). Therefore, although it is the full (or 'dirty') fair value gains or losses on the hedged item and hedging instrument that are used to measure the ineffectiveness for the hedge relationship, it is the 'clean' fair value gains or losses that should be used to determine the amounts that remain in the cash flow hedge reserve. The clean fair value is the fair value excluding any accrued interest.

For a swap that has a clean fair value of zero on the date of designation (i.e. an on-market swap), the cumulative clean fair value gain or loss will be equal to the clean fair value. However, if the swap has a non-zero fair value on the date of designation (i.e. an off-market swap), the calculation of the clean fair value gain or loss is more complex. One method of calculating the clean fair value gain or loss is to split the off-market swap into an on-market component swap and an 'embedded financing' component, where the embedded financing component will be a strip of fixed cash flows equal to the difference between the fixed leg on the off-market swap and the fixed leg of the on-market component swap. The on-market component swap has a floating leg that matches the off-market swap and a fair value of zero on the date of designation. The embedded financing component and on-market component swap are determined as of the designation date and are not subsequently adjusted. The cumulative clean fair value gain or loss on the on-market component swap will be equal to the clean fair value of that component. The cumulative clean fair value gain or loss on the embedded financing component will be the cumulative change in clean fair value of the embedded financing component plus the portion of the designation date fair value of the embedded financing cash flows that have been settled and accrued (but not yet settled) since the inception of the hedge.

Therefore, the cumulative clean fair value gain or loss on the hedging instrument as a whole is the cumulative change in the clean fair value of the hedging instrument plus the portion of the designation date fair value of the embedded financing component *that has been settled and accrued since the inception of the hedge*. There are other acceptable

methods of calculating the clean fair value gain or loss that give the same result as the above; for example, by deducting the designation date fair value of the settled and accrued cash flows of the on-market component from the fair value gain or loss on those cash flows of the off-market swap that have yet to be settled or accrued.

Examples illustrating the journal entries for a cash flow hedge of floating rate debt using an off-market interest rate swap are at 3.5-2 and 3.5-3 in chapter C11.

2.3 Net investment hedge

A hedge of a net investment in a foreign operation is a hedge of the foreign currency exposure arising from the reporting entity's (generally, the group's) share in the net assets of that foreign operation. Under IAS 21 when the group's share of the net assets of a foreign operation are translated into the functional currency of the ultimate parent the retranslation gain or loss is recognised in other comprehensive income. It does not matter which currency the monetary assets and liabilities of the foreign operation are denominated in, because all those monetary items are firstly retranslated into the foreign operation's functional currency. It is the translation of those net assets of the foreign operation into the ultimate parent's functional currency that is the designated hedged risk.

IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* addresses whether the hedged risk in a net investment hedge is the difference between the functional currency of the foreign operation and the presentation currency of the group or rather the difference between the functional currency of the foreign operation and the functional currency of the parent. The IFRIC (now the IFRS Interpretations Committee) consensus was that the hedged risk in a net investment hedge refers to the difference between the functional currency of the foreign operation and the functional currency of the parent. The IFRIC acknowledged that this question is only relevant to the extent that the presentation currency of the group differs from the functional currency of the parent. The IFRIC recognised that there are competing arguments for either view but found that the arguments in favour of looking to the functional currency of the parent were more compelling. The IFRIC concluded that the presentation currency does not create an exposure to which an entity may apply hedge accounting. The functional currency is determined on the basis of the primary economic environment in which the entity operates. Accordingly, functional currencies create an economic exposure to changes in cash flows or fair values; a presentation currency does not. [IFRIC 16:BC14]

A hedge of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment as defined in IAS 21, assuming it meets all other requirements for hedge accounting, is accounted for similarly to a cash flow hedge: [IAS 39:102]

A more detailed discussion of complex issues that can arise with net investment hedging is included in **section 5 of chapter C10**.

IAS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation. [IAS 21:8]

Net investment hedging is only permitted in consolidated financial statements because it is only in consolidated financial statements that the net assets of the foreign operation are recognised. An exception is a foreign operation that is not a separate legal entity (e.g. branch of the reporting entity that has a functional currency different from the functional currency of the reporting entity). In this case, the investor may apply net investment hedging in its individual financial statements by designating the translation risk of the net assets of the foreign branch. This is acknowledged in IFRIC 16:2.

In August 2014, the Board issued an amendment to IAS 27 *Separate Financial Statements* to include the equity method as one of the options in IAS 27 to account for an entity's investment in a subsidiary, joint venture or associate in its separate financial statements (selected as an accounting policy choice and applied consistently for each category of investments, i.e. the same measurement applied to all subsidiaries, all joint ventures or all associates). As a result of the amendment to IAS 27, an entity may use the equity method for such investments in its separate financial statements and, to the extent such interests are foreign operations, net investment hedging may be applied.

