

Financial instruments under IFRS

Revised IAS 32 and IAS 39 and IFRS 7



A guide through the maze

October 2006 (second edition)

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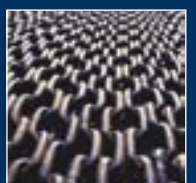
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Preface

Accounting for financial instruments under IFRS is complex. Entities should take the time to understand the requirements, including the impact on systems, processes and documentation. This publication provides an overview of revised IAS 32, revised IAS 39 and IFRS 7, as they are applied by first-time adopters and existing IFRS preparers.



The revisions to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement are far from superficial. The IASB has rewritten the derecognition requirements and has made a number of changes in other key areas. These will have a significant impact on IFRS preparers. More recently, IFRS 7, Financial Instruments: Disclosures, has introduced some significant disclosure requirements.

Whether you are a first-time adopter or an existing IFRS preparer, I hope you find this publication useful in assisting you to work with the requirements.

Pauline Wallace

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Introduction

This publication has separate chapters covering: the scope of the requirements; debt/equity classification; initial recognition and classification; derecognition; subsequent measurement; fair values and impairment; and hedge accounting.



The main chapters provide an ‘at a glance’ summary of the key issues for the topic. They also contain a summary of the respective transition rules for both existing IFRS preparers and first-time adopters.

A summary of the IAS 32 and IFRS 7 disclosure requirements is presented in the Appendix.

The revised standards amend IFRS 1, First-time Adoption of International Financial Reporting Standards, to permit entities adopting IFRS for the first time in 2005 not to restate comparative financial statements to incorporate the requirements of the revised standards. Both revised standards must be applied retrospectively.

Since this publication was originally released, the IASB has issued the following amendments to IAS 32 and IAS 39:

- Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk – Amendment March 2004
- Transition and Initial Recognition of Financial Assets and Financial Liabilities – Amendment December 2004
- Cash Flow Hedge Accounting of Forecast Intragroup Transactions – Amendment April 2005
- The Fair Value Option – Amendment June 2005
- Financial Guarantee Contracts – Amendment August 2005
- IFRS 7, Financial Instruments: Disclosures

Scope

The scope of the revised standards is very wide-ranging. Anything that meets the definition of a financial instrument is covered unless it falls within one of the specific exemptions.

Within scope of revised IAS 32 and IAS 39	Within scope of IAS 32 only	Out of scope
Debt and equity investments		Investments in subsidiaries, associates and joint ventures
Loans and receivables		Lease receivables (Note 1)
Own debt	Own equity	Lease payables (Note 1) Tax balances Employee benefits
Cash and cash equivalents		
Derivatives – for example: Interest rate swaps Currency forwards/swaps Purchased/written options Commodity contracts (Note 2) Collars/caps Credit derivatives Cash or net share settleable derivatives on own shares	Derivatives on own shares settled only by delivery of a fixed number of shares for a fixed amount of cash	Own use commodity contracts
Derivatives on subsidiaries, associates and joint ventures		
Embedded derivatives		
Loan commitments held for trading (Note 3)		Other loan commitments
Financial guarantees (Note 4)		Insurance contracts Weather derivatives

Note 1 – Leases: Lease receivables are included in the scope of IAS 39 for derecognition and impairment purposes only. Finance lease payables are subject to the derecognition provisions. Any derivatives embedded in lease contracts are also within the scope of IAS 39.

Note 2 – Commodity contracts: Contracts to buy or sell non-financial items are within the scope of revised IAS 32 and IAS 39 if they can be settled net in cash or another financial asset and they do not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements (known as 'own use commodity contracts'). Settling net includes taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price.

Note 3 – Loan commitments: Loan commitments are outside the scope of revised IAS 39 if they cannot be settled net in cash or by some other financial instrument unless: they are held for trading or to generate assets of a class which the entity has a past practice of selling; or the entity chooses to include them with other derivatives under IAS 39.

Note 4 – Financial guarantees: A financial guarantee is a contract that requires the issuer to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make a payment when due in accordance with the original or modified terms of a debt instrument. The issuer of such a financial guarantee would account for it initially at fair value under IAS 39, and subsequently at the higher of that amount initially recognised less cumulative amortisation recognised in accordance with IAS 18 or the amount determined in accordance with IAS 37. Guarantees based on an underlying price or index are derivatives within the scope of IAS 39.

Debt/equity classification

Overview

At a glance – the key issues

- Substance rather than legal form governs the classification by the issuer of a financial instrument.
- The critical feature in identifying a liability is the existence of an obligation to pay cash or to exchange another instrument under conditions that are potentially unfavourable to the issuer.
- The liability and equity components of compound instruments are accounted for separately.
- Derivatives on own shares are treated as derivatives where they contain a right or an obligation to settle on a net basis in cash or shares or where they may be settled by delivery of a variable number of own shares.

Classification

Revised IAS 32 establishes principles for distinguishing between liabilities and equity. The substance of a financial instrument, rather than its legal form, governs its classification.

An instrument is a liability when the issuer is or can be required to deliver either cash or another financial asset to the holder. This is the critical feature that distinguishes a liability from equity. An instrument is classified as equity when it represents a residual interest in the net assets of the issuer.

All relevant features need to be considered when classifying a financial instrument. For example:

- If the issuer can or will be forced to redeem the instrument, classification as a liability is appropriate;
- If the choice of settling a financial instrument in cash or otherwise is contingent on the outcome of circumstances beyond the control of both the issuer and the holder, the instrument is a liability as the issuer does not have an unconditional right to avoid settlement; and
- An instrument which includes an option for the holder to put the rights inherent in that instrument back to the issuer for cash or another financial instrument is a liability.

The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument.

Not all instruments are either debt or equity. Some, known as compound instruments, contain elements of both in a single contract. Such instruments, such as bonds that are convertible into equity shares either mandatorily or at the option of the holder, must be split into liability and equity components. Each is then accounted for separately. The liability element is determined first by fair valuing the cash flows excluding any equity component, and the residual is assigned to equity.

The table illustrates the decision process to determine whether an instrument is a financial liability or equity instrument.

Instrument	Cash obligation for principal	Cash obligation for coupon/dividends	Settlement in fixed number of shares	Classification
Ordinary shares	x	x	n/a	Equity
Redeemable preference shares with 5% fixed dividend each year subject to availability of distributable profits	✓	✓	x	Liability
Redeemable preference shares with discretionary dividends	✓	✓	x	Liability for principal and equity for dividends
Convertible bond which converts into fixed number of shares	✓	✓	✓	Liability for bond and equity for conversion option
Convertible bond which converts into shares to the value of the liability	✓	✓	x	Liability

Derivatives on own shares

Derivative contracts that only result in the delivery of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments are classified as equity instruments. All other derivatives on own equity are treated as derivatives and accounted for as such under revised IAS 39. This includes any that: can or must be settled on a net basis in cash (or other financial assets) or in shares; may be settled gross by delivery of a variable number of own shares; or may be settled by delivery of a fixed number of own shares for a variable amount of cash (or other financial assets). Any derivative on own equity which gives either party a choice over how it is settled is a financial asset or liability unless all of the settlement alternatives would result in equity classification. The table opposite illustrates this.

Instrument	Classification	Example
A contract that is settled by the issuer delivering a fixed number of the issuer's own shares in exchange for a fixed monetary amount of cash or other assets	Equity	A warrant giving the counterparty a right to subscribe for a fixed number of the entity's shares for a fixed amount of cash
A contract that requires an entity to repurchase (redeem) its own shares for cash or other financial assets at a fixed or determinable date or on demand	Liability (redemption amount)	Forward contract to repurchase own shares for cash
An obligation to redeem own shares for cash that is conditional on the counterparty exercising a right to redeem	Liability (redemption amount)	Written option to repurchase own shares for cash
A contract that will be settled in cash or other assets where the amount of cash that will be received or delivered is based on changes in the market price of the entity's own equity	Derivative asset or liability	Net cash settled share option
A contract that will be settled in a variable number of own shares determined so as to equal a fixed value or a value based on changes in an underlying variable (eg, a commodity price)	Derivative asset or liability	Forward contract on the price of gold that is settled in own shares
A contract containing multiple settlement alternatives (eg, net in cash, net in own shares, or by exchanging own shares for cash or other financial assets)	Derivative asset or liability	Share option that the issuer can decide to settle either in cash or by delivering own shares for cash

Transition

For existing IFRS preparers

Point to consider:

- The requirements of revised IAS 32 must be applied retrospectively and this may affect the prior classification of financial instruments, including derivatives on own shares.