2.3-4

Applying fair value hedge to the investments in a subsidiary, associate or joint venture when such investments are measured at cost in a separate financial statements

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

However, as an alternative, the investor may wish to apply fair value hedge accounting for the foreign exchange risk of its investment in its foreign operation if the investment is not measured at FVTPL under IAS 39. For example, if an investor makes an investment in a foreign operation that meets the definition of a subsidiary, and the investor recognises the investment at cost in its separate financial statements, the investing entity will be exposed to a risk that will affect profit or loss (i.e. the foreign currency risk that arises upon disposal of the foreign subsidiary). If the investing entity has a foreign currency derivative,

or a foreign currency denominated liability that was used to fund the investment in the foreign operation, that instrument could be designated as a hedging instrument in respect of a portion of the foreign currency risk of the investment in the subsidiary equivalent to the notional on the hedging instrument. In order to qualify for this treatment, the entity must be able to determine that foreign currency risk with respect to the investment in the subsidiary exists of an amount equal to at least the notional of the hedging instrument. For the entity to make this claim, it must either be able to measure the fair value of the investment in local currency terms or, at a minimum, be able to determine that the fair value in local currency terms is not below the notional of the hedging instrument. Applying fair value hedge accounting would result in the gain or loss on the hedging instrument being recognised in profit or loss along with the associated movement in the foreign currency risk on the designated portion of the investment in the subsidiary.

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

2.3.1 Hedging net investments with loans

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

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

currency risk does not affect profit or loss. Foreign currency risk only arises from the date the debt is recognised in the statement of financial position because it is translated thereafter into the entity's functional currency under IAS 21. The quantum of this foreign currency risk that will affect profit or loss following the issue of the debt bears no relation to the quantum of foreign currency risk that arises prior to the date the debt is issued.

The following example explores this issue further.

Example

On 1 January, Entity C, a US dollar functional currency entity, has a highly probable forecast 10 per cent fixed rate debt issuance of €100 million in one month's time, and wishes to hedge the variability in the US dollar equivalent proceeds that it will receive from the point in time when the hedging instrument is entered into to the point in time when the debt is issued. Entity C will enter into a foreign currency forward contract to sell €100 million and to buy an equivalent amount of US dollars, based on the forward rate for delivery when the debt is expected to be issued. At the date Entity C enters into the foreign currency forward contract, it is expected that the combination of the net cash flows from the forward contract and the euros to be received from issuing the debt should equal US\$100 million, all other things being equal.

Entity C cannot designate the changes in foreign currency risk between the date of entering into the derivative and the date the forecast debt is expected to be issued as a qualifying hedge exposure. This is because the foreign currency risk on the debt will only arise and affect profit or loss from the date it is recognised as a liability and is retranslated from euro to Entity C's US dollar functional currency during the period it remains outstanding. The gains/losses on the forward contract prior to the debt being issued bear no relationship to the foreign currency gains/losses that will be recognised after the debt is issued. Furthermore, the functional currency amount of interest in future periods is unaffected by movements in foreign currency prior to the debt being issued, as illustrated below.

Assume the foreign currency exchange rate at 1 January is US\$1:€1 and at 1 February is US\$1.5:€1. Using the 1 January exchange rate, the annual interest in US dollars would be US\$10 million. At the rate of exchange prevailing on 1 February, the amount of euro proceeds necessary to raise US\$100 million would be €67 million. The related annual interest, assuming constant interest rates, would be €6.7 million. However, translating euro into US dollars, the annual interest is still US\$10 million (since €6.7 million × 1.5 = US\$10 million). As demonstrated, the annual interest expense in functional currency terms is unaffected by a change in exchange rates between the date

the foreign currency forward contract is entered into and the date the debt is issued.

Once the debt is issued, it will be a recognised monetary item and will be retranslated from euro to US dollars on an ongoing basis in accordance with IAS 21 with any resulting foreign exchange gains or losses recognised in profit or loss. Once recognised, the debt could be designated in either a cash flow or fair value hedge of foreign currency risk.