For first-time adopters

Point to consider:

- There is no need to separate a compound instrument into its liability and equity components if the liability component is no longer outstanding at the date of transition to IFRS.

Stop press

Financial instruments puttable at fair value and obligations arising on liquidation

The IASB issued an exposure draft in June 2006 proposing to amend IAS 32 for financial instruments puttable at fair value. As stated above, these instruments are currently classified as financial liabilities in IAS 32. The objective of this exposure draft is to develop a limited scope, short-term solution to improve the financial reporting of financial instruments puttable at fair value and instruments with obligations arising on liquidation that have characteristics similar to ordinary shares. The exposure draft proposes an amendment that would require a financial instrument puttable at fair value to be classified as equity provided specified criteria are met.

Initial recognition and classification

Overview

At a glance – the key issues

- Financial assets and liabilities are initially measured at fair value.
- An entity may designate a financial instrument irrevocably on initial recognition as held at fair value through profit or loss, provided certain criteria are met.
- Loans purchased by the entity that would otherwise meet the definition of loans and receivables are classified as such.
- Failure to comply with the rules for held-to-maturity assets taints the whole category.
- Transfers into and out of the held for trading category after initial recognition are prohibited.
- Embedded derivatives should be accounted for separately if their economics are not 'closely related' to those of the host contract.

Initial recognition

Under revised IAS 39 an entity is required to recognise a financial asset or liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument.

Initial measurement: financial assets and liabilities are initially measured at fair value (discussed in the measurement chapter). Usually this will be the same as the fair value of the consideration given (in the case of an asset) or received (in the case of a liability). However, if this is not the case, any difference is accounted for in accordance with the substance of the transaction. For example, if the instrument is valued by reference to a more favourable market than the one in which the transaction took place, an initial profit is recognised.

Transaction costs: These are included in the initial carrying value of financial assets and liabilities unless they are carried at fair value through profit or loss when the transaction costs are recognised in the income statement.

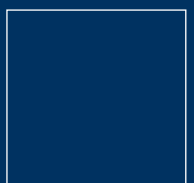
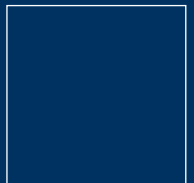
Classification

Financial assets – four categories

- Financial assets at fair value through profit or loss
- Loans and receivables
- Held-to-maturity investments
- Available-for-sale financial assets

Financial assets at fair value through profit or loss

This category has two sub-categories: financial assets held for trading and those designated to the category at inception. A financial asset is held for trading if acquired or originated principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin or if it is part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. Trading assets include debt and equity securities and loans and receivables acquired by the entity with the intention of making a



short-term profit from price or dealer's margin. Derivatives are always categorised as held for trading unless they are accounted for as hedges. The second sub-category includes any financial assets that an entity has decided to designate to the category on initial recognition provided such a designation results in more relevant information either:

- because it eliminates or significantly reduces a measurement or recognition inconsistency (ie, accounting mismatch); or
- because it is part of a group of financial assets, financial liabilities or both that is managed, and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information about this group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24).

In addition, if a financial asset contains one or more embedded derivatives, the entity may designate the entire contract as fair value through profit or loss unless the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract, or it is clear with little or no analysis that separation of such an embedded derivative is prohibited by IAS 39.

This designation is irrevocable. The asset cannot be moved to another category during its life.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They typically arise when an entity provides money, goods or services directly to a debtor with no intention of trading the receivable. However, a loan acquired as a participation in a loan from another lender is also included in this category, as are loans purchased by the entity that would otherwise meet the definition. Other loans and receivables acquired are classified and accounted for as held-to-maturity, trading or available-for-sale. If the holder does not recover substantially all its initial investment from a financial asset, other than because of credit deterioration, it cannot classify it as a loan or receivable.

Held-to-maturity investments

Held-to-maturity investments are financial assets with fixed or determinable payments and fixed maturity (eg, debt securities and redeemable preference shares) that an entity has the positive intent and ability to hold to maturity. This category excludes originated loans. Equity securities cannot be classified as held-to-maturity because they do not have a fixed maturity date. The intent and ability must be assessed not only when the assets are initially acquired but also at each subsequent balance sheet date. A positive intent to hold assets to maturity is a much higher hurdle than simply having no present intention to sell.

If an entity sells more than an insignificant amount of held-to-maturity securities, other than in exceptional circumstances, this casts doubt on its intent or ability to hold investments to maturity. The consequences are harsh: the entity is prohibited from using the held-to-maturity classification for any financial assets for two financial years. All its held-to-maturity investments are reclassified as available-for-sale and measured at fair value. When the prohibition ends (at the end of the second financial year following the tainting), the portfolio becomes 'cleansed' and the entity is once more able to classify the securities as held to maturity.

Available-for-sale financial assets

All financial assets that are not classified in another category are classified as available-for-sale. The available-for-sale category includes all equity securities other than those classified as at fair value through income. An entity also has the right to designate any asset, other than a trading one, to this category at inception.

Financial liabilities – two categories

- Financial liabilities at fair value through profit or loss
- Other financial liabilities

Financial liabilities at fair value through profit or loss

The category of financial liabilities at fair value through profit or loss also has two sub-categories: liabilities held for trading and those designated to the category at inception. Financial liabilities held for trading include:

- derivative liabilities that are not accounted for as hedging instruments;
- obligations to deliver securities or other financial assets borrowed by a short seller;
- financial liabilities that are incurred with the intention to repurchase them in the near term; and
- financial liabilities that form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking.

As with financial assets, an entity has the right to designate any financial liability to this category on initial recognition provided it meets one of the criteria detailed above for assets. This designation is irrevocable. The liability cannot subsequently be transferred to another category.

Reclassification of assets between categories

Reclassifications between categories are relatively uncommon under revised IAS 39 and are prohibited into and out of the fair value through profit or loss category.

Reclassifications from the held-to-maturity category as a result of a change of intent or ability are treated as sales and, other than in exceptional circumstances, result in the whole category being 'tainted'. The most common reason for a reclassification out of the category, therefore, is when the whole category is tainted and has to be reclassified as available-for-sale for two years. In such circumstances, the assets are re-measured to fair value, with any difference recognised in equity.

An instrument may be reclassified into the category where the tainted held-to-maturity portfolio has been 'cleansed' (see earlier). In this case the financial asset's carrying value at the date of reclassification is recharacterised as amortised cost. Any unrealised gains and losses already recognised remain in equity until the asset is impaired or derecognised.

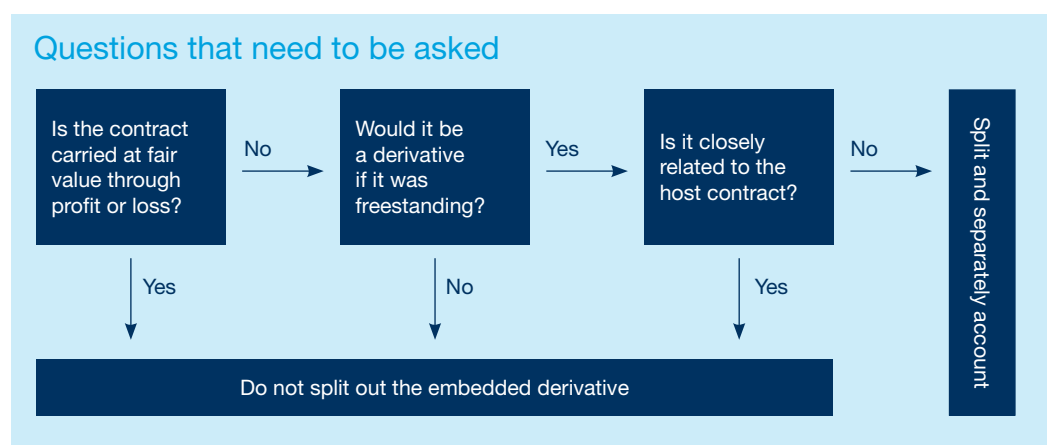
Embedded derivatives

Revised IAS 39 defines a derivative as a financial instrument with all these characteristics:

- its value changes in response to changes in an 'underlying' price or index;
- it requires no initial net investment or an initial net investment that is smaller than would be required to purchase the underlying instrument; and
- it is settled at a future date.

Revised IAS 39 prevents abuse of the requirements for carrying derivatives at fair value through profit or loss by requiring separate recognition of derivatives embedded in a host contract that is accounted for differently. An embedded derivative should be split from the host contract and accounted for separately if:

- its economics are not ‘closely related’ to those of the host contract (see examples below);
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the entire contract is not carried at fair value through profit or loss.



The following table contrasts contracts containing embedded derivatives to identify those which are not ‘closely related’:

Not ‘closely related’	‘Closely related’
<ul style="list-style-type: none"> • Equity conversion or put option in debt instrument • Fixed rate debt extension option • Debt security with interest or principal linked to commodity or equity prices • Credit derivatives embedded in a host debt instrument • Sales or purchases not in (1) measurement currency of either party (2) currency in which products are routinely denominated in international commerce or (3) currency commonly used in the economic environment in which transaction takes place 	<ul style="list-style-type: none"> • Interest rate swap embedded in a debt instrument • Inflation indexed lease contracts • Cap and floor in a sale and purchase contract • Prepayment option in a mortgage where the option’s exercise price is approximately equal to the mortgage’s amortised cost on each exercise date • A forward foreign exchange contract that results in payments in either party’s reporting currency • Dual currency bonds • Foreign currency denominated debt

Transition

For existing IFRS preparers

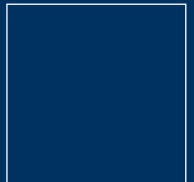
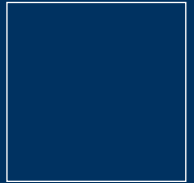
Points to consider:

- When revised IAS 39 is first applied, an entity is allowed to classify any of its financial assets as at fair value through profit or loss or as available-for-sale and any of its financial liabilities as at fair value through profit and loss provided that the assets and liabilities meet the criteria for such designation. There are detailed requirements concerning the transition to the use of the fair value option in IAS 39.
- The category loans and receivables originated by the entity has been replaced by the category loans and receivables. The definition of loans and receivables has also been expanded to include loans purchased by the entity but debt instruments are excluded if they are quoted in an active market.

For first-time adopters

Points to consider:

- On first-time adoption, an entity will classify all its financial assets in accordance with revised IAS 39, irrespective of their classification under local GAAP.
- A financial asset can be classified as a held-to-maturity investment if (1) there is, at the date of transition, a positive intent and ability to hold it to maturity and (2) the asset does not meet the criteria for classification as 'loans and receivables'.
- A financial asset can be classified as loans and receivables if it meets the definition when the entity first applies IAS 39.
- A non-derivative financial asset or liability must be classified as trading if the asset or liability was acquired or incurred principally for the purpose of selling or repurchasing it in the near term or is, at the date of transition, part of a portfolio of identified financial instruments which are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.
- Derivatives not designated as hedging instruments must be classified as held for trading.
- Any financial asset can be classified as available for sale at the date of transition and any financial asset or liability can be designated as at fair value through profit or loss provided those assets and liabilities meet the criteria for such designation. There are detailed requirements concerning the transition to the use of the fair value option in IAS 39.



Derecognition

Overview

At a glance – the key issues

- A financial asset (or part of a financial asset) is derecognised when
 - the rights to the cash flows from the asset expire
 - the rights to the cash flows from the asset and substantially all risks and rewards of ownership of the asset are transferred
 - an obligation to transfer the cash flows from the asset is assumed and substantially all risks and rewards are transferred
 - substantially all the risks and rewards are neither transferred nor retained but control of the asset is transferred.
- If the entity retains control of the asset but does not retain or transfer substantially all the risks and rewards, the asset is recognised to the extent of the entity's continuing involvement.
- A financial liability is removed from the balance sheet only when it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled, or expires.
- A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition.

Derecognition is the term used for the removal of an asset or liability from the balance sheet. Revised IAS 39 sets out the criteria for derecognition of financial assets and liabilities and the consequential accounting treatment.

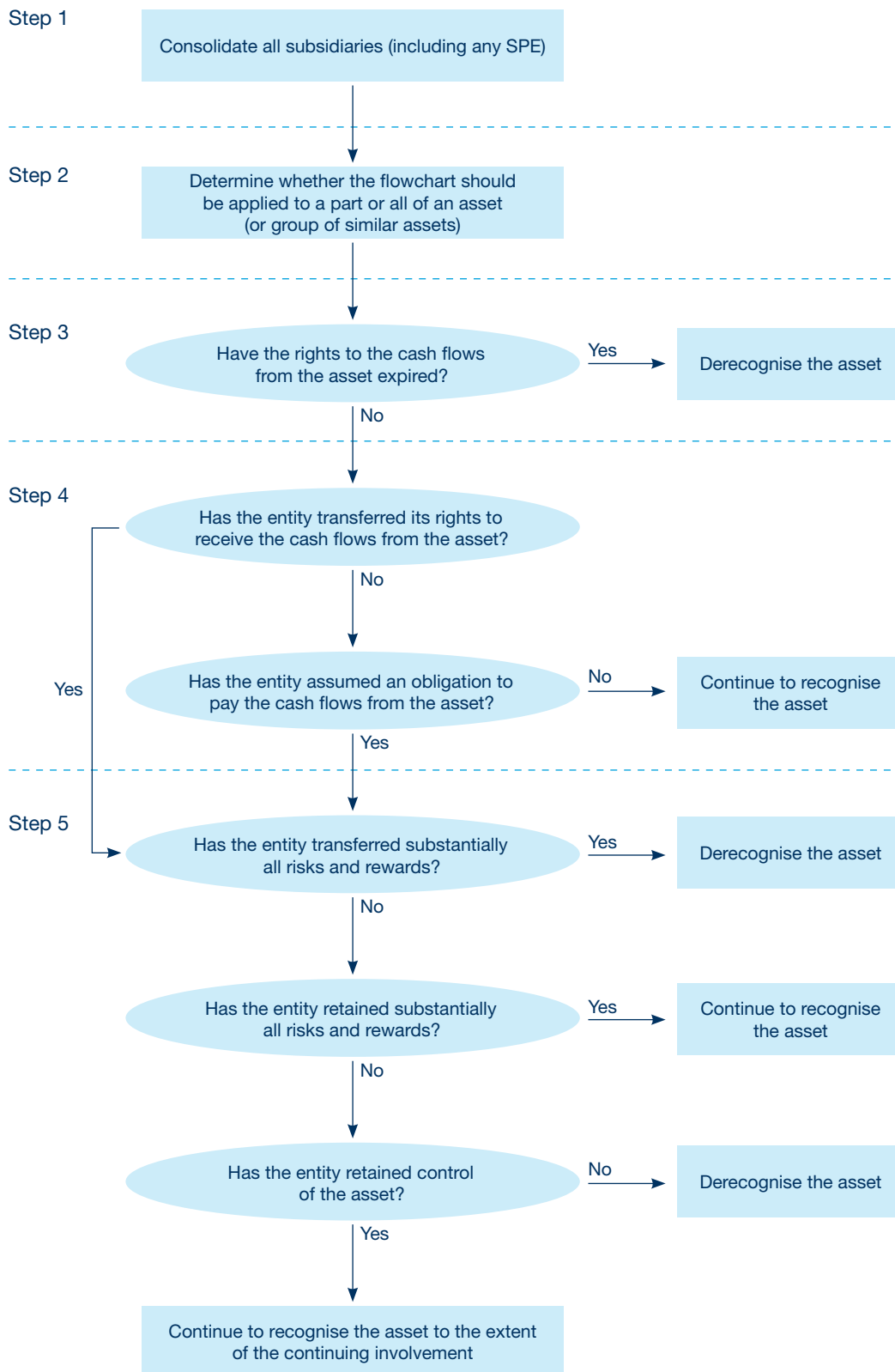
Derecognition of financial assets

In many cases it is not difficult to assess whether or not a financial asset should be derecognised. For example, when a manufacturer receives a payment from a customer for the delivery of spare parts the manufacturer no longer has any rights to further cash flows from the receivable and should remove it from the balance sheet.