2.6 Hedging capitalised borrowing costs

2.6-1

Hedging capitalised borrowing costs: eligibility

Neither IAS 39 nor IAS 23 *Borrowing Costs* provides guidance on whether an entity can cash flow or fair value hedge interest rate risk when the interest is partly or fully capitalised under IAS 23 as part of a qualifying asset. In the Basis for Conclusion on IAS 23 the Board makes reference to US GAAP on this topic (ASC 815-25-35-14), stipulating that, in the context of fair value hedges, "the derivative gains and losses (arising from the effective portion of a derivative instrument that qualifies as a fair value hedge) are part of the capitalised interest cost". However, the Board states explicitly that "IAS 23 does not address such derivative gains and losses". [IAS 23:BC21]

The fact that borrowing costs are capitalised in respect of a qualifying asset under IAS 23 should not, in itself, mean that an entity cannot apply hedge accounting for interest rate risk in respect of the borrowings used to fund that asset. IAS 39 requires that a hedge must result in the hedged risk affecting profit or loss, which will be the case when interest on debt is capitalised because the qualifying asset will affect profit or loss either through amortisation, impairment or sale.

2.6-2

Cash flow hedge accounting for capitalised borrowing costs – basis adjustment

If an entity applies cash flow hedge accounting it is necessary to consider whether the hedged variable interest cash flows result in the recognition of a non-financial asset as contemplated in IAS 39:98 (see 2.2.3 in chapter C9). This is because under IAS 39:98 if a hedged forecast transaction subsequently results in the recognition of a non-financial asset, an entity is required to choose as an accounting

If an entity does not apply hedge accounting and, therefore, the derivatives are classified as at fair value through profit or loss, it is not appropriate for the entity to capitalise part of the derivative as part of the borrowing costs under IAS 23. All gains and losses on non-hedging derivatives must be immediately recognised in profit or loss.

2.7 Hedging non-financial items

As described at 3.9 in **chapter C9** a non-financial asset or liability may qualify as a hedged item in limited circumstances. More complex aspects of hedging non-financial items are described below.

2.7.1 Hedging foreign currency risk of non-financial asset held at cost

If an entity is hedging foreign currency risk, this risk must be separately measurable. A non-financial asset that was purchased in a foreign currency cannot be hedged for foreign currency risk because foreign currency risk is not evident in that non-financial item. However, the foreign currency risk associated with a forecasted sale of that non-financial item could qualify as a hedged item.

2.7.1

Hedging a foreign currency risk of non-financial item held at cost

It is important to distinguish between hedging foreign currency risk of a non-financial item and hedging foreign currency risk in relation to the forecast sale or purchase of that non-financial item.

The following example illustrates that it is not possible to hedge the foreign currency risk of a non-financial item because the foreign currency risk is not evident and not separately measurable. However, if an entity is purchasing or selling a non-financial item in a foreign currency, it is a fixed amount of foreign currency that will be needed to buy or will be received from selling that non-financial item, and a qualifying foreign currency exposure therefore exists.

Example

Entity A, a sterling functional currency entity, acquires some plant and machinery in US dollars from Entity B, an unrelated third-party US dollar functional currency entity. In the financial statements of Entity A, the plant and machinery will be translated at the US\$:£ exchange rate at the date of the purchase (i.e. at historical rate).

If Entity A used US dollar borrowing to finance the purchase of the plant and machinery, these US dollar borrowings cannot be used as a hedging instrument in a fair value hedge of the foreign currency risk of the plant and machinery because the hedged item does not contain any separately measurable foreign currency risk.

If Entity A was to demonstrate that the disposal of the plant and machinery in US dollars was highly probable, then the US dollar-denominated debt could be used as a hedging instrument against the forecast sale in US dollar provided that the timing of the future cash flows on the debt coincided with the timing of the future cash flow on the disposal.

Non-derivatives can be used as hedging instruments only when hedging foreign currency risk. This is discussed further at 4.1 in **chapter C9**.

2.7.2 Hedging all risks except foreign currency

2.7.2-1

Hedging all risks except foreign currency risk of non-financial items

IAS 39:82 is clear that a non-financial item can be designated as hedged item in its entirety for all risks or just foreign currency risk. With respect to non-financial items, therefore, it is possible to hedge all risks except foreign currency risk, as long as all other hedge accounting criteria are met. However, an entity is not permitted to designate a portion of all risk (except the portion attributable to foreign currency risk).

IAS 39:IG.E.3.4, which discusses the interaction between IAS 39 and IAS 21, further supports this understanding of IAS 39:82. For financial instruments, fair value is first determined in the currency in which the contract is denominated, and translation of the contract into the functional currency of the entity is secondary. If it can be clearly demonstrated that the exposure to fair value of the non-financial instrument excluding foreign currency risk can be identified and measured, and hedged for all risks except foreign currency risk, such exposure is a permissible hedging designation.

The following example explores this issue further.

Example

Entity O expects to purchase 1,000 barrels of oil in six months that is highly probable of occurring. The purchase price will be the market price at the date of purchase and will be priced in US dollars. Entity O's functional currency is the Australian dollar.