Where a company sells a portfolio of trade receivables or mortgages in order to receive finance, however, it is less obvious whether those financial assets should be derecognised. Examples of such arrangements are debt factoring and securitisation schemes.

The flow chart overleaf summarises the criteria for derecognition in revised IAS 39.

A detailed explanation of each step follows after the flow chart.



Step 1

Consolidate all subsidiaries (including any SPE)

Many derecognition structures use entities (eg, trusts, partnerships, etc.) that have been specifically set up for the acquisition of the transferred assets. The transfer of assets to such an entity might qualify as a legal sale. However, if the relationship between the transferor and the transferee suggests that the transferor controls the transferee the transferor needs to consolidate the transferee.

The derecognition principles therefore have to be applied on a consolidated level.

An entity first consolidates all subsidiaries and special purpose entities in accordance with IAS 27 and SIC-12 and then applies the derecognition principles to the resulting group.

Step 2

Consolidate all subsidiaries (including any SPE)

The next step is to identify the assets (or part of assets) which should be tested for derecognition.

The tests may be applied to any of the following:

- an entire asset (eg, an unconditional sale of a financial asset);
- a fully proportionate share of the cash flows from an asset (eg, a sale of 10 percent of all principal and interest cash flows);
- specifically identified cash flows from an asset (eg, a sale of an interest-only strip); or
- a fully proportionate share of specifically identified cash flows from an asset (eg, a sale of a 10% interest-only strip).

Step 3

Have the rights to the cash flows from the asset expired?

If the contractual rights to the cash flows from a financial asset (or part of the asset) have expired or are forfeited the financial asset should be derecognised.

This is the case when a debtor discharges its obligation by paying the holder of the financial asset or when the debtor's obligations to the holder have ceased (eg, when the rights under an option expire).

Step 4

Has the asset been transferred?

A transaction qualifies as a transfer if the entity transfers the contractual rights to receive the cash flows to a third party or where it retains the contractual rights but assumes a contractual obligation to pass on these cashflows to another.

Test 1

Has the entity transferred its rights to receive the cash flows from the asset?

Some transactions clearly involve the transfer of rights to another party. For example, an entity that has sold a financial asset (eg, a legal sale of a bond) has transferred its rights to receive the cash flows from the asset. The transfer then has to be assessed in Step 5 to determine whether it meets the derecognition criteria.

Test 2

Has the entity assumed an obligation to pay the cash flows from the asset?

An entity that retains its contractual rights to receive cash flows from a financial asset may still assume a contractual obligation to pass on the cash flows to one or more entities (pass through arrangements).

This situation may arise, for example, if the transferor is a special purpose entity or trust, and issues beneficial interests in the underlying financial assets that it owns to investors whilst continuing to service those financial assets (ie, custody of the underlying asset remains with the transferor).

Additional requirements have to be fulfilled to conclude that a pass-through arrangement meets the criteria for a transfer.

If the following conditions are met the entity has to perform the derecognition tests in Step 5 in order to determine whether it meets the derecognition criteria:

- The entity has no obligation to pay cash flows to the transferee unless it collects equivalent cash flows from the transferred asset.
- The entity is prohibited from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pass through cash flows.
- The entity is obliged to remit any cash flows without material delay and subject to certain investment restrictions.

If the conditions are not met, the financial assets remain on the balance sheet.

Step 5

Perform derecognition tests

Test 1

Has the entity transferred substantially all risks and rewards?

If the entity transfers substantially all the risks and rewards of ownership of the asset (eg, an unconditional sale of a financial asset), the entity derecognises the asset.

The transfer of risks and rewards is evaluated on the entity's exposure before and after the transfer to the variability in amount and timing of the cash flows that are likely to occur in practice. In most cases, it will be clear whether the entity has transferred substantially all the risks and rewards without the need for a calculation. If substantially all the risks and rewards have been transferred, the asset is derecognised.

If the entity has not transferred substantially all risks and rewards Test 2 has to be carried out.



Test 2

Has the entity retained substantially all risks and rewards?

If the entity retains substantially all the risks and rewards of ownership of the asset, the entity continues to recognise the asset.

If the transferor's exposure has not changed substantially as a result of the transfer it has retained substantially all risks and rewards of ownership and should not derecognise the asset.

For example, this would be the case in a sale and repurchase transaction where the repurchase price is set at the sales price plus a lender's return, or where a sale of a financial asset is accompanied by a total return swap that transfers the full exposure back to the transferor.

If the entity has not retained substantially all the risks and rewards test 3 has to be carried out.

Test 3

Has the entity retained control of the asset?

If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the asset, the entity has to determine whether it has retained control of the asset.

Control is based on the transferee's practical ability to sell the asset. The transferee has this ability if it can sell the asset in its entirety unilaterally to an unrelated third party without needing to impose further restrictions on the transfer.

The key issue is what the transferee is able to do in practice and not what contractual rights the transferee has. A transferee has the practical ability to sell the asset if it is traded in an active market because the transferee could purchase the asset in the market if it needs to return the asset to the transferor.

If an asset subject to a call option can be readily obtained by the transferee in the market the transferor has lost control although he has retained some of the risks and rewards in relation to the asset.

On the other hand the contractual right to dispose of an asset is of little practical use if there is no market for the asset.

If the entity has lost control the asset is derecognised.

If the entity has retained control, it continues to recognise the asset to the extent of its continuing involvement.



Consequences of derecognition or failed derecognition

Derecognition of a financial asset – gain recognition

On derecognition of a financial asset in its entirety, the difference between the carrying amount and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) is included in the income statement.

If only a part of a financial asset is derecognised the previous carrying amount of the financial asset is allocated between the part that continues to be recognised and the part that is derecognised based on relative fair values at the date of transfer.

The difference between the carrying amount allocated to the part derecognised (including any cumulative gain or loss relating to the part derecognised that had previously been recognised in equity) and the consideration received is included in the gain or loss on derecognition.

Failed derecognition of a financial asset – substantially all risks and rewards of ownership retained

A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition. The entity recognises a financial liability for the consideration received for the transferred asset.

If the transferee has the right to sell or repledge the collateral the asset is presented separately in the balance sheet (eg, as loaned asset, pledge securities, or repurchase receivable).

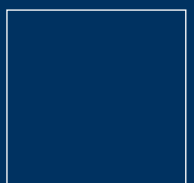
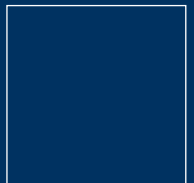
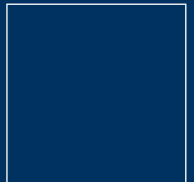
Failed derecognition – not substantially all risks and rewards of ownership retained (continuing involvement)

If the asset is not derecognised because the entity has neither transferred nor retained substantially all the risks and rewards of ownership and control has not passed to the transferee, the entity continues to recognise the asset to the extent of its continuing exposure to the asset. Consequently to that extent a liability must also be recognised. Revised IAS 39 contains detailed guidance on how to account for a range of different scenarios. Essentially, the principle is that the combined presentation of the asset and liability should result in the recognition of the entity's net exposure to the asset on the balance sheet either at fair value, if the asset was previously held at fair value, or at amortised cost, if the asset was accounted for on that basis.

The treatment of the changes in the liability should be consistent with the treatment of changes in the asset. Consequently, when the asset subject to the transfer is classified as available-for-sale, gains and losses on both the asset and the liability will be taken to equity.

Securitisation

The new derecognition model will probably have a significant impact on securitisation structures. A classic receivables securitisation programme, where a company sells its receivables to a multi-seller vehicle on a revolving basis, is likely to encounter the following difficulties in achieving derecognition.



1. Since the SPE is likely to be consolidated under SIC-12, there will be no transfer of the right to cash flows from the reporting group and therefore the transfer will have to meet the criteria for pass through cash flows set out in Test 2 of Step 4. Few securitisations are structured in such a way as to pass these tests.
2. Even if the structure does meet the transfer requirements it is unlikely that substantially all the risks and rewards have been passed to the transferee so full derecognition will not be achieved by that route.
3. Assuming that the transferor does not retain substantially all the risks (as may often be the case) the control test will always fail since the SPE will not have the ability to sell the asset.

Consequently, the entity will need to recognise the assets to the extent of its continuing involvement.

Derecognition of financial liabilities

A financial liability (trading or other) is removed from the balance sheet when it is extinguished, that is when the obligation is discharged, cancelled or expired.

The condition is met when the liability is settled by paying the creditor or when the debtor is released from primary responsibility for the liability either by process of law or by the creditor.

A payment to a third party, including a trust (sometimes called “in-substance defeasance”) does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

Management will frequently negotiate with the entity’s bankers or bond-holders to cancel existing debt and replace it with new debt on different terms. For example, an entity may decide to cancel its exposure to high-interest fixed-rate debt, pay a fee or penalty on cancellation, and replace it with variable-rate debt. IAS 39 provides guidance to distinguish between the settlement of debt that is replaced by new debt, and the restructuring of existing debt.

The distinction is based on whether or not the new debt has substantially different terms from the old debt. Terms are substantially different if the present value of the net cash flows under the new terms discounted using the original effective interest rate is at least 10% different from the present value of the remaining cash flows under the original debt. This distinction is important for gain or loss recognition. A gain or loss on settlement of a financial liability is recognised in the income statement. Any net cash flow in relation to the restructuring of financial liabilities is an adjustment to the debt’s carrying amount and is amortised over the remaining life of the liability.

Transition

For existing IFRS preparers

Points to consider:

- All derecognition requirements in revised IAS 39 are applied prospectively. Any financial asset or liability that was derecognised before 1 January 2004 under current IAS 39 requirements need not be recognised on the balance sheet.
- Any financial instrument that did not meet the derecognition requirements under current IAS 39 but meets the requirements under revised IAS 39 is derecognised.
- An entity may apply retrospectively all derecognition requirements from a date of its choosing (before 1 January 2004).

For first-time adopters

Points to consider:

- A first-time adopter will apply the derecognition requirements in revised IAS 39 prospectively from 1 January 2004. Non-derivative assets or liabilities derecognised under previous GAAP remain derecognised provided they were initially derecognised before 1 January 2004.
- Retrospective application from an earlier chosen date is allowed if the required accounting information is available.
- A first-time adopter has to recognise all derivatives and other interests (i.e. servicing rights) and consolidate all special purpose entities (SPEs) that it controls at the date of transition to IFRS.



Subsequent measurement, fair values and impairment

Overview

At a glance – the key issues

- Subsequent measurement of financial assets and liabilities depends on the classification:
 - Trading assets and liabilities and available-for-sale assets are measured at fair value.
 - Loans and receivables and held-to-maturity investments are carried at amortised cost.
- The best evidence of fair value is quoted market prices in an active market.
- If quoted market prices are not available, entities use valuation techniques incorporating observable market data.
- Cost less impairment is a last resort for investments in unlisted equity instruments.
- Objective evidence that a loss has been incurred is required before calculating an impairment loss.

Subsequent measurement – financial assets

There are four categories of financial assets as described earlier in the chapter ‘Initial recognition and classification’. This classification is important because it determines the subsequent measurement of the asset. The following table summarises the principles:

Financial assets	Measurement	Changes in carrying amount	Impairment test (if objective evidence)
Financial assets at fair value through profit or loss	Fair value	Income statement	No
Loans and receivables	Amortised cost	Income statement	Yes
Held-to-maturity investments	Amortised cost	Income statement	Yes
Available-for-sale financial assets	Fair value	Equity	Yes

Subsequent measurement – financial liabilities

There are only two categories of financial liabilities: those at fair value through profit or loss (including trading liabilities) and other. Trading liabilities (including derivatives when they have negative fair values) are measured at fair value. The changes in fair value are included in the net profit or loss for the period.

All other (non-trading) financial liabilities are carried at amortised cost.

Amortised cost and effective interest method

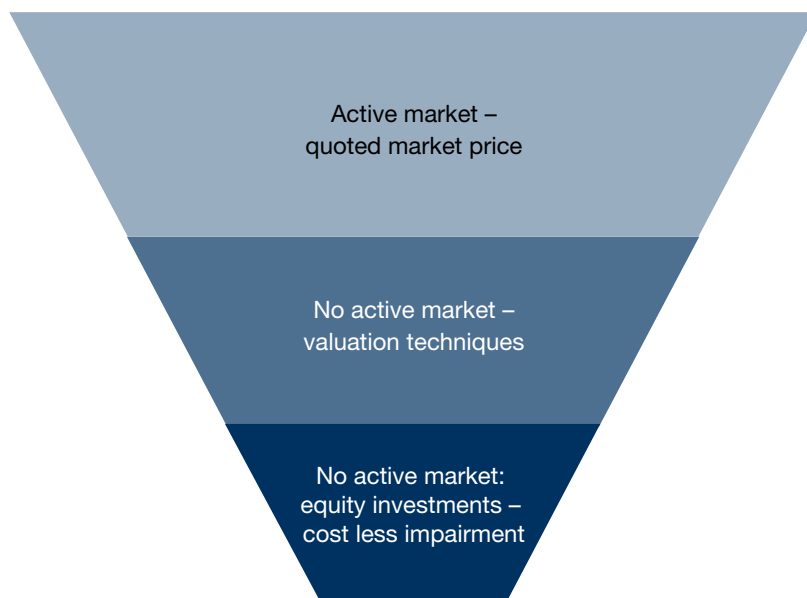
The carrying amount of a financial instrument carried at amortised cost is computed as the amount to be paid/repaid at maturity (usually the principal amount or par/face value); plus or minus any unamortised original premium or discount, net of any origination fees and transaction costs and less principal repayments.

The amortisation is calculated using the effective interest method. This method calculates the rate of interest that is necessary to discount the estimated stream of principal and interest cash flows (excluding any impact of credit losses) through the expected life of the financial instrument or, when appropriate, a shorter period to equal the amount at initial recognition. That rate is then applied to the carrying amount at each reporting date to determine the interest income (assets) or interest expense (liabilities) for the period. In this way, interest income or expense is recognised on a level yield to maturity basis.

It is important to note that in the determination of the effective interest rate, the estimation of the cash flows does not take into consideration any future credit losses anticipated on that instrument.

Fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. There is a general presumption that fair value can be reliably measured for all financial instruments. In looking for a reliable measure of fair value, revised IAS 39 provides a hierarchy to be used in determining an instrument's fair value:



Active market – quoted market price: The existence of published price quotations in an active market is the best evidence of fair value, and they must be used to measure the financial instrument. The phrase 'quoted in an active market' means that quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an

arm's length basis. The price can be taken from the most favourable market readily available to the entity even if that was not the market in which the transaction actually occurred. The quoted market price cannot be adjusted for 'blockage' or 'liquidity' factors. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market prices.

No active market – valuation techniques: If the market for a financial instrument is not active, fair value is established by using a valuation technique. Valuation techniques that are well established in financial markets include recent market transactions, reference to a transaction that is substantially the same, discounted cash flows and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price, and should be consistent with accepted economic methodologies for pricing financial instruments. Normally the amount paid or received for a financial instrument is the best estimate of fair value at inception. However, where all data inputs to a valuation model are obtained from observable market transactions, the resulting calculation of fair value can be used for initial recognition.

No active market – equity instruments: Normally it is possible to estimate the fair value of an equity instrument that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant, and no reliable estimate can be made, an entity is permitted to measure the equity instrument at cost less impairment as a last resort. A similar dispensation applies to derivative financial instruments that can only be settled by physical delivery of such unquoted equity instruments.

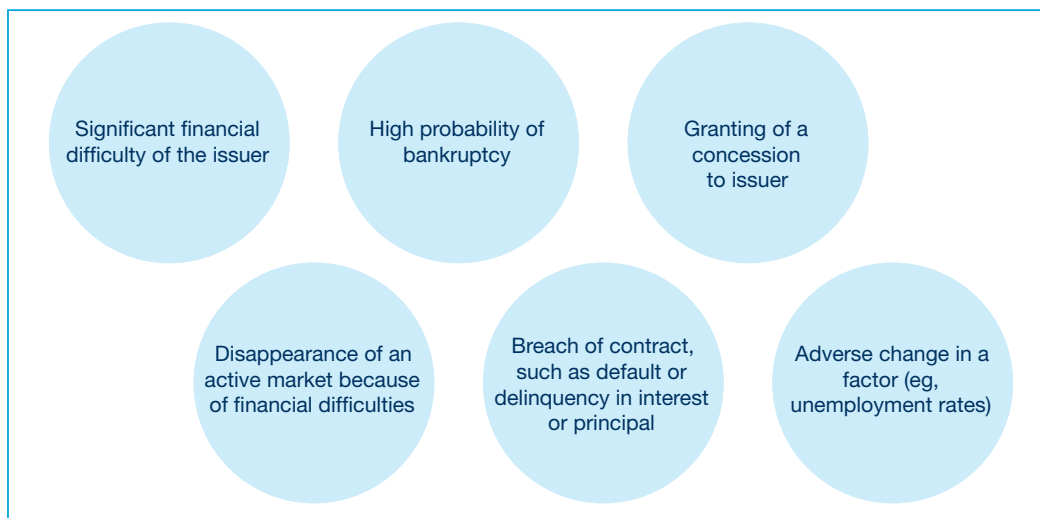
It will be clear from the above that, in some circumstances, it might be possible to recognise a gain on initial recognition of a financial instrument. However, the circumstances in which this will be permitted are very tightly controlled.

Impairment of financial assets

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of a past event that occurred subsequent to the initial recognition of the asset. Expected losses as a result of future events, no matter how likely, are not recognised.

An entity should assess at each balance sheet date whether there is objective evidence that a financial asset or group of assets may be impaired.

Examples of factors to consider are:



The disappearance of an active market or the downgrade of an entity's credit rating is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other information. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

If there is objective evidence that impairment has been incurred and the carrying amount of a financial asset carried at amortised cost exceeds its estimated recoverable amount, then the asset is impaired. The recoverable amount is the present value of the expected future cash flows discounted at the instrument's original effective interest rate. The use of this rate prevents a market value approach from being imposed for loans and receivables. The carrying amount should be reduced to its recoverable amount either directly or through the use of an allowance account. The amount of the loss is included in net profit or loss for the period.

If there is objective evidence of impairment of available-for-sale financial assets carried at fair value, the cumulative net loss (difference between amortised acquisition cost and current fair value less any impairment loss previously recognised in profit or loss) that has previously been recognised in equity is removed and recognised in the income statement, even though the asset has not been sold. Entities are prohibited from reversing impairments on investments in equity securities. However if the fair value of an available-for-sale debt instrument increases and the increase can be objectively related to an event occurring after the loss was recognised, the loss may be reversed through profit or loss.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). Those characteristics should be relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Estimates of changes in future cash flows for groups of assets should reflect and be directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, payment status, or other factors indicative of changes in the probability of losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Transition

For existing IFRS preparers

Points to consider:

- Changes in fair value of available-for-sale investments must be recognised in equity.
- A loan or other financial asset measured at amortised cost that is individually assessed for impairment and found not to be impaired has to be included in a group of similar financial assets that are assessed for impairment on a portfolio basis. In addition, there is new guidance on what constitutes objective evidence of impairment. An existing IFRS preparer may need to amend its systems for evaluating impairment of financial assets, particularly if it does this on a portfolio basis.
- Impairment losses on an equity instrument classified as available-for-sale cannot be reversed.
- Impairment losses on a debt instrument classified as available-for-sale can be reversed through profit or loss if its fair value increases and the increase can be objectively related to an event occurring after the loss was recognised.
- Under revised IAS 39 effective interest rates are calculated based on estimated cash flows. Existing IFRS preparers may have to revise previous effective rates based on the new definition.

For first-time adopters

Points to consider:

- Impairment methodology is likely to be different from that used under an entity's previous GAAP. In particular, general provisions are not permitted and all impairment of debt instruments must be measured using a discounted cash flow methodology.
- An entity's estimates of loan impairments at the date of transition to IFRSs are consistent with estimates made for the same date under previous GAAP.
- Many financial instruments will need to be fair valued, with no adjustments for blockage or liquidity provisions if they are quoted in an active market.
- The amortised cost at the date of transition will need to be calculated, using effective interest rates as set out in revised IAS 39.

Hedge accounting

Overview

At a glance – the key issues

- In order to apply hedge accounting, strict criteria, including the existence of formal documentation and the achievement of effectiveness tests, must be met.
- Hedge accounting can be applied to three types of hedging relationships: fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation.
- Hedge accounting must be discontinued prospectively if the hedging relationship comes to an end (eg, the hedging instrument is sold), one of the hedge accounting criteria is no longer met (eg, the hedge does not pass effectiveness tests) or the hedging relationship is revoked.

Criteria for hedge accounting

IAS 39 requires that hedges meet certain criteria in order to qualify for hedge accounting. These include requirements for formal designation of the hedging relationships as well as rules on hedge effectiveness.

A hedging relationship qualifies for hedge accounting if, at inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

Hedge documentation

Risk management objective and strategy

Identification of the hedging instrument

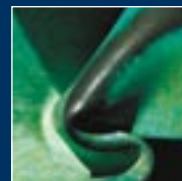
The related hedged item or transaction

The nature of the risk being hedged

How the entity will assess the hedging instrument's effectiveness

What instrument can be designated as a hedging instrument?

All derivatives that involve an external party may be designated as hedging instruments except for some written options. An external non-derivative financial asset or liability may not be designated as a hedging instrument except as a hedge of foreign currency risk.



What items or transactions can be hedged?

The fundamental principle is that the hedged item creates an exposure to risk that could affect the income statement.

The hedged item can be:

- a single asset, liability, firm commitment or forecast transaction;
- a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics;
- a non-financial asset or liability (such as inventory) for either foreign currency risk or the risk of changes in the fair value of the entire item;
- a held-to-maturity investment for either foreign currency risk or credit risk (but not interest rate risk);
- a portion of the risk or cash flows of any financial asset or liability; or
- a net investment in a foreign operation.

Hedge accounting is prohibited for hedges of net positions but it is possible to track back from the net position to a gross position and to designate a portion of the latter as the hedged item if it meets the other criteria for hedge accounting.

Categories of hedges

Hedge accounting may be applied to three types of hedging relationships: fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation.

Fair value hedges

A fair value hedge is a hedge of the exposure to changes in the fair value of a recognised asset or liability or a previously unrecognised firm commitment to buy or to sell an asset at a fixed price, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect reported profit or loss.

In a fair value hedge, the gain or loss from remeasuring the hedging instrument at fair value (derivative) or the foreign currency component of its carrying amount (non-derivative) is recognised immediately in the income statement. At the same time, the carrying amount of the hedged item is adjusted for the gain or loss attributable to the hedged risk and the change is also recognised immediately in the income statement to offset the value change on the derivative.

The IASB issued an amendment to IAS 39 in 2004, permitting fair value hedge accounting to be applied to a portfolio hedge of interest rate risk (sometimes referred to as a 'macro hedge'). Special requirements apply to this kind of hedge.

Cash flow hedges

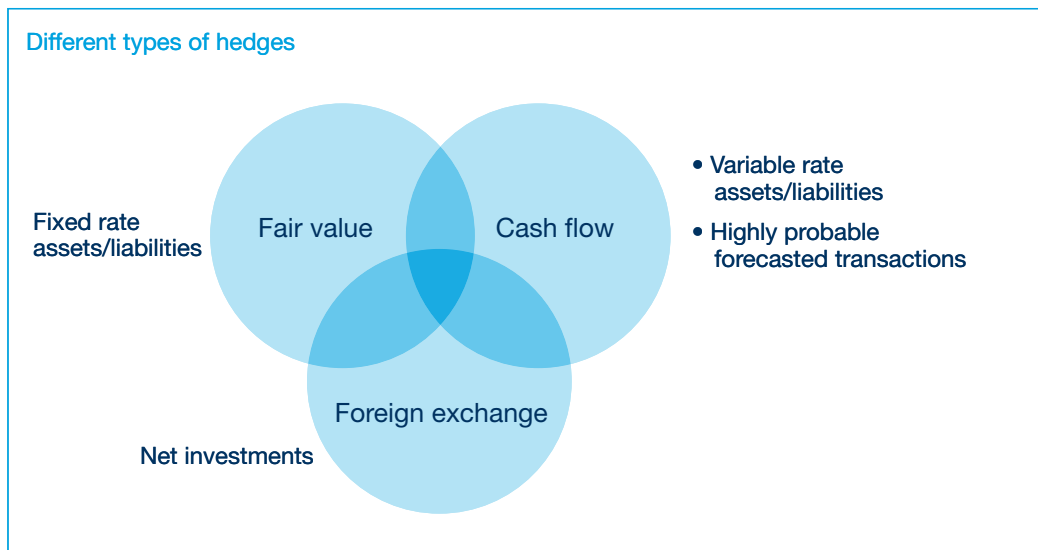
A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability or a forecast transaction and (ii) could affect reported profit or loss. Hedges of the foreign currency risk associated with firm commitments may be designated as cash flow hedges. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity.

The gain or loss deferred in equity is recycled to the income statement when the hedged cash flows affect income. If the hedged cash flows result in the recognition of a non-financial asset or liability on the balance sheet, the entity can choose to adjust the basis of the asset or liability by the amount deferred in equity. This choice has to be applied consistently to all such hedges.

However, such basis adjustment is prohibited if a financial asset or liability results from the hedged cash flows.

Hedges of a net investment in a foreign operation

Under IAS 21, the net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. If a derivative or non-derivative is designated as a hedge of that interest, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity.



Hedge effectiveness/ineffectiveness

To qualify for hedge accounting, revised IAS 39 requires the hedge to be highly effective. There are separate tests to be applied prospectively and retrospectively and these tests are mandatory:

- **Prospective effectiveness testing** has to be performed at inception of the hedge and at each subsequent reporting date during the life of the hedge. This testing consists of demonstrating that the entity expects changes in the fair value or cash flows of the hedged item to be almost fully offset (i.e. nearly 100%) by the changes in the fair value or cash flows of the hedging instrument.
- **Retrospective effectiveness testing** is performed at each reporting date throughout the life of the hedge in accordance with a methodology set out in the hedge documentation. The objective is to demonstrate that the hedging relationship has been highly effective by showing that actual results of the hedge are within the range of 80-125%.

Hedge ineffectiveness is systematically and immediately reported in the income statement.



Discontinuing hedge accounting

Hedge accounting must be discontinued prospectively if any of the following occurs:

- a hedge fails the effectiveness tests
- the hedging instrument is sold, terminated or exercised
- the hedged position is settled
- management decides to revoke the hedge relationship, or
- in a cash flow hedge, the forecast transaction that is hedged is no longer expected to take place.

When a debt instrument (a non-derivative liability) has been adjusted for changes in fair value under a hedging relationship, the adjusted carrying amount becomes amortised cost. Any 'premium' or 'discount' is then amortised through the income statement over the remaining period to maturity of the liability.

If a cash flow hedge relationship ceases, the amounts accumulated in equity will be maintained in equity until the hedged item affects profit or loss. However, if the hedge accounting ceases because the forecast transaction that was hedged is no longer expected to take place, gains and losses deferred in equity have to be recognised in the income statement immediately. Similarly, any amounts accumulated in equity while a hedge of net investment was effective remain in equity until the disposal of the related net investment.

Transition

For existing IFRS preparers

Points to consider:

- All accounting requirements should be applied retrospectively.
- For a hedge of a firm commitment, gains and losses recognised in equity before the date of transition to revised IAS 39 have to be reclassified as assets or liabilities. Cash flow hedge accounting may continue to be applied to hedges of foreign currency risk on firm commitments.
- Basis adjustments to financial assets or liabilities resulting from hedges of forecast transactions are no longer permitted and consequently the carrying amount of such instruments must be adjusted. However, an existing IFRS preparer is not permitted to adjust the carrying amount of non-financial items for gains and losses on cash flow hedges that were previously included in the carrying amount, even if it chooses not to apply basis adjustments prospectively under the revised standard.

For first-time adopters

Points to consider:

- All derivatives that are designated as hedging instruments must be measured at fair value.
- All hedge relationships that existed under previous GAAP are recognised in the opening balance sheet. If they do not meet the conditions for hedge accounting under IAS 39, the entity will apply the IAS 39 provisions to discontinue hedge accounting prospectively.
- Any hedge relationship that was not designated under previous GAAP cannot be retrospectively designated as a hedge, even if it meets all the IAS 39 criteria.

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Disclosures

For annual periods beginning before 1 January 2007, all disclosures relating to financial instruments are set out in revised IAS 32. The intention is to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows and to assist in assessing future cash flows associated with those instruments.

Transactions in financial instruments may result in the assumption or transfer of one or more financial risks. The information disclosed should help users of financial statements to assess the extent to which the entity is exposed to financial risk as a result of those transactions.

Summary of required disclosures

- **Risk management policies and hedging activities:** A description of financial risk management objectives and policies, including the policy for hedging each major type of forecast transaction for which hedge accounting is used.

For fair value, cash flow and net investment hedges:

- a description of the hedge;
- a description of the hedging instruments and their fair values at the balance sheet date; and
- the nature of the risks being hedged.

For cash flow hedges only, the periods in which the transactions are expected to occur, when they are expected to enter into the determination of profit or loss, a description of any transaction for which hedge accounting had previously been used but which is no longer expected to occur, the amount of gains/losses recognised in equity and the amount, if any, removed from equity (and reported in profit or loss) for the period.

- **Terms, conditions and accounting policies:** The extent and nature of financial instruments, including significant terms and conditions that may affect future cash flows and the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.

For financial instruments that create a potentially significant exposure to the risks, terms and conditions disclosed might include:

- the principal, stated, face, or other similar amount;
- the date of maturity, expiry, or execution;
- early settlement and conversion options, including details of their exercise;
- the amount and timing of scheduled future cash flows in respect of the instrument's principal amount;
- interest, dividends, or other periodic returns on principal and their timing
- collateral held or pledged; and
- where appropriate, the currency in which receipts or payments are denominated.

- **Interest-rate risk:** Exposure to interest-rate risk, including contractual repricing or maturity dates and effective interest rates, where applicable.

Where there are a significant number of financial instruments, the carrying amounts of financial instruments exposed to interest-rate risk may be grouped and presented according to maturity/ repricing in the following periods after balance sheet date:

- no later than 1 year;
- separately by period for each year between years 1 and 5; and
- later than 5 years.
- **Credit risk:** Exposure to credit risk, including maximum credit-risk exposure at the balance sheet date, without taking account of any collateral, and significant concentrations of credit risk.
- **Fair value:** The fair value of each class of financial assets and financial liabilities.

In the rare case where the fair value of investments in unquoted equity instruments cannot be measured reliably and they are carried at cost, a statement of that fact together with a description of the assets, their carrying amount, an explanation of why their fair value cannot be measured reliably, if possible, the range of estimates within which fair value is highly likely to lie, and any gains/losses arising on sale of such assets.

The methods and significant assumptions applied in determining fair values, and the extent to which fair values are determined by market prices/transactions or estimated using a valuation technique.

Where fair values are determined using a valuation technique:

- the extent to which fair values are based on assumptions not supported by observable market prices;
- where applicable, the sensitivity of valuation assumptions used; and
- the change in fair value recognised in profit or loss for the period.
- **Other disclosures:** Significant items of income, expense, and gains and losses resulting from financial assets and financial liabilities, whether included in profit or loss or as a separate component of equity, including:
 - for financial assets/liabilities not designated as at fair value through profit or loss, total interest income and expense;
 - for available-for-sale financial assets, gains/losses recognised in equity and amounts released from equity into profit or loss for the period; and
 - the amount of interest income accrued on impaired financial assets.

For financial assets transferred that do not qualify for derecognition or where any entity retains a continuing involvement in securitised financial assets:

- details of the assets;
- the nature of the continuing involvement;
- the extent of such transfers/transactions; and
- information about the risks retained.

Other specific disclosures:

- the reason(s) for reclassification of a financial asset as one required to be reported at cost/ amortised cost rather than at fair value;
- impairment losses for each significant class of financial asset;
- extensive disclosures in respect of any accepted and pledged collateral;
- the carrying amounts of financial assets and financial liabilities that: (1) are classified as held for trading, and (2) were designated as at fair value through profit or loss;
- for financial liabilities designated as at fair value through profit or loss: (1) the amount of change in fair value not attributable to changes in a benchmark interest rate, and (2) the difference between the carrying amount and the amount the entity would be contractually required to pay;
- the existence of multiple embedded derivative features whose values are interdependent in a compound instrument together with the effective yield on the liability component; and
- defaults of principal/interest in respect of loans payable and any other breaches of loan agreements that permit the lender to demand repayment.



For annual period beginning on or after 1 January 2007, all disclosures relating to financial instruments are set out in IFRS 7. The intention of this standard is to require entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date and how the entity manages those risks. This standard incorporates many of the disclosure requirements previously set out in IAS 32; we have therefore set out below a summary of additional disclosures required by IFRS 7.

Summary of additional disclosures required by IFRS 7

The changes brought by IFRS 7 can be split into four key areas:

- disclosing risk 'through the eyes of management';
- expanded quantitative disclosures of risk;
- the introduction of sensitivity analysis; and
- enhanced disclosure of an entity's financial position and performance.

The new disclosure requirements should be applied for annual periods beginning on or after 1 January 2007; earlier application is encouraged. They apply to all entities. However, the extent of disclosure required will reflect the entity's use of financial instruments. Entities that make more use of financial instruments and have greater associated exposure to risk will need to give more disclosures.

Disclosing risk 'through eyes of management': IFRS 7 requires quantitative and qualitative disclosures about an entity's exposure to credit risk, liquidity risk and market risk arising from its use of financial instruments. It requires the following qualitative disclosures for each type of risk:

- the exposures to the risk and how they arise;
- the entity's objectives, policies and processes for managing the risk;
- the methods used to measure the risk; and
- any changes to the above disclosures from the previous reporting period.

The standard also requires summary quantitative data about the entity's exposure to each type of risk at the reporting date. This information is to be given 'through the eyes of management' – ie, based on internal reports provided to management. Certain minimum disclosures are also required to the extent they are not already covered by the 'through the eyes of management' information.

Expanded quantitative disclosures of risks: The quantitative minimum disclosures of interest rate risk and credit risk have been expanded. In particular:

- the quantitative disclosures for credit risk include the amount of exposure to credit risk at the reporting date by each class of financial instrument (trade debtors are captured by this requirement); and
- on liquidity risk, disclosure of financial liabilities categorised by their earliest contractual maturity date, and a description of how the entity manages the liquidity risk inherent in these financial liabilities is required. For example, an entity that uses a stand-by line of credit to manage their liquidity risk should disclose this fact.

Introduction of sensitivity analysis: Another new requirement is a sensitivity analysis for each component of market risk to which an entity is exposed (currency risk, interest rate risk and other price risk). Every entity should disclose the impact of reasonably possible movements in each relevant market risk variable on profit and loss and equity. The format and presentation of this

disclosure is not prescribed in IFRS 7. The application and implementation guidance, however, offer advice on preparing the analysis. The application and implementation guidance also include an example illustrating that the analysis can be simple; they show, for example, the effect on post-tax profit of a 10 basis-points increase in interest rates and a 10% weakening of a key exchange rate.

Enhanced disclosure of financial position and performance: IFRS 7 requires enhanced balance sheet and income statement disclosures. Below are just three examples:

- disclosure of the carrying amount and net gains/net losses for each of the categories of financial instruments in IAS 39 (ie, held-for-trading, available-for sale, etc);
- disclosures when hedge accounting is used. These include the ineffectiveness recognised in profit or loss for each type of hedge (fair value hedges, cash flow hedges and hedges of net investments in foreign operations); and
- disclosure of movements on the allowance account, if an entity uses such an account to record credit losses.



Glossary

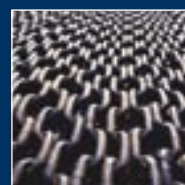
Amortised cost	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
Available-for-sale financial assets	Those financial assets that are designated as available-for-sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.
Cash flow hedge	A hedge of the exposure to variability in cash flows that: (i) is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and (ii) could affect profit or loss.
Derecognition	Removal of a previously recognised financial asset or financial liability from an entity's balance sheet.
Derivative	A financial instrument with all three of the following characteristics: <ul style="list-style-type: none"> (a) its value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the 'underlying'); (b) it requires 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 (c) it is settled at a future date.
Effective interest method	A method of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or interest expense over the relevant period.
Effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Embedded derivative	A component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that the contract would otherwise require to be modified based on a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. 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.
Equity	Any contract that evidences a residual interest in the assets an entity after deducting all of its liabilities.
Fair value	The amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction. In an active market, for assets it is the market bid price and for liabilities it is the market offer price.
Fair value hedge	A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.
Financial instrument	Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
Financial asset	Any asset that is: <ul style="list-style-type: none"> (a) cash; (b) an equity instrument of another entity; (c) a contractual right: <ul style="list-style-type: none"> (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: <ul style="list-style-type: none"> (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.



<p>Financial asset or financial liability at fair value through profit or loss</p>	<p>A financial asset or financial liability that meets either of the following conditions:</p> <ul style="list-style-type: none"> (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is: <ul style="list-style-type: none"> (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when doing so results in more relevant information, because either: <ul style="list-style-type: none"> (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IAS 24, Related Party Disclosures (as revised in 2003)), for example the entity’s board of directors and chief executive officer. <p>An entity may also designate an entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss if the contract contains one or more embedded derivatives, unless:</p> <ul style="list-style-type: none"> (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered, that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.
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Financial liability	<p>Any liability that is:</p> <p>(a) a contractual obligation:</p> <ul style="list-style-type: none"> (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or <p>(b) a contract that will or may be settled in the entity's own equity instruments and is:</p> <ul style="list-style-type: none"> (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
Financial guarantee	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
Firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or date.
Forecast transaction	An uncommitted but anticipated future transaction.
Hedge effectiveness	The degree to which offsetting changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
Hedged item	An asset, liability, firm commitment, highly probable forecast future transaction, or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.
Hedging instrument	A designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. A non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.
Held-to-maturity investments	A financial asset with fixed or determinable payments and fixed maturity that an entity has the positive intent and ability to hold to maturity, other than those that the entity on initial recognition elects to designate as held for trading or available for sale, or that meet the definition of loans and receivables.



<p>Loans and receivables</p>	<p>Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:</p> <ul style="list-style-type: none"> (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available-for-sale. <p>An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.</p>
<p>Net investment in a foreign operation</p>	<p>The amount of the reporting entity's interest in the net assets of that operation.</p>
<p>Regular way purchase or sale</p>	<p>A contract for the purchase or sale of a financial asset that requires delivery of the asset within the time frame generally established by regulation or convention in the marketplace concerned.</p>
<p>Tainting</p>	<p>Where an entity sells or transfers more than an 'insignificant amount' of its held-to-maturity investments it must reclassify all of them as available-for-sale. It is then prohibited from classifying any assets as held-to-maturity for the next two full annual financial periods, until confidence in its intentions is restored.</p>
<p>Trading financial assets and liabilities</p>	<p>A financial asset or financial liability is classified as held for trading if it is:</p> <ul style="list-style-type: none"> (a) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) a derivative (except for a derivative that is a designated and effective hedging instrument).
<p>Transaction costs</p>	<p>Incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. Transaction costs include fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.</p>

